The ECR and financial advisers

Faculty of Actuaries Sessional Meeting, Edinburgh

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Agenda

- Introduction
- Why is employer covenant strength an issue?
  - Deficit recovery
  - Clearance applications
- Advisers
- What are the key metrics?
  - Profitability
  - Cash flow and free cash flow
  - Net assets
  - Liquidation
- A conceptual framework

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Introduction

- I will leave the pensions issues to the pensions experts
- This presentation is about the financials

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Why is employer strength an issue?

Deficit recovery plans

- Code of Practice – Funding Defined Benefits:
  - To determine technical provisions (risk/return mix of assets)
  - To determine recovery plans (affordability)

Clearance applications

- Clearance Statements – Guidance from the PR:
  - Categorisation into Type A, B and C events
  - For trustees to negotiate with employers
  - Ways in which pension scheme security may be improved
  - "Reasonable" test

Banks use financial advisers……………

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Financial advisers

- Typically accountants from a restructuring background
- Understanding of:
  - Advising banks in similar situations generally
  - Financial analysis
  - Negotiations for improving security
  - Entity priority issues
  - All set in commercial context
- Often work with M&A teams in their corporate finance departments for valuation issues

What are the key metrics

- PR takes the view that profitable, stable businesses are the best covenant to schemes
  - Does not want unnecessarily to intervene in employers' businesses
  - Does not want to see the golden goose killed
  - But, wants a sensibly funded scheme
- The financial adviser's metrics are often framed around this and the more detailed guidance given by the PR

What are the key metrics?

Profitability:

- What are the likely factors which could affect profitability?
- Bear in mind that timescales are often lengthy – risk inevitably increases with time
- Sensitivity analysis
- Reliable or normalised profit run rate over time
- Example metrics on next slide

What are the key metrics?

Profitability:

- EBITDA, less capex, adding back P&L element of pension contributions – how many times does this cover pension contributions?
- Net profit, adding back P&L element of pension contributions – how may times does this cover pension contributions?
- Dividend policy impact?
- Is capex discretionary?

What are the key metrics?

Cash flow and free cash flow

- Function of profitability, subject to balance sheet movements
- Free cash flow cover to pension contributions ratio (eg):
  - Distressed businesses – free cash flow before pension contributions and debt amortisation
  - Non-distressed business – free cash flow before pension contributions and dividends
- How much does turnover have to fall before this is a breach? Measure of business resilience
- Remember that, especially for growing businesses, some capital needs to be retained
- See example at end

What are the key metrics?

Net assets

- Again, net assets adding back the deficit to see how many times the deficit is covered
- May want to do this on FRS17 and s75 bases
- Can be used to consider FSDs – 3 stage approach:
  1. Net assets, at book values
  2. Net assets, at book values, adjusted for fair value
  3. Fair value of enterprise

Liquidation analysis

- What will the scheme get back in liquidation?
- Relevant to investment risk
- Entity priority issues

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What are the key metrics?

	Pre-transaction	Post-transaction
FRS17 deficit	£200m	£200m
Secured bank debt	£100m	£500m
S75 deficit	£600m	£600m
Recovery timescale	10 years	5 years
Annual recovery plan payments	£20m	£40m
FCF	£50m	£45m
S75 deficit settled on liquidation?	£200m surplus	£200m shortfall
Distributable reserves	£400m	Nil
Equity:bonds mix	75%:25%	Move to less risk

A conceptual framework

Degree of prudence= level of deficit

Low------------ High

Poor asset cover but strong cash flow	Poor asset cover and weak cash flow
Good asset cover and strong cash flow	Good asset cover and weak cash flow

Short--------------------------- Long

Recovery period

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