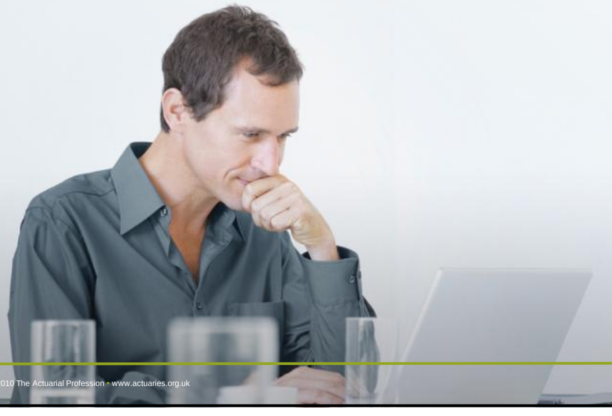
The Actuarial Profession
making financial sense of the future

**C4: De-risking solutions are everywhere – but what is the impact on the sponsors of schemes that have transacted?**
**Celene Lee**





## Agenda

C4: De-risking solutions are everywhere – but what is the impact on the sponsors of schemes that have transacted?

**This session will examine the impact on the sponsors of schemes for which the trustees carried out a buyout, buy-in or longevity swap transaction over the past few years and whether it was a commercially sensible decision in the eyes of the outside world.**

Speaker: Celene Lee, Hewitt Associates

Intermediate

## How did it all start?

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### Apax writes down investment in Emap business to zero

Private equity group Apax has written off its investment in Emap, the business magazine publisher that it jointly owns with Guardian Media Group (GMG).

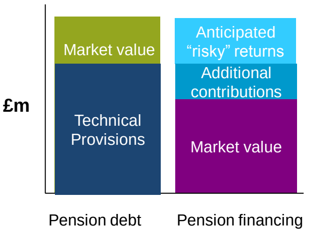
## Agenda

- Introduction / ground rules
- What role does a pension scheme play within a corporate entity?
- Theories & observations
- Conditions for transactions
- Analyses and case studies on specific transactions
- Conclusions and Further Thoughts

# Pension as corporate debt

- Pension liabilities represent debt owed by the Company to scheme members.
- Increasingly, the view of:
  - credit rating agencies
  - banks
  - legislation and regulators
  - shareholders?
- But market value complicated because:
  - pensions debt not regularly traded
  - value of debt depends on non-financial factors

**So should pensions be treated any differently to other debt?**

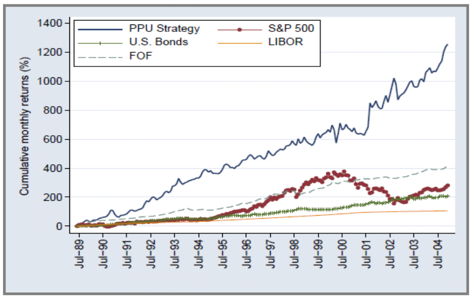



BT credit downgrade
- Feb 2010 BBB to BBB-
- Downgrade followed announcement of recovery plan
- £533M index up for 17 yrs starting 2012
- Reported to have cost £6M a year
- In 2001, A to A-, cost £30M a year
- S&P believed risk of additional demands from tPR

Boots Case Study
- created £225m of shareholder value;
- directly affected company financing decision (£300m share buy-back); and
- overall risk unchanged according to the rating's agencies.

# Theories and observations

**1** **Profiting from mis-pricing** - Franzoni & Marin (2005) devised profitable trading strategy based on analyst's NOT taking into account US pension liabilities "on balance sheet". Claim strategy would have earned 20% p.a. to 2004 (see graph)




Graph is from Franzoni & Marin paper: "Portable Alphas from Pension Mispricing"

It shows the performance of their PPU strategy from 1989 to 2004 (blue line). Outperformance over LIBOR, S&P500 and a fund of funds index is clear – but is it sustainable in future years?

**2** **Babcock longevity purchase -** 12 May 2009 share price up 68 to 480p "on announcement of first UK longevity swap" But was this just result of strong results for the year to March? Pre-tax profit was up 27% and revenue climbing 22%.

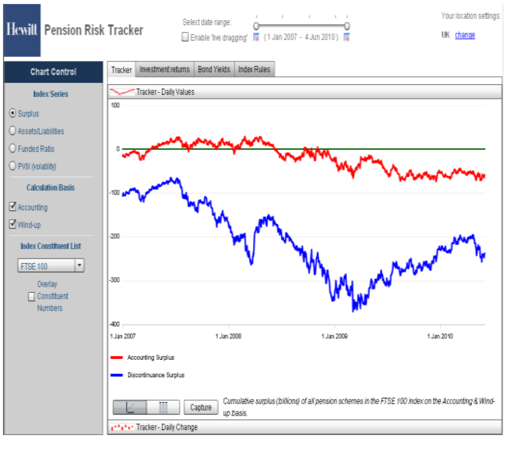
## Theories and observations

**3** **Credit Spreads** – Cardinale (2007) found that pension scheme deficits were priced into US companies' credit spreads. Effect not symmetric, so surpluses were not priced in at all – trapped surplus?

**4** **Credit Spreads II** – conversely Hewitt's Paul Nicholas (2008) found that pension scheme deficits (and surpluses) were NOT priced into UK companies' credit spreads – much more significant was long-term leverage on balance sheet and equity volatility. Why are UK analysts ignoring the impact of pension deficits?

## Measuring pension schemes – how do equity analysts see it?

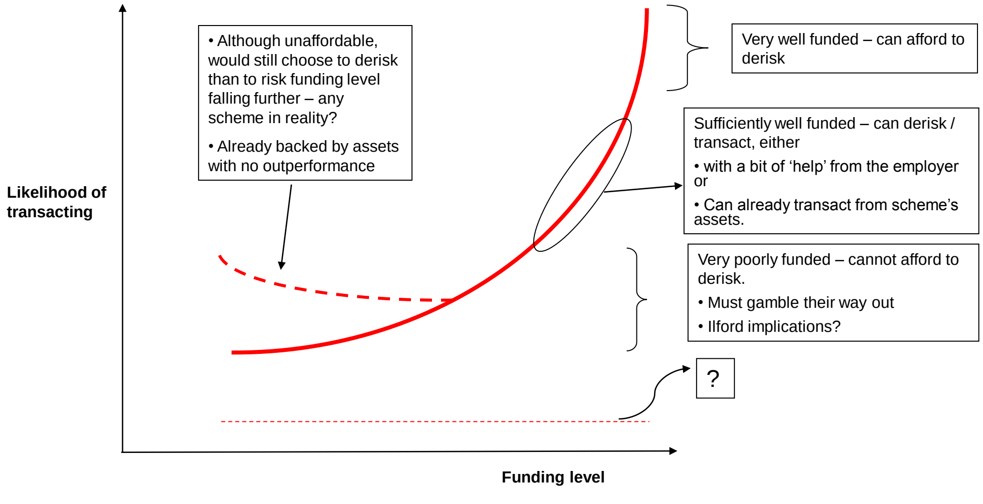
How do equity analysts see it? Which is the right answer?




Differs by sector & materiality
- Accounting basis
- Technical Provisions
- Solvency / self sufficiency

IASB exposure drafts
- No kicker from return-seeking assets
- Capitalised expense
- Attitude towards holding risky assets?
- Closer to 'buyout'?

## Not so surprising someone offers to 'take it off your hands'……




## What should we analyse?

1. Long term benefit
   - No management time
   - Focus on what the company does best
   - No more volatility
   - More predictable business
   - But it does come with a cost
   - Cost vs Benefit?
2. Ease corporate transactions
3. Industry wide schemes
   - Resolve practical section 75 debt issues?

Criteria
- Material
- Measurable
- Comparable
- Publicly available information

**Impact on stock price of pension de-risking**

| Company | Announcement date | Performance vs. FTSE on day announced |
|---|---|---|
| Rank Group | 29 Feb 08 | 8% (over a week) |
| Morgan Crucible *(Pensioner buyin)* | 17 Mar 08 | 0.79% |
| BBA *(Pensioner buyin)* | 22 Mar 08 | (1.28%) |
| Delta *(Pensioner buyout)* | 05 Jun 08 | 5.88% |
| Cable & Wireless *(Pensioner buyin)* | 04 Sep 08 | 2.16% |
| RSA *(Longevity swap)* | 14 Jul 09 | 0.71% |
| Liberty Int. *(Full buyout)* | 4 Feb 2010 | 1.08% |

Source : Pension Corporation

# Food sector

| | Market cap (end of May 2010) | Accounting date | Pension Liabilities | Deficit | Liabs / MC | Deficit / Market cap | Total debt |
|---|---|---|---|---|---|---|---|
| Dairy Crest | £480 M | 31/3/09 | L = £576M<br>A =£513M | £63M | 1.2x | 13% | £389M (@2010) |
| Uniq | £17 M | 31/12/09 | L = £728M<br>A = £500M | £228M | 43x | 1340% | £27M |
| Northern Foods | £210M | 31/3/09 | L= 705M<br>A=£637M | £68M | 3.4x | 32% | £287M |
| Premier Foods | £520M | 31/12/09 | L = £2,959M<br>A= £2,530M | £429M | 5.7x | 83% | £1,421M |

# Longer term – cash implications

Revenue (£M)

| | 2010 | 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|---|
| Dairy crest | 1,630 | 1,648 | 1,570 | 1,309 | 1,161 |
| Uniq | | 287 | 287 | 736 | 541 |
| Northern foods | 977 | 975 | 932 | 889 | 862 |
| Premier foods | | 2,661 | 2,604 | 2,125 | 841 |

Net income pre tax (£M)

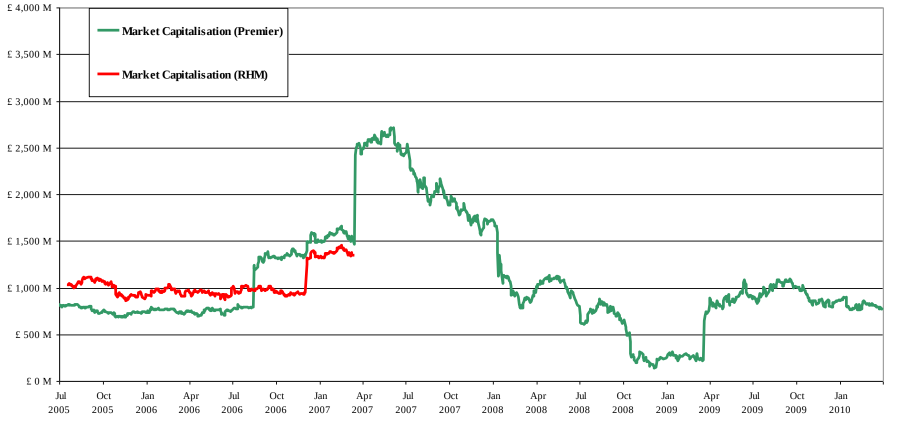
| | 2010 | 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|---|
| Dairy crest | 78 | 103 | 66 | 65 | 38 |
| Uniq | | -18.5 | 0 | -44 | -59 |
| Northern foods | 14 | 3 | 35 | 28 | 16 |
| Premier foods | | 47 | -405 | -78 | 59 |

Operating income pre tax (£M)

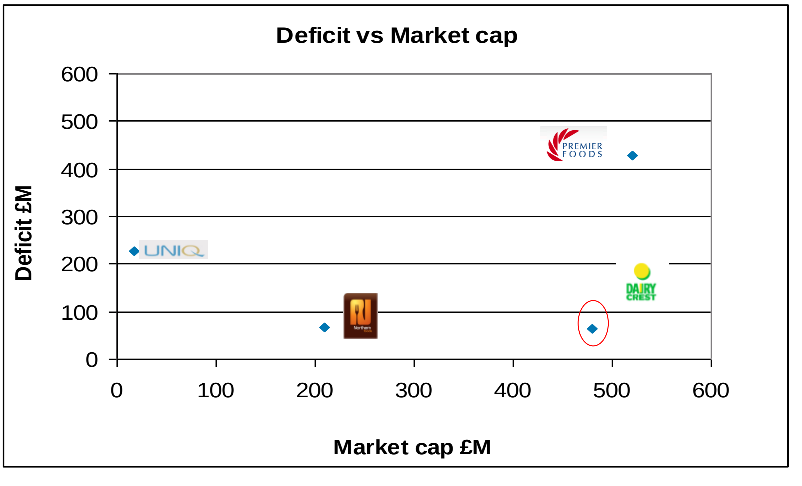
| | 2010 | 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|---|
| Dairy crest | 99 | 68 | 74 | 67 | 46 |
| Uniq | | -3 | -5 | -50 | -49 |
| Northern foods | | 17 | 44 | 40 | 43 |
| Premier foods | | 174 | -58 | 72 | 101 |

| Latest recovery plan | |
|---|---|
| Dairy Crest | £20M a year from October 2009 |
| Uniq | Deficit of £130M, TP funded on 71% of buyout, account of £87M |
| Northern Foods | 91% funded on TP (D=£75M)<br>78% of buyout, no conts, inv rets |
| Premier Foods | Total conts of £200M from March 09 to 14, c £40M a year |

## Company size



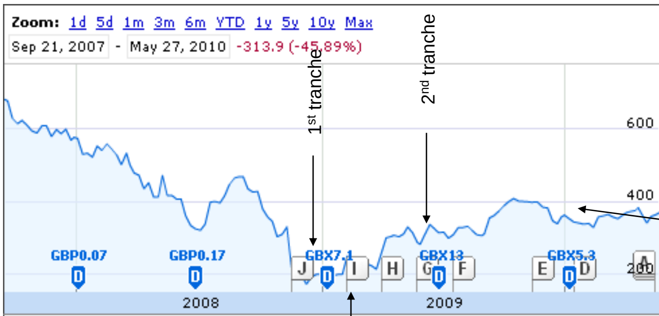

## Can we segment them?



## How about longer term? Food sector
## One and Five Year Period


## And without Uniq
## One and Five Year Period

## Other than pensions




YE 31 March 2010

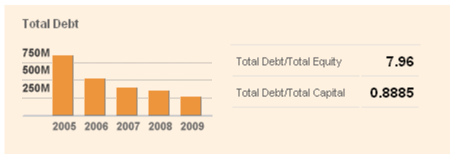
-Headlines include DB closed to future accrual

- Substantially reduced our pension scheme exposure

Sell WCL – cash proceeds, to repay bank debt

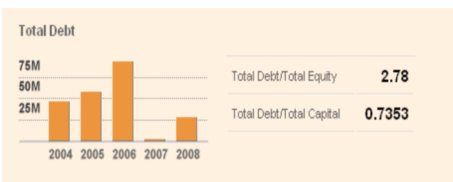
Sell YDC for £63.5M to repay debt, increase headroom under banking covenants

Rank's total debt

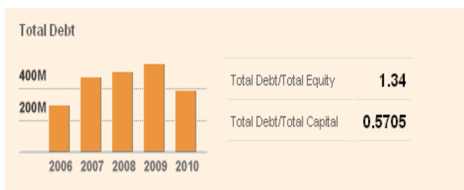



## Debt levels

Uniq

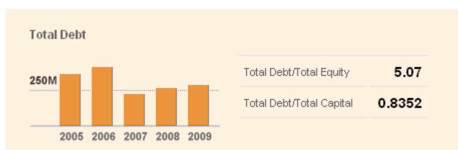



Dairy Crest




Premier Foods


Northern Foods



## Conclusions & Further thoughts

So have we answered the question? What does the ‘outside world’ think?

**Positive**

- Capitalise on actions
- Reduce balance sheet volatility (at what cost?)
- Good to be seen to be reducing debt in this environment – impact on business strategy?

**Negative**

- The ‘outside world’ are no fools – still getting grilled on remaining deficit
- Still crystallising pension cost at buyout now rather than ‘later’
- Real cash transaction

## Conclusions & Further thoughts

So have we answered the question? What does the ‘outside world’ think?

- Pension scheme not the only factor
- Clear determination to reduce debt level
- Self-selecting?
- Pension risk can be ‘overplayed’, becomes central focus
- Real impact on financing cost
  - Credit downgrade
  - Trustees demand on security
  - Hindrance to corporate transaction
- Unpredictable relationship with trustee / tPR?

**But**

- Control of trustee relationship
- No change in legislation
- Pension accounting still the focus
- Lack of transparency means pension cost is still ‘smoke and mirrors’
- Manage size by ETVs

**One final question …..**