

KNOW YOUR STRENGTH



THE Pensions Regulator has made it clear to pension scheme trustees they need to understand the credit strength of their sponsor, and this should feed through into funding and investment decisions.

Whenever corporate activity is proposed, trustees need to understand the impact on the employer's covenant; but trustees should consider the support for the scheme whenever money is flowing into or out of their sponsor's business – including for the payment of dividends and/or share buy-back programmes.

What issues should trustees consider in order to ensure that they fulfil their obligations? In addition, they need to decide whether a high-level review is enough, or whether they need to commission an in-depth investigation at much higher cost?

The first step could be to ask the sponsor what their current financial position is. However, there is always a danger that the picture painted by the CFO has been viewed through his/her rose-tinted spectacles. So perhaps the trustees should ask someone independent of the sponsor instead.

This latter route clearly has more credibility, and changes in corporate governance have made independent reviews both more common and more acceptable to wider audiences. The influences of Messrs Cadbury, Higgs, Greenbury and Turnbull (not to mention Sarbanes-Oxley) have highlighted the need for better governance to corporates (both through coercion and compulsion), and scandals such

Lane Clark & Peacock's DAVID POYNTON says trustees must understand how good the scheme sponsor's covenant is

as Enron have increased the focus on the truly independent review. As a result, the sponsor may be more willing to accept the need for trustees to employ advisers in this area now, than ever before.

The Pensions Regulator suggests trustees should treat their scheme deficit as a corporate loan, and they should act like a lending banker when dealing with their sponsor. But what does this mean, and how do the credit departments of clearing and investment banks view that covenant?

Their first task is normally to consider what has happened over the last few years in the sponsor's business. The progression of various accounting ratios is commonly considered, and while some of these are important indicators of the health of the sponsor's business, others can tell the trustees very little. The relevance depends on various industry factors, so whoever is advising you must know the implications of the output and be able to relate that to your specific business.

A ratio which told the trustees the sponsor's debtor days were only 15 (i.e. debtors taking an average of 15 days to pay what they owe) might sound very good. In some industries this may be so, but in a retail business there are often no debtors (as all customers pay up-

front, with cash and credit cards having a clearing cycle of less than three days). So a statistic which looks good at first glance could actually be indicative of underlying problems.

For lending banks, and by allegory trustees, cash is often king. A business can readily make a paper profit while haemorrhaging cash.

There are, of course, many demands on a sponsor's cash. Maintenance capital expenditure is required to keep the business on an even keel (despite what some corporate finance experts may suggest when lauding EBITDA as a profit measure); management may have decided upon an acquisition strategy which will require funding; and stated dividend policy can rarely be changed adversely without impacting the share price.

So when trustees are required to judge how much a company can afford to pay to the scheme, it can be very difficult to decide with any degree of certainty. Increasing the contribution requirement may require additional borrowing, reduce internal investment or, when taken to the extreme, could potentially lead to bankruptcy. When the trustees' best chance of funding benefits in the long term is reliance on the sponsor, care must be taken not to squeeze too much money out of them in the short term, at the expense of

the long-term survival of the business.

The pension deficit must be addressed, and the company will often have a funding plan in place. However, these contributions might not be sufficient to meet the trustees' needs. There is obviously a compromise to be reached in such a situation.

Careful consideration also needs to be given to the position of each company creditor. Where would the scheme stand if the company were to be wound-up tomorrow, once any preferential creditors have been repaid?

How big is the pension deficit, and how does this compare with the other debt currently owed by the company? How do the deficit payments compare to the annual scheme operating charge, dividend policy and to last year's net operating cash-flow?

This new area can quickly lead to conflicts of interest, especially where the only trustees with financial expertise are also company board members. This again drives trustees towards external advice when considering covenant strength in order to fulfil their duties.

To make sure they really understand the strength of their employer, trustees must pick their advisers carefully. As well as asking what they have to offer, and on what basis, trustees should check out the experience of the person who will be giving that advice – after all credibility is very important for all of us. ●

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