Actuarial Advisory Firm of the Year - Europe

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PENSIONS DEALS IN THE STORM AND BEYOND

One can hardly say that the pensions aspects of corporate transactions have got any easier in recent years. A combination of hazardous investment markets, rising pensioner longevity and increasingly demanding legislation have made employers' obligations more and more onerous. Pension fund trustees, regulators and advisers have been concerned by employers first being almost force-fed with cheap debt as the credit bubble developed, then facing a sharp worsening in terms and availability of bank finance. While the UK is arguably the most extreme example, the same trends apply worldwide.

While none of the resulting challenges should be underestimated, neither should one underestimate the range and effectiveness of the solutions available. In most cases, pension exposures do not need to be a "show-stopper" - provided parties are realistic, and understand the perspectives of other stakeholders. Here are some reflections on strategies that have proved effective in these most testing times.

Buyer beware

The most important measure for potential purchasers continues to be considering pensions from an early stage. The earlier the key issues are identified, the more solutions are available, here are just a few examples:

- If the best solution to pensions turns out to be walking away from the whole deal, then the earlier this is determined the better. In most situations where this is the case, a high level review can pick this up quickly and at limited expense. While not a cheerful outcome, it does avoid wasting material amounts of time and money on deals that are just not going to happen. On a happier note, it means that the firepower available can be focused on other opportunities.
- Due diligence needs to go much deeper than studying pensions disclosures in company accounts – which tend to give an artificially rosy picture in current conditions. Liabilities are normally calculated based on headline yields on AA rated corporate bonds with no allowance for expected defaults. These yields have ballooned in the credit crunch, with the result that liabilities taken at face value can massively understate the likely cash costs of funding the pension plan.
- Understanding the degree of variability of deficits – which are highly geared due to being the difference between asset and liability figures which are themselves subject to significant variations – is key to taking an appropriate view.
- Pension fund trustees continue to be an important and powerful stakeholder. The financial crisis has further increased potential nervousness about corporate transactions on the part of trustees - especially where the company's access to capital could be limited if things do not go according to plan. But we have, however, seen many trustees responding positively to transactions which are shown to support an employer's long-term growth prospects, or help stabilise its capital structure. Where appropriate, this can be underpinned by anticipating the views of trustees and their advisers on different capital structures, and settling on a structure which minimises their concerns, but is still commercially effective.
- Where a deal proceeds, it often makes sense to follow it in short order with risk-reduction measures, such as insuring part of the liabilities (often referred to as a pensions buyout or buy-in) or encouraging the trustees to change the investment strategy.

Where does this leave the sell-side?

If the buy-side has challenges to meet, this applies even more to sellers – but again there are many ways to beat the averages, for example:

- In our experience, providing potential purchasers with early clarity on pension obligations can go a long way towards achieving an optimal outcome. It continues to surprise me how seldom this is done. Arguably the concerns triggered by any lack of clarity are often disproportionate – especially in the current climate – but this is a reality which has to be tackled. In our experience, this is best done by anticipating the questions a purchaser is likely to ask, assembling the necessary information in advance, and presenting it in an organised and credible way.
- Sellers often resort to talking about things which can be changed after a sale – clearly these are much more effective if they are finished before the sale process starts. Options range from painful measures such as closing a plan to future accrual, through to quick wins in areas such as managing Pension Protection Fund (PPF) levies. In these areas, early planning can pay large dividends.
- One of the opportunities arising from the financial crisis has been a fall in the cost of securing certain pension liabilities with life insurers. Insurers can use investment grade corporate bonds to help back these pension liabilities. Even after reserving for default risk at heightened levels, current yields enable insurers to offer much keener prices than were available in previous years. There has therefore been a major increase in the number of situations where it makes sense to take pensions off the table ahead of a transaction, by buying out pensions with an FSA-regulated insurer.

In practice, success in addressing pensions issues often requires a "cocktail" of solutions, tailored to the situation, and combining cutting edge techniques with getting the basics right. This is indeed challenging, but it need not be insurmountable. **ACQ**