

## *Preparing for pensions in an M&A transaction*

After a strong start to M&A activity globally in 2011, with some commentators even predicting a return to 2007 levels, the year as a whole turned out to be somewhat muted.

Now at the start of 2012, uncertainty reigns throughout the markets. There is little doubt that this is creating opportunities to invest in businesses at attractive valuations for those who have access to the necessary capital – and there are probably more such investors than one might at first think, with private equity houses having been relatively restrained recently, and many companies stock-piling cash.

In this LCP M&A pensions update we take a look at:

- How pensions can be examined at an early stage before committing material resources to a transaction; and
- How sellers can prepare their business for sale to avoid being tripped up with a large price reduction for pensions.

### *Taking an early stage look at pensions*

When it comes to buying a business, pensions can be key. We are increasingly being asked to undertake high-level “pre due diligence” on potential acquisition targets in advance of a purchaser deciding whether to pursue and devote time and resources to a particular deal.

Often a surprising amount of information is available in the public domain and, if initial contact has been established, a great deal of insight can often be gained from a carefully planned high-level initial conversation with the vendor.

The precise issues will depend on the circumstances of the transaction, but key things to look out for include:

- Published information frequently paints an unrealistic picture. This is due to differences in the regulations for accounting purposes and cash funding purposes, and significant changes in financial conditions since the time of publication. However, it is usually possible from publicly available information to make a helpful assessment of the latest funding position and its sensitivity to changes in market conditions - even if it is, by necessity, only broad.
- How does the scheme invest its assets and what does this mean for how volatile the funding position might be?

*It is often surprising how much pensions information can be obtained ahead of due diligence*

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- How does the company describe its relationship with trustees? If the relationship is open and transparent and the trustees are briefed on the transaction and ready and prepared to speak with the purchaser, then the process is likely to be much less painful than if the relationship is strained and/or acrimonious.
- With regard to the trustees, it is important to be “self-aware” and understand how the trustees are likely to view you as a potential owner, compared to the current situation, and to factor this in accordingly.
- How is the transaction likely to be structured? In particular, are there any participating employers withdrawing from the scheme which may trigger section 75 debts?

Finally, it is worth noting that whilst many of the biggest pension issues will often relate to UK plans (owing to the type of typical pensions provisions and the legislative environment), there are often important aspects worth investigating in other jurisdictions. For example, it is not uncommon to find pension plans described as “defined contribution” in European and other jurisdictions when in fact they are not, and quasi-pension benefits such as guaranteed termination payments which are not accounted or reserved for at all. With different cultures and languages, we find that the key is knowing exactly how to form the right question to ask, in relation to each of the relevant countries.

## *Preparing a business for sale*

Canny sellers are increasingly making sure they get their pensions house in order before it comes to marketing a business. Doing so can improve the price achieved as a result of:

- Attracting greater competition from a wider variety of bidders, some of whom might otherwise have been put off by pensions.
- Giving greater certainty to the eventual bidder regarding future pension costs, and so reducing the risk margin they need to factor into their bid.

There are a number of steps which could be taken, but how do you know which are the right ones, likely to deliver the most value?

Clearly, different actions are appropriate in different situations and to a large degree it depends where you are starting from. However, we have encountered a number of cases recently where expensive and poorly-designed “member-option” exercises of questionable value are being undertaken, whereas easier “quick wins” (such as those listed below) have been neglected.

Member option exercises (such as enhanced transfer values or pension increase exchanges) can be time-consuming and expensive. When they are well designed (eg the terms of the option offered to members are reasonable, and member guidance is

*We find that many sellers neglect quick wins at the expense of poorly designed member option exercises*

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available), they can reduce company risk and cost, at the same time as giving members an option that they value.

However, if the exercise is poorly designed, then not only is take-up likely to be lower (which limits the value achieved) but a potential purchaser may have cause to worry about new risks being introduced (such as future “mis-selling” type claims). As such, the overall impact of a poorly designed exercise can be detrimental.

On the other hand, there are many simple and practical steps that companies can take to help ease a sale.

- Consider the make-up of the trustee board, which the company can usually influence to some degree. The aim here should be to ensure that the company has a good working relationship with the trustees and that enough trustees have sufficient experience and expertise to be able to deal with commercial negotiations.
- Engage with, and work proactively with, the trustees on investment matters. Although investment strategy is the sole responsibility of trustees in the UK, it is ultimately the company which underwrites investment risk. In our experience trustees are almost always willing to take on board the company’s views if well explained.
- Consider the timing of the funding valuation cycle – typically these occur every three years. A recently-signed schedule of contributions with the trustees will give the buyer greater

certainty about contribution levels in the short to medium term. It may be over the top to move the valuation date, but at the same time putting the business up for sale at a critical time in funding negotiations with the trustees is unlikely to be helpful.

- At an appropriate point, brief the trustees about the transaction and be open about the benefits and even potential challenges such as the possibility of higher gearing. A buyer will appreciate any feedback on how the trustees might react to such a scenario, rather than take a (usually cautious) stab in the dark.
- Gather complete information on the company’s pension arrangements including details of any non-standard benefits and discretionary practices etc. Assume you will get awkward and probing questions from buyers, and the quicker and more confidently you can respond the greater confidence this will give that there are no serious issues with data or latent liabilities.
- Try to resolve any legal issues with the scheme. For example, if there is doubt over whether indexation is linked to RPI or CPI or whether equalisation changes were properly effected, then you must expect that a buyer will factor the most expensive option into their assessment.

A further option is to secure benefits with an insurance company prior to sale. Not only will this take the financial risks of pensions off the table, it will also stop pensions delaying completion of the transaction.

Ensuring an effective and constructive trustee body is key

**LCP's M&A Consulting Practice**

LCP's M&A Consulting Practice has been advising clients on mergers and acquisitions for more than 20 years. Comprising eight partners who work regularly on transactions and supported by experienced staff, local offices and network partners in all major markets, we have a wealth of experience of both UK and international pensions issues.

One of the things that sets us apart is our in-depth and practical experience of advising trustees of pension schemes. This means we can understand and advise on how issues and potential solutions are likely to appear from the perspective of the trustees and their professional advisers, and their likely reactions.

LCP has advised on the pensions aspects of some of the largest and most noteworthy transactions in recent years, as well as many mid-market deals.

For more information or to discuss how we can help you, please contact David Lane, Ben Adams or the partner at LCP who normally advises you via telephone +44 (0) 20 7439 2266 or by email to [enquiries@lcp.uk.com](mailto:enquiries@lcp.uk.com)

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LCP is a firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics.

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