The Actuarial Profession
making financial sense of the future

D3: Creating economic and shareholder value

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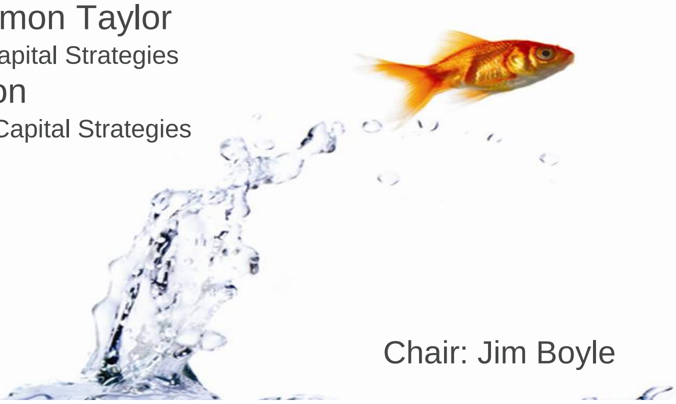

Chair: Jim Boyle

Agenda

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JLT PENSION CAPITAL STRATEGIES

- Overview
- Measures of corporate value
- Typical corporate strategies
- Stakeholders
- Shareholder Value and Agency Theory
- Conflicts of interest
- Summary

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Overview

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- Session aims to stimulate discussion
- It is a hotchpotch of different theories and discussions
- Please don't agree with all of our points
- Aim to provide a debate
- Not providing the answers, hopefully provides more questions
- Even if you disagree, may stimulate thought
- Whistle stop visit using academic models from various fields of management theory

Measures of Corporate Value

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Some measures of corporate value

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- Book Value
  - Adjusted Book Value
- Market Multiples
  - Market Value
  - Dividend Yield
  - Earnings Per Share
  - Price to Book Ratio
  - Tobin's Q (market cap / replacement cost of assets net of liabilities)
  - PE Multiple
  - Price to Cash Flow
  - Enterprise Value to EBITDA
- Enterprise Value
- Economic Value

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Adjusted Book Value

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Question: What does the book value of a company represent?

- The liquidation value of the assets less the liabilities
- The replacement cost of the assets less the liabilities
- The market value of the assets less the liabilities
- The value of the business (economic value) less the liabilities
- The value of the business to a potential purchaser
- The sunk cost

'However, under *another* accounting procedure ...'

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Answer: A bit of all of them, dependent upon the particular circumstances of an organisation.

- We need therefore to adjust book value to be fit for purpose for the particular corporate valuation.
- The pension scheme (amongst other items) falls under these auspices

'However, under *another* accounting procedure ...'

Enterprise Value

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Enterprise Value = Common equity at market value + Debt at Market Value + Minority Interest at Market Value (if any) – Associate Company at Market Value (if any) + Preferred Equity at Market Value – Cash and Cash Equivalents

In effect on the purchase of a company the enterprise value is the cost of settling with all security holders

- Cash subtracted because when it is paid out as a dividend after purchase, it reduces the net cost to the purchaser – although if the cash to be reinvested, then this is debateable
- Enterprise Value should also reflect the value of any unfunded pension liabilities
  - But on what measure?
  - Would argue given this is a settlement, should be the cost of settling the benefits
    - Annuity purchase?
    - Transfer to another company?
    - Transfer to the member?

Discounted Cash Flow Valuation of the Enterprise

- Project future cash-flows from the enterprise
- Discount back at the weighted average cost of capital
  - Use rates pertinent to the enterprise
- How do we factor in the pension scheme?
  - Could use the expected rates of return on the assets (making an appropriate assumptions for returns available on the deficit
  - Could knock off the net deficit – but on what basis?
  - Do we knock off the expected costs of settlement?

Enterprise Value – Example

The situation before any compromise:

Market Cap: £9million
No Debt
Pension Scheme Deficit: £436million (on buyout basis)

Enterprise Value before adjustment for pension scheme £9million (but share price does reflect some view of pension obligations)
Enterprise Value with pension scheme -£427million

But, how much would the enterprise be worth if pension scheme removed?

In this case enterprise valued at £90million with no pension scheme

Pension deficit for equity swap (90% of equity), leaves 10% of equity but no pension scheme
Enterprise value (for original shareholders) post debt for equity swap: £9million – and definitely no debt
Trustee hold £81million of shareholding
Was able to unlock since didn't have to discharge liabilities at full solvency level
Would need TPR and PPF agreement (amongst others)

Economic Value

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Extremely difficult to determine

- The worth of a good or service as determined by the market
- What if there is no market?
- How much of one good would it cost to exchange for another good?
- The value of the good changes dependent upon who is the recipient.
  - A higher non-increasing pension has greater value than a lower start level but indexing pension to an individual with a shorter life expectancy
- The cost of insuring the good may be significantly higher than the value of the good to a particular member

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Where does that leave us with regard to value?

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Hypothesis:

From the corporate perspective the Economic Value is the present value of the actual cost that it takes to discharge the pension scheme

- But we don't know this until the pension scheme has run its course. If we wish to understand the expected cost then we need to try to estimate the economic value

From the Corporate Perspective the Economic Value of the Pension Scheme is the minimum expected cost of transferring liability from the scheme to the third party that will accept the transfer discounted at the weighted average cost of capital to the organisation

- Difficult to assess
- We know the WACC, but perhaps not the future WACC
- We can assess the cost of buying annuities for all
- We can take a stab at the cost of buying annuities for all at a future date
- We can't assess if any members would be prepared to exchange their benefits at a lower cost
  - Unless we ask them
  - ETV, PIE, TV to IVPP etc

Shareholder value is generated if liabilities are discharged at a cost lower than that implicitly assumed to be the shareholding weighted expected cost of liabilities of the scheme

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Corporate Governance and Corporate Strategy

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Corporate governance of a pension scheme

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- There is no single correct answer
- However it is important to:
  - Govern the scheme appropriately from the corporate perspective
  - Understand the risks
  - Understand the costs
  - Understand the cash constraints
- Apply the UK Corporate Governance Code?
  - Leadership, i.e. adopt a corporate governance structure above the scheme
  - Effectiveness, i.e. appropriate balance of skills, sufficient time, induction, etc.
  - Accountability, i.e. answer to Shareholders and Stakeholders and present a balanced view of the scheme's current and prospective position
  - Remuneration, i.e. avoid paying more than is necessary for services, but pay enough for appropriate services
  - Establish a dialogue with Shareholders and other relevant Stakeholders

What are the typical actions undertaken around the pension scheme from the corporate perspective?

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- Strategic
  - Enhanced Transfer Value
  - Pension Increase Exchange
  - Transfer Value to Immediate Vesting Personal Pension
  - Guarantees and contingent assets
  - Asset backed contributions
  - Valuation negotiations
  - Changing benefit provision
  - Cessation of Accrual
  - Corporate mergers, sales and acquisitions
  - Scheme mergers
  - Asset de-risking?
  - PPF levy management
- Operational
  - Participate on trustee boards
  - Regular contributions

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A framework to consider strategy?

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Strategy / Impact	Cash Impact	Risk Impact	Cost Impact
Enhanced Transfer Value	High	High	Neutral TPs High Solvency
Pension Increase Exchange	Low	Low	Moderate TPs Moderate Solvency
TV to IVPP	Varies	High	Neutral TPs Low/Moderate Solvency
Annuity Purchase	Varies	High	Moderate TPs Neutral Solvency
Asset Backed Contributions	Low	Low	Neutral TPs Neutral Solvency
Valuation Negotiations	High	Low	Low TPs Neutral Solvency
DE-risk assets	Low	Medium	Low TPs Nil Solvency
RE-risk assets	Low	Medium	Low TPs Nil Solvency

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Stakeholders and Conflicts

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Pension scheme stakeholders from the corporate perspective

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- Trustees
  - Company
  - Independent
  - Member Nominated
- Sponsor
  - Principal Employer (Board and Directors)
  - Participating Employer (Board and Directors)
  - Parent Company (Board and Directors)
- Shareholders
- Lenders
- Pension Scheme Members
  - Actives
  - Deferreds
  - Pensions
  - Contingent members
- TPR
- PPF
- Employees not in the pension scheme
- Other (e.g. Customers, Suppliers, Advisors, Service providers, Auditors)

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Pension scheme stakeholders from the corporate perspective

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- Lots of Stakeholders
  - Can we classify them?
- Power/Interest Matrix (Eden and Ackermann)
  - Could also classify by Power, Urgency and Legitimacy
- Moving stakeholders

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Example Power/ Interest Matrix

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Increasing Interest

Subjects **Members**	Players **Trustees**
Crowd **TPR**	Leaders and Context setters **Company**

Increasing Power

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Moving Stakeholders

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- Diagram shows what may be the start point for some relevant stakeholders for a given corporate strategy
- Clearly there are many more stakeholders, but the example focuses on four key ones
- In order to achieve any strategy it may be important to move certain stakeholders
- For example, if trustees are resistant to a strategy, then perhaps seek to reduce power or reduce interest
- It may be vital to ensure that TPR remains in the crowd
- Increasing member interest in a particular strategy may be important in order to influence the trustees – if the members are supportive
- Key point is to identify all relevant stakeholders and to seek to influence appropriately to provide the maximum chance for the strategy to succeed

Stakeholder Salience – Classifying Stakeholders

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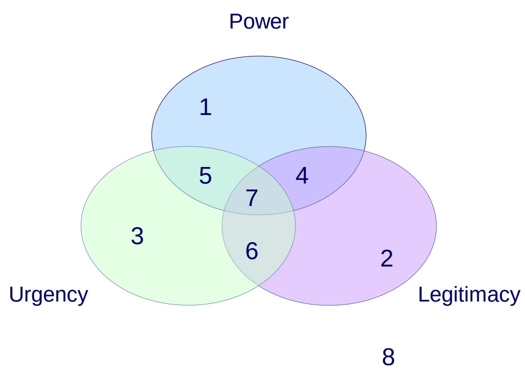

1	Dormant
2	Discretionary
3	Demanding
4	Dominant
5	Dangerous
6	Dependent
7	Definitive
8	Non-stakeholder (defunct?)

Shareholder value and stakeholder value

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Shareholder Value

- For a publicly traded company, Shareholder Value (SV) is the part of its capitalization that is equity as opposed to long-term debt. In the case of only one type of stock, this would roughly be the number of outstanding shares times current share price.

Stakeholder Value

- The intrinsic or extrinsic worth of a business measured by a combination of financial success, usefulness to society, and satisfaction of employees, the priorities determined by the makeup of the individuals and entities that together own the shares and direct the company.

Agency Theory

- Agency theory suggests that the firm can be viewed as a nexus of contracts (loosely defined) between resource holders. An agency relationship arises whenever one or more individuals, called principals, hire one or more other individuals, called agents, to perform some service and then delegate decision-making authority to the agents.
- The Principal – Agent problem is that Agents may not always make decisions that benefit the Principals. For example decisions can be made to generate short term wealth for agents at the cost of longer term wealth for the principals.

Agency Theory - Examples

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Example 1:

- Corporate mergers – a large proportion of corporate mergers do not add shareholder value. Lloyds TSB and HBOS is often cited as an example of managers not acting in the best interest of shareholders

Example 2:

- Executive Pay increasing although companies are losing value dramatically, e.g. Trinity Mirror and the Shareholder Spring

Example 3:

- The trustees purchasing annuities for pensioners as they retire if there is a doubt about company strength and one of the trustees is a pensioner member of the scheme

Example 4:

- Trustees plan to increase commutation factors but delay because one of the MNTs is not retiring for several years

Just as care needs to be taken to manage the Agent - Principal problem from the corporate perspective, care also needs to be taken in the pension scheme perspective.

Conflicts of Interest – Corporate and Trustee

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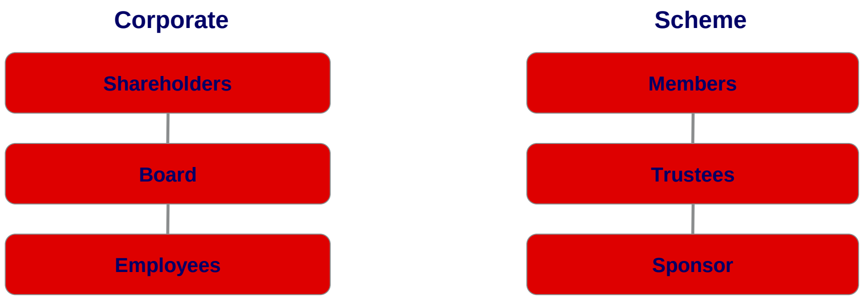

The flip side of Agency Theory relates to the concentration of shareholder power in a handful of individuals, entities or organisations. Not a problem if there is a sole shareholder, but if one or a few dominant shareholder exist, then decisions can be skewed towards these entities. The issue becomes much greater if the shareholders are also Board members. Applying the same rationale to the Pension Scheme, we can see that member trustees have the same potential conflict.

Care needs to be taken to manage this conflict.

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Summary

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- Value – very difficult to define, many different perceptions of value
- Many strategies do not generate corporate value
  - May not in itself be a bad thing
  - Stakeholder value very important
- Principal – Agent problem can exist in pension schemes as well as companies
- Essential to be aware and to manage all conflicts, corporate and member nominated trustee
- Management of stakeholders essential, classification very important to enable successful management
- Most valuable benefit to some members is not the scheme pension as defined

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