JG FINANCIAL TRAINING

JG Financial Training Ltd
329 The Whitehouse
9 Belvedere Road
London SE1 8YS
United Kingdom
Tel: +44 2077 712681
Mob: +44 7789 746338

Losing Connaught and Rok looks like Carelessness!

If Lady Bracknell were a UK fund manager in 2010 she might well have remarked "To lose one company in such a promising sector may be regarded as a misfortunate; to lose two looks like carelessness!"

Connaught plc and Rok Group plc provided Social Housing Repairs and Maintenance, a sector that enjoys high levels of essential and non-discretionary expenditure. It is low risk, highly fragmented and increasingly consolidating as public and private sector organizations come under growing pressure to reduce cost and improve service. In recent years, both companies had expanded throughout the UK through a combination of organic growth and bolt-on acquisitions and had positioned themselves to capitalize on the increasing trend towards outsourcing of services by Local Authorities and Social Landlords.

It therefore came as a shock to investors when both Connaught and Rok announced profit warnings, breached banking covenants and collapsed into administration within three months of each other in the second half of 2010.

By contrast, Mears Group plc, a rival in the sector, continues to trade as a going concern and reassured investors that it has been unaffected by cutbacks in public sector spending and can see no adverse changes to market conditions.

The collapse of Connaught and Rok therefore does seem rather like carelessness, and in this article we investigate the causes that may have contributed to their downfall. What lead Connaught and Rok to be so highly leveraged? Could investors have seen it coming? And what lessons can non-executive directors, auditors, investors and financiers learn from these situations in order to become smarter and wiser in the future?

Operating Profiles
Inevitably Connaught and Rok had different operating profiles and we should first consider their differing size and scope.

Connaught was the leading provider of integrated services in the UK and operated primarily in the social housing and compliance markets with a relatively simple group structure. Its Social Housing division provided Local Authorities and Social Landlords with a range of planned and response maintenance services, whilst its Compliance division provided safety, health and risk management solutions to SMEs and multi-site businesses.

In contrast, **Rok Group** aimed to be 'The Nation's Local Builder', and served a more diverse range of customers. Services ranged from emergency repairs to new construction projects and consequently the group was severely affected by the downturn in the construction industry in 2008 and 2009. Rok responded by restructuring and downsizing the regional construction business and by the start of 2010 it had reconfigured itself into three operating divisions focused on Maintenance and Improvements, Construction and Social Housing, with the latter dedicated to providing the services offered by the other two divisions to Local Authorities and Social Landlords.

In order to provide a comparative benchmark, we also examined **Mears Group plc** which still trades as a going concern in the sector. Mears' main division, 'Social Housing', provides rapid response and planned maintenance services to Local Authorities and Social Landlords, whilst its other division, 'Domiciliary Care', provides personal care to elderly people in their own homes. There is a degree of customer overlap between these divisions and in such cases the group seeks to deliver more value through a combined 'Care and Repair' solution.

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Relative Size and Operating Profit Margins

			Operating Profit Margins[2]			
	LTM Social Housing revenue (£'m) [1]	Social Housing % of total revenues [1]	2010 – H1[2]	2009 – H2	2009 – H1	2008
Connaught	556.6	72%	5.8%	6.2%	5.6%	5.7%
Rok Group	190.4	27%	4.3%	3.9%	5.1%	n/a
Mears Group	363.9	73%	5.4%	7.2%	4.7%	6.1%

(1): Social Housing revenues and % of total revenues based on the segmental reporting from each group's 2010 interim results.
(2): Year end and Interim dates are as follows: Connaught – August and February; Mears and Rok both December and June. Adjusted operating profit margins taken from segmental disclosures.

Social Housing was the dominant division within Connaught, accounting for over 70% of group revenue, but it was a much smaller component within Rok's portfolio, accounting for just 27%. Both companies generated profit margins in excess of 5% in H1'09, however, Rok's margins declined in the twelve months that followed and was at least 1% below Connaught at its 2010 interims. Finally, it is notable that Connaught exhibited the least volatility in its margins, which may have been due to the smoothing effect of its accounting policy for mobilization costs to be discussed later.

Leverage and M&A Activity

The significant amounts of goodwill on both Connaught's and Rok's balance sheets gives a clear indication how both of them became so leveraged.

2009 Year-ends	Connaught	Rok	Mears
Goodwill and Acquisition Intangibles	199.8	146.4	67.9
Other assets and liabilities	42.4	16.5	7.0
Working Capital [1]	14.3	(10.5)	24.5
Net (Debt)/Cash	(89.0)	(46.7)	6.5
Shareholders Funds	167.5	105.7	105.9
Net Tangible Assets [2]	(32.3)	(40.7)	38.0

(1): Working capital equals inventory plus trade and other receivables <1yr, less trade and other payables < 1yr
(2): Net Tangible Assets equals shareholders funds less goodwill and acquisition intangibles

Both groups expanded their UK coverage through a succession of bolt-on acquisitions, funded through a mixture of debt and equity finance. The target businesses typically contained few tangible assets and therefore the purchase price was made up almost entirely of goodwill.

Connaught stated in its 2009 accounts that "we acquire earnings enhancing, complementary businesses that allow us to further develop our strategic capability, extend our presence in our current markets, or gain a foothold in new adjacent areas". The group's focus on earnings enhancement was consistent with annual incentive targets for its executive directors and therefore naturally encouraged them to be acquisitive. Around £175m of acquisitions were completed between 2006 and 2009, funded with varying mixtures of debt and equity, and the high volume of deals put pressure on existing financial reporting systems which failed to keep pace with the growth.

During 2006 and 2007, Rok acquired a number of businesses involved in plumbing, heating and electrical services (PHE) to gain comprehensive UK coverage. Like Connaught, the group readily resorted to debt finance, and made two further acquisitions in 2008 for around £30m which were almost entirely settled in cash.

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Cash Generation

The string of acquisitions made by Connaught and Rok should have lead to significant increases in operating cash flow, but instead gave rise to a steady stream of exceptional transaction and integration costs. The movement in net debt for each company during 2009 illustrates just how little operating cash flow was being generated relative to the level of outstanding net debt as follows:

	Connaught	Rok	Mears
Net Debt b/fwd (2008)	(70.9)	(43.7)	6.6
Operating Cash Flow (OCF)	13.7	5.6	25.4
Interest and Tax	(15.4)	(0.9)	(6.0)
Net Capex	(10.0)	(2.2)	(4.4)
Impact of Acquisitions and Exceptionals	(15.5)	(8.5)	(11.1)
Dividend	(3.5)	(3.5)	(3.7)
Other [1]	12.6	6.5	(0.3)
Net Debt c/fwd (2009)	(89.0)	(46.7)	6.5
Net Debt b/fwd / OCF	5.2x	7.8x	n/a

(1) Other includes equity issuance/buybacks and proceeds on sale of discontinued operations

Despite being the smallest company, Mears generated the highest operating cash flow in 2009 and was able to maintain its net cash position during the period. By contrast Connaught's and Rok's opening indebtedness amounted to 5.2x and 7.8x their operating cash flows respectively, and despite the poor cash generation both companies continued to declare and pay dividends right up to their collapse.

Having considered the reasons how Connaught and Rok became so leveraged, we now examine those factors which should have served as warning signs to investors.

Governance Profile

Corporate collapses are often linked to weaknesses in corporate governance and Connaught certainly appears to fit this trend. The group failed to fully comply with the Combined Code on Corporate Governance (June 2008) through having an Executive Chairman (Mike Tincknell) and a non-executive director (Tim Ross) who had served beyond the recommended term of 9 years. These compliance issues would have been mitigated if there were at least four or five NEDs, however, the board only had the bare minimum of three. Furthermore one of the NEDs (Caroline Price) had spent 10yrs in their earlier career working for PwC, Connaught's auditors, and was prevented from holding shares in the Group due to their "spouse's professional independence rule". It was not disclosed whether the spouse currently worked for PwC but this certainly raises concerns over conflicts of loyalty.

Rok, however, disproves any direct link between corporate collapse and weak governance, since the group fully complied with the Combined Code. In contrast to Connaught, it had an independent Chairman and three other NEDs with no extended length of service.

Incentive Awards

After Governance structures, we also compared remuneration and incentives across the three companies, which revealed some surprising differences.

Connaught's annual incentive awards were based entirely on driving financial performance across the business, with adjusted EPS as the Key Performance Indicator. Given this target, the directors would surely have been tempted to pursue as many bolt-on acquisitions as possible, irrespective of strategic rationale, since:

- Acquisition and integration costs as well as amortization of acquisition intangibles were excluded from the adjusted earnings per share calculation; and
- Provided the earnings multiples of the targets were less than the PE multiple of incremental debt and equity, the deals would provide immediate earnings accretion

Connaught's Remuneration Committee reassessed the incentive scheme at the end of 2009 and included additional financial and strategic targets for 2010, namely "order book growth, customer loyalty, employee engagement, cash conversion and management team performance". Although some of these targets are clearly more subjective and difficult to measure, they are far more appropriate to ensure executives do not entirely focus on accounting profit.

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Rok's annual incentives were more balanced, with two-thirds based on financial targets (profit and cash performance) and one-third on non-financial strategic objectives. In addition, a quarter of any award was in deferred shares that vested after two years, to ensure long-term retention and alignment with shareholders' interests.

Of the three, however, Mears appears to have the most diverse range of performance measures. Annual incentives were determined based on a variety of factors including strategic, operating, financial and individual targets and intended to reward "on-going stewardship of the Group and contribution to core values". As a result, despite 15% eps growth in 2009, Mears only awarded a bonus to its Executive Chairman, whilst all the Connaught directors received a 80% bonus for delivering 34% 'acquisition fuelled' eps growth.

Internal Controls and IT Systems

For Connaught and Rok, the internal controls and IT systems were meant to ensure that the valuation of work in progress and amounts recoverable on contracts was robust and not reliant on significant estimates and judgments. Maintaining reliable controls and efficient systems would inevitably be challenging, given the volume of acquisitions and integration involved in building their UK coverage, and this proved to be a serious failing for both companies.

At Connaught, it was clear by the end of 2009 that the IT system and organizational structure were no longer fit for purpose. The group revealed that it was developing a new core financial system costing £8-10m which would roll out over the following 24-month period, and in its interim management statement announced a £6.8m 'exceptional' reorganization charge to "seamlessly deliver multi service, multi division contracts".

Rok restructured itself in 2009 and presented new segmental disclosures in which Response Maintenance, Improvements & Refurbishments and Plumbing, Heating and Electrical (PHE) services were all bundled together into a new Maintenance and Improvements division. It was this division, rather than Social Housing or Construction, which proved to be the group's Achilles heel, and it incurred £6.8m of restructuring charges during the first half of 2010 in attempting to streamline the fixed cost base at PHE.

It is always reassuring to shareholders if a group has an internal audit function, however, this can never guarantee the integrity of internal controls. Rok, for example, had an internal audit function known as 'Rok Assurance', but this did not prevent serious failures in financial controls and the recognition of loss-making contracts within the PHE unit, which were uncovered following an independent review by BDO.

Connaught's board of directors confidently stated in their 2009 accounts that "due to the size of the Group and the effectiveness of existing control and review procedures, a separate internal audit function is not required." The group instead placed reliance on a whistle blowing policy operated by a third party service provider. Staff were able to report concerns regarding potential malpractice within the organization and complaints were directed to the relevant management team or Group Company Secretary if appropriate. As the business began to unravel in 2010, however, the Board finally saw sense and revealed in their interims that they were introducing an independent internal audit function in the second half of the year. Regrettably it came far too late.

Accounting Policies: Revenue Recognition and Mobilisation Costs

Some of the most alarming issues which emerged from the profit warnings and subsequent collapses were surrounding the accounting for revenue recognition and the capitalization of costs associated with a new contract, known as 'mobilisation costs'.

Connaught and Rok generated the majority of their revenues through long-term contracts, which requires judgment over when revenues, expenses and profitability should be recognized over the life of each contract. Both companies applied the principles of IAS 18 'Revenue Recognition' which essentially states that where the outcome of a long-term contract can be measured reliably, revenue and costs are recognized by reference to the stage of completion of the contract activity at the balance sheet date. Due to weaknesses in IT systems and financial controls, however, both companies failed to reliably measure the outcomes of dozens of contracts, leading to profit warnings and their ultimate collapse.

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Unlike IAS 18 'Revenue Recognition' there is no explicit standard on mobilisation costs, which led to a divergence in accounting treatment between companies in the sector. Connaught and Rok capitalized their mobilisation costs as an asset and amortised them over the life of the contract, whereas Mears Group prudently expenses them immediately.

Connaught's accounting policy stated that "pre-contract costs are expensed as incurred, except where there is a reasonable certainty that the contract will be awarded, in which case they are recognized as an asset which is amortised to the income statement over the period in which they are reimbursed".

Similarly, Rok, which referred to such costs as 'Pre-agreement costs', stated that "When it is probable that a contract will be awarded and the agreement is expected to generate sufficient net cash inflows to enable recovery, costs incurred in the period associated with the award of the agreement are deferred and recognized over the life of the agreement. All pre-agreement costs are expensed as incurred up to the point where the contract award is considered probable."

By contrast, Mears' accounting policy states, "All costs relating to tender, contract set-up and the initial inefficiencies during the period of contract mobilization are written off as they are incurred."

Unfortunately, mobilization and pre-agreement costs were not explicitly presented in Connaught's and Rok's accounts and so it was difficult to identify how much cost had been capitalized and the year on year change. The accounts simply disclosed:

- Trade receivables, which are amounts that had been invoiced but not yet settled; and
- Amounts recoverable on contracts, which are both amounts that had been recognized as revenue but not yet invoiced (i.e. not necessarily agreed by the client), and amounts that had been incurred as mobilization costs but not yet expensed to the income statement

'Amounts recoverable on contracts' is clearly more subjective and the amounts disclosed in Connaught's 2009 accounts were particularly alarming.

Connaught 2009 extract (1)	2008	2009	% Change
Trade Receivables	39.7	49.8	31%
AROC < 1yr	68.6	91.2	33%
AROC > 1yr	12.6	27.8	121%
Total	120.9	168.8	40%

(1) Source: Connaught Group plc 2009 annual report and accounts

After reading the disclosure note, it becomes clear that the £27.8m of amounts recoverable on contracts due after more than one year were the mobilization costs and their 121% year on year increase was vastly disproportional to the increase in level of trading activity. By adopting this accounting policy, Connaught effectively increased its net asset position by £27.8m (excluding tax effects) and its 2009 operating profit by £15.2m. Had the group followed the more prudent policy of expensing the mobilisation costs, its 2009 operating profits and eps would have actually been lower than in the prior year.

Two other concerns should also be highlighted. Firstly, the fact that AROC < 1yr is substantially higher than trade receivables suggests poor working capital management and significant time delays between work done and invoicing clients. Secondly, the fact that trade receivables and AROC < 1yr increased by over 30% raises questions over whether the group was also less prudent in its approach towards revenue recognition during the year.

Once again Mears' disclosures provide a useful comparable benchmark to Connaught. In their case, the majority of amounts due had been invoiced and recognized within trade receivables and there were no AROC > 1yr:

Mears: 2009 extract	2008	2009	% Change
Trade receivables	47.8	48.2	1%
AROC < 1yr	24.2	30.7	27%
AROC > 1yr	Nil	Nil	n/a
Total	72.0	79.9	11%

Given Rok's more diverse operating profile it is difficult to draw any comparisons with its trade and other receivables. Although they capitalized mobilization costs, this did not appear to have been material as it was not recognized

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separately as AROC > 1yr. Like Connaught, however, the group had significantly more AROC in proportion to trade receivables, which indicated their poor working capital management.

Although the overall amount due declined by 9% during the period, this was far less than the almost 30% decline in group revenues due to the shrinkage of the construction business and therefore this should also have raised questions over revenue recognition.

Rok: 2009 extract	2008	2009	% Change
Trade receivables	66.9	62.3	-7%
AROC < 1yr	75.9	74.4	-2%
Retentions (<1yr)	36.9	27.1	-27%
Total	179.7	163.8	-9%

Working Capital
Having looked at revenue recognition and trade receivables, the overall working capital position is also revealing.

2009 Results	Connaught	Rok	Mears
Group Revenue	659.6	714.8	470.1
Inventory	7.5	8.2	17.3
Trade and Other Rec'bles < 1yr	154.8	182.9	82.9
Debtor Days (1)	86 days	91 days	70 days
Trade and Other Payables < 1yr	(148.0)	(201.6)	(75.8)
Available cash and headroom	£110m	£40m	£80m
Net Working Capital	14.3	(10.5)	24.5
Working Capital Ratio (2)	1.1x	0.9x	1.3x
Days purchases outstanding – 09	54	44	49
Days purchases outstanding – 08	49	37	49

(1) Debtor Days estimated based on average of opening and closing trade and other receivables over the final six month period of the year and revenue recognized during that period
(2) Working Capital Ratio calculated as (inventory + trade and other receivables < 1yr) divided by trade and other payables.

Although Connaught's revenues were around 40% greater than Mears, the absolute level of its trade receivables and payables were nearly double. This clearly indicates the group's poor operating procedures for invoice processing, and it compensated for this by placing heavy reliance on its trade payables for interest free credit. Rok was the most extreme case and only had £40m of available cash and headroom in the event that trade creditors tightened their terms. Judging by the increase in days purchases outstanding for both companies during the period, creditors must have been growing increasingly frustrated at the delays in invoice settlement.

One final point should also be highlighted in relation to Rok's unfortunate business mix. Its construction division was cash generative (i.e. working capital negative) whilst its maintenance and improvements division was cash consumptive (i.e. working capital positive). Consequently, the scaling back on construction operations in 2009 increased the group's working capital by around £25m and placed further pressure on the group's bank facilities and liquidity position.

Having compared the operating, financial and accounting differences between the three companies, several company specific events and disclosures should also be highlighted.

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Connaught's Disclosures and Events

Mis-statement of Cash Conversion Ratio and Analysis of Movement in Net Debt
One of Connaught's key performance indicators was the operating cash conversion ratio, which indicated the group's ability to turn operating profits into cash. In its 2009 results presentations, the ratio was frequently highlighted together with the underlying numerator and denominator in the equation as follows:

- Operating Profit, before exceptionals and amortisation of acquisition intangibles (EBITA)
- Cash Flow from Operating Activities, before exceptionals, finance costs and taxes (CFO)

It is noticeable, however, that the ratios disclosed in results presentations did not actually reconcile with numbers subsequently disclosed in the interim and annual cash flow statements as follows:

	H1 2010	2009	H1 2009	2008
EBITA	23.8	48.4	20.2	35.9
CFO (1)	6.4	13.7	(1.5)	25.7
CFO from results presentations (2)	8.5	31.3	2.6	26.5
Cash Conversion Ratios				
Audited measure (3)	26.9%	28.3%	(7.4)%	71.6%
Audited measure (LTM)	42%			
Results measure (4)	35.7%	64.7%	12.9%	73.8%
Results measure (LTM)	72%			

(1): Sourced from Connaught's interim and annual reports
(2): Sourced from Connaught's investor presentations
(3): CFO/EBITA
(4): CFO from results presentations / EBITA

Whilst the differences between the audited CFO and the results CFO for the interim results are minor and may have been due to genuine reclassification differences, there is clearly a material difference of £17.6m in the 2009 annual results. Consequently, whilst Connaught claimed that its cash conversion ratio was 65% in 2009 and that its rolling 12m cash conversion at its 2010 interims was 72%, the audited numbers indicated they were actually only 28% and 42% respectively.

Similarly, the group provided a reconciliation of net debt in its 2009 annual results presentations, which also materially mis-stated the operating cash flow as follows:

	Analyst Presentation	Audited Accounts	Difference
Net Debt b/fwd	(70.9)	(70.9)	-
Operating Cash Flow (as above)	31.3	13.7	(17.6)
Interest and Tax	(15.4)	(15.4)	
Net Capex	(10.0)	(10.0)	
Impact of Acquisitions and Exceptionals	(32.4)	(15.5)	16.9
Dividend	(3.5)	(3.5)	
Changes in source of finance and other	12.0	12.6	0.6
Net Debt c/fwd	(88.9)	(89.0)	(0.1)

Connaught appears to have reclassified around £17m of cash flows between operating activities and the impact of acquisition and exceptionals, which gave a misleading impression to investors of its ability to service its net debt.

Actions of Executive Directors
Shortly after releasing the 2009 results, Mark Davies (CEO) and Stephen Hill (FD) exercised their entire holdings of ESOS options, amounting to 2.5m and 1m shares respectively, and realized substantial proceeds. A few months later in January 2011, Mark Davies resigned as CEO and since there was no immediate successor Mark Tincknell took over as CEO and Tim Ross became Non-executive Chairman on a temporary basis.

'One-off' Restructuring Costs and IT upgrade
The Interim Management Statement released on 15 December 2009 was full of optimism and promise but also disclosed a physical reorganization of the Group's operations was underway to align "infrastructure, systems, property

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and customer service". Another 'exceptional' one-off cost of £6.8 million was forecast for the year in order to "seamlessly deliver multi service, multi division contracts efficiently". Together with the £8-10m IT upgrade which had been announced a few months earlier, this reorganization highlighted again how existing structures were not fit for purpose and required a radical overhaul.

Rok's Disclosures and Events

Key Performance Indicators and Going Concern Statement in the 2009 Accounts
The precarious state of Rok's finances and its inability to generate sufficient cash flow to service its financial obligations were already evident in its 2009 accounts. Its Key Performance Indicator disclosures clearly showed it was not converting profits into cash and its operating margins were significantly below target.

2009 accounts (1)	Profit turned to Cash (2)	Operating Profit Margin (3)
Target	100%	5%
2007	109%	3.6%
2008	20% (4)	2.1%
2009	40% (4)	3.2%

(1) Sourced from page 9 of the Rok's 2009 annual report and accounts
(2) Profit turned to Cash measured by dividing cash generated from operations before defined benefit pension contributions and exceptionals by adjusted operating profit
(3) Operating Profit Margin measured by dividing continuing adjusted operating profit by group revenues. Operating profit adjusted for intangible asset charges and exceptional items
(4) Profit turned to cash reflects the working capital impact of the scaling back of Rok's construction capacity.
(5) Sourced from page 59 of Rok's 2009 annual report and accounts

The most alarming disclosure of all, however, was the directors' statement regarding Going Concern, which included the following sentences (5):

"The current economic conditions create uncertainty particularly over the level of demand for the Company's products and over the cost of the Company's raw materials, and the change in the Company's business mix means that cash inflows lag outflows to a greater extent than in earlier years. The Company's forecasts and projections, taking account of the above and of reasonably possible changes in trading performance, show that the Company should be able to operate within the level of these facilities, including meeting quarterly covenant tests. Based on the Company's forecasts the minimum anticipated headroom on the banking facilities, which occurs for a short period, is £5m".

Despite such uncertainty, however, the directors still proposed a final dividend amounting to £3m.

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Conclusions: Lessons Learned

Having considered all of the above, I believe there are ten important lessons we can all learn from this carelessness:

M&A: A high volume of bolt-on acquisitions increases financial and operating risks, if funding and integration are not managed effectively. They must generate incremental cash flow and not just incremental earnings

Corporate Governance: Non-executive directors should outnumber the executive directors, especially if there is an executive chairman. Their independent judgment may become impaired if they serve beyond the recommended nine year maximum or have any historic or current relationship with the audit firm.

Incentives: Annual incentives based purely on financial performance and 'adjusted' eps can lead to excessive deal-making and leverage. Instead, they should be wider in scope and include operating, financial and cash flow targets.

Internal Controls and IT: Strong internal controls and efficient IT systems are essential to ensure accurate management information and must keep pace with corporate growth. Mention of 'IT upgrades' and 'the introduction of new systems' indicate the existing systems are not fit for purpose.

Accounting Policies: Aggressive accounting policies such as the capitalization of mobilization costs reflect management's attitude towards financial reporting and earnings management. Prudence should always be preferred.

Trade and Other Receivables: Amounts recoverable on contracts in excess of trade receivables suggests inefficiencies and delays in client invoicing.

Working Capital: Always examine the gross as well as the net working capital position and compare the outstanding trade payables against available headroom and cash to assess liquidity risk. If suppliers loose confidence, the company may face a liquidity crisis and breach financial covenants.

Ratios in Results Presentations: Be skeptical of ratios in results presentations, such as cash conversion, and double-check them against the audited accounts.

Dividends: A dividend payout does not necessarily indicate availability of free cash flow but may simply provide false assurance.

Management Optimism: CEO's are eternal optimists but sometimes blinded by financial reality. Don't trust statements such as 'once in a lifetime opportunities' and 'the outlook remains positive' until you have understood the company's liquidity and solvency risks and are confident that it can continue as a going concern.

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Appendix 1: Connaught's Sequence of Events prior to Collapse

Interim Management Statement at the AGM highlights more 'One-off' Restructuring Costs: 15 December 2009
The Interim Management Statement was full of optimism and promise but also disclosed a physical reorganization of the Group's operations was underway to align "infrastructure, systems, property and customer service". Another 'exceptional' one-off cost of £6.8 million was forecast for the year in order to "seamlessly deliver multi service, multi division contracts efficiently". Together with the £8-10m IT upgrade, this reorganization highlighted again how existing structures were not fit for purpose and required a radical overhaul.

Resignation of the CEO: 29 January 2009
Connaught surprised investors by announcing the resignation of Mark Davies as CEO. This had not been mentioned in the Interim Management Statement and since there was no immediate successor Mark Tincknell took over as CEO and Tim Ross assumed the role of Non-executive Chairman on a temporary basis. Despite the reshuffle, the group reassured investors that 'trading remained in line with management expectations'.

Interim Results: 27 April 2010
Directors report "strong trading performance across all sectors of the business" and refer to the favourable market trends within Social Housing as a 'once in a lifetime opportunity'. The dividend was increased by 20% to reflect confidence in the trading outlook.
However:
- New Chairman had still not been appointed
- The group incurred £5.7m exceptional costs, comprising £2.6m of acquisition fees and integration costs and £3.2m of re-organisation costs which had already been disclosed in the Interim Management Statement
- £4.2m of development costs had been incurred on the new financial system, MS Dynamics, as part of the £8-10m upgrade
- An additional net £3.3m of mobilization costs had been deferred during the period

Appointment of Sir Roy Gardner as new Chairman: 10 May 2010
- Sir Roy Gardner's appointment and purchase of £500k of Connaught shares reassured investors

Profit Warning: 25 June 2010
Connaught warned revenue and operating profit would be £80m and £13m below forecast, due to issues concerning revenue recognition and mobilization costs on 31 contracts within its Social Housing division. Furthermore, revenue and operating profit forecasts would also be lower in 2012 by £120m and £16m respectively.

Interim Management Statement: 8 July 2010
- Tincknell stepped down immediately on health grounds and would assist in the search for a new CEO
- Hill announced he would step down as FD at the end of October
- Chairman initiated an independent review by Deloitte of the accounting policy for mobilisation costs to ensure that, in light of "the more contractual and tightened economic environment" this policy remained appropriate in its current form
- Another acquisition completed in May 2010 for £5.5m
- Ongoing restructuring expected to yield £25m in cost savings in 2012
- Covenant ratios are disclosed, and based on current expectations the Board "fully expect to be able to operate within existing covenant levels."
- Sir Roy commented that "The outlook remains positive"

Breach of Covenants and New Management Team: 26 July 2010
- Working capital issues and pressure from suppliers and subcontractors lead to revised net debt forecast above £120m and breach of covenants
- Discussions with lenders have been 'constructive'
- New management team of four drafted in by Sir Roy to provide immediate executive assistance
- Ongoing review of forecast trading performance
- Sir Roy commented that "These are challenging times for Connaught"

Emergency £15m overdraft facility agreed: 29 July 2010
- Total facilities temporarily increased to £216m

JG Financial Training Ltd
329 The Whitehouse
9 Belvedere Road
London SE1 8YS
United Kingdom
Tel: +44 2077 712681
Mob: +44 7789 746338

- Discussions ongoing regarding refinancing
- Ongoing review of forecast trading performance

Review of Trading and Financial Performance/ Further Profit Warning: 6 August 2010

- Adjusted operating profit now forecast at break-even for 2010
- Provisions required for future losses on contracts
- Restatement of prior year accounts, to reflect write-down of asset values
- Segmental analysis to be reviewed
- Urgent turnaround required
- Sir Roy remained “committed to seeing the process through”

Administrators Appointed: 7 September 2010

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Appendix 2: Rok's Sequence of Events prior to Collapse

Trading Statement: 30 April 2010
- Rok warned that profits would be below forecast due to adverse weather conditions

Profit Warning and Problems within PHE: 11 August 2010
- Financial Control weaknesses within Plumbing, Heating and Electrical (a sub-division of the Maintenance and Improvements division) resulted in another profit warning
- Finance Director suspended pending independent review by BDO

Interim Results: 17 August 2010
- Construction and Social Housing were relatively stable but severe problems within Maintenance and Improvements due to high fixed cost base
- £6.8m restructuring costs incurred in the first half relating to Maintenance and Improvements and PHE
- "Continued investment in systems and technology", with a new system being introduced to bring greater consistency to estimating the cost of individual insurance repair jobs.
- Rok maintained that "whilst the isolated shortcomings in financial control at the PHE unit will have a significant impact on this year's results, the fundamentals of our business remain sound."
- CEO concluded with a consistent upbeat message that "Cash generation is strong and our focus on achieving materially lower debt has been successful. Our revised, lower fixed cost base and forecasts for the business means the Board looks ahead with renewed confidence."
- Confidence was expressed through a proposed interim dividend paid amounting to £900k.

Results of Independent Review into PHE: 30 September 2010
- Financial and Operational weaknesses caused PHE problems
- Finance Director not held responsible and reinstated, but decides to resign

Administration: 8 November 2010
- Refinancing discussions break down and PwC appointed as administrators

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Appendix 3: Financial Covenants

Since the breaching of banking covenants lead Connaught and Rok into administration, we also considered the nature and sensitivities surrounding these covenants. Note that since covenants are typically tested on a monthly or quarterly basis using internal management information, calculating the ratios based on annual or semi-annual data can only provide a rough approximation.

Connaught
At its 2009 year-end, the group disclosed total borrowings of £145.4m, comprising:

Aug-2009	Drawn	Facility	Headroom
Bank Loans	£90.0m	£157.3m (2)	£67.3m
Private Placement (1)	£54.7m		
Finance Leases	£0.7m		
Total Borrowings	£145.4m		
Cash	£56.4m		
Net Debt	£89.0m		

(1) Private Placement liability stated net of issuance fees of £1.3m that are amortised over the life of the instrument
(2) The bank facilities comprised a £112.3m committed facility and a £45m revolving credit facility, both expiring in 2012.

Connaught had completed the private placement in August 2009, raising $92m (£56m) with maturities in 2012 and 2014. Total committed bank facilities at the year-end amounted to £157.3m (2), supported by an RBS-led syndicate, indicating the group had around £67m of available headroom. In addition, the group had cash of £56.4m giving an overall net debt position of £89m.

The terms of its financial covenants were subsequently revealed in the group's interim management statement on 8 July 2010, as follows:

- EBITDA/ Interest expense > 3.5x
- Net Debt / EBITDA < 3.0x
- Net Assets + 50% retained profits > £120m
- Adjusted Operating Cash Flow / Debt Service cost >1.0x

Coverage Test	6m/e Feb-10	y/e Aug-09
EBITDA	25.8	51.7
Interest expense	4.5	8.8
EBITDA/Interest expense	5.7x	5.9x
Threshold	3.5x	3.5x
EBITDA exceeds threshold by (1)	20.1	20.9
Leverage Test		
Net Debt	97.5	89.0
EBITDA	25.8	51.7
Threshold	3.0x	3.0x
Net Debt/EBITDA	1.9x	1.7x
EBITDA exceeds threshold by(1)	19.1	22.0
Solvency Test		
Net Assets	192.1	167.5
Threshold	120.0	120.0
Net Assets exceed threshold by	72.1	47.5
Cash Flow Coverage		
Adjusted Operating Cash Flow	6.4	13.7
Debt Service Cost (2)	4.5	8.8
Threshold	1.0x	1.0x
Adjusted OCF/Interest expense	1.4x	1.6x
Adjusted OCF exceeds threshold by(1)	3.8	4.9

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(1) Thresholds for the 2010 interims estimated based on annualized data (ie. Multiplying the interim income statement data by two)
(2) Debt Service cost assumed to equal interest expense

Based on the above analysis, adjusted operating cash flow appeared to be the key constraint. In reality, the profit warning announced on 25 June 2010 resulted in a drop in forecast operating profit by £13m. Trade creditors became agitated and the company's working capital requirement increased, leading to increased net debt of £120m. This would have triggered three of the four covenant tests forcing the group into refinancing discussions. When it was subsequently revealed on 6 August 2010 that adjusted operating profits were forecast to just break-even in 2010 the banks decided that administration was their best solution to minimize losses.

Rok Group
At the end of 2009, the bank loans amounted to £51.9m with available headroom of approximately £35m.

Aug-2009	Drawn	Facility	Headroom
Bank Loans	£51.9m	£87.2m	£35.3m
Finance Leases	£0.3m		
Total Borrowings	£52.2m		
Cash at Bank and in Hand	£5.5m		
Net Debt	£46.7m		

In March 2009, Rok renegotiated a 3yr bank facility, comprising a £17.2m secured loan against the commercial development sites held for disposal and a £70m Revolving Credit Facility (RCF). The RCF amortised at £2.5m every 6 months from June 2010 and was subject to the following quarterly covenant tests:

- Net Debt/EBITDA 2.5x – 3.0x
- EBITA to net finance charges > 4.0x
- Adjusted net worth (ex. net pension liability of £12.7m) > £100m

Coverage Test	6m/e Jun-10	y/e Dec-09
EBITA	4.5	22.6
Net Finance Charges	1.5	2.2
EBITA/Net Finance Charges	3.0x	10.3x
Threshold	4.0x	4.0x
EBITA exceeds threshold by (1)	BREACH	13.8
Leverage Test		
Net Debt	47.6	46.7
EBITDA	6.7	28.1
Net Debt/EBITDA	3.6x	0.8x
Threshold	2.5x	2.5x
EBITDA exceeds threshold by (1)	BREACH	23.5
Solvency Test		
Net Assets (ex. pension deficit)	117.5	123.3
Threshold	100.0	100.0
Net Assets exceed threshold by	17.5	23.3

(1) Thresholds for the 2010 interims estimated based on annualized data

The problems in PHE led to poor interim results and downgraded profit forecasts for the full year. Trade creditors became agitated and the company's working capital requirement increased sharply, leading to full utilization of the bank facilities. Coverage and Leverage covenants were breached and with banks unwilling to provide emergency facilities or refinance, Rok was put into administration in November 2010.