

The Actuarial Profession
making financial sense of the future

Pensions Conference 2010
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Employer Covenant 2006 to 2010

How Things Have Changed

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2006 to 2010... so what's changed?

2006	2010
 <p>"What's Employer Covenant?"</p>	 <p>"Do we need Covenant advice?"</p>

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2006 – 2010 Developments in Employer Covenant Thinking

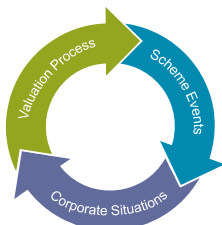
2006	2010
<ul style="list-style-type: none"> • Some Regulatory guidance • Little practical experience • Reluctance to engage • Fragmented service providers • Trail blazing, but in which direction? • Inconsistent output • Limited application • Isolated piece of work 	<ul style="list-style-type: none"> • Increasing TPR emphasis • Direct experience • Growing willingness to engage • Dedicated service providers • Better understanding of client needs • Streamlined, focussed output • Wide ranging applications • Working in partnership

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Typical Situations where Employer Covenant Advice is Sought

Valuation Process

- Assumptions
- Recovery Plans
- Investment Strategy



Scheme Events

- Apportionment or Withdrawal Arrangements
- Scheme Mergers
- Scheme Closures

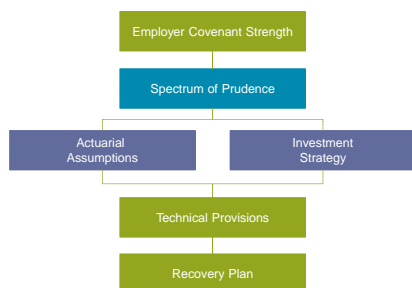
Corporate Situations

- Refinancing Financial Distress
- Merger and Acquisitions

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Informing the Valuation Process



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A Valuation Problem

Issues

- Independent Trustee told by owners (co-trustees) that the business was struggling
- Valuation overdue and "essential to close the scheme to avoid administration"
- Historical information good, forecast information limited
- Company view was that assumptions should be weak
- Also believed 20 year recovery plan was reasonable and offered £75,000 per annum

Solutions

- Independent view of the Company avoided conflicts of interest
- Demonstrated profitable, financially stable, cash generative business
- Overall covenant "Moderate"
- High level cash flow forecasts produced to demonstrate likely free cash flow
- Actuaries able to properly reflect covenant in valuation
- Increased to £100,000 per annum with a share of free cash after necessary capital expenditure spend

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... and another one

Issues

- UK group had undergone corporate restructure which had resulted in a sale of a group of profitable overseas subsidiaries to its parent
- Trustees told after the event but advised "nothing to worry about"
- Despite financial forecasts to the contrary, Trustees told that Company unable to make any contributions to the scheme... Company also wished to wait for markets to get back to normal (!) and to avoid a trapped surplus (!!)
- Three year contribution holiday requested
- Company view was that covenant was strong, although was unwilling to make payments

Solutions

- Assessment of UK structure pre and post and evaluation of transaction value / impact on covenant
- Appeared to be at arms length but created an intercompany debtor. Overall assessment was neutral, but caveated
- Review of all forecasts and sensitivity analysis showed that Company could afford to make some level of contribution
- Company was funding other group companies despite inter-company debtor being deferred
- Willingness a clear issue
- Trustees advised that three year holiday unacceptable as forecast only showed twelve months
- Flexibility for 2010 subject to proper commitment
- Ongoing... but a solution in sight

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Corporate Stress and Financial Restructuring

Substantial Liabilities

- Aggregate buy-out deficits £571Bn at March 2009
- Total UK Corporate lending £480Bn at November 2009

Competing Demands

- Banks very aware of the risks associated with DB Schemes
- Sponsors face constrained borrowing capacity / pressure to reduce debts

The Squeeze

- Schemes are often seen as malleable creditors
- Longer recover plans
- Increased risk

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A Restructuring and Refinancing Problem

Overview

- Scheme deficit £165m / £350m ranked pari passu with £400m Bank debt
- Possible breach of lending covenants
- Banks looking to restructure loans and move away from covenant-lite lending
- Banks insisting on TPR clearance being obtained but only limited mitigation on offer.

Issues

- Inexperienced trustees presented with a fait accompli and extremely aggressive stance.
- Proposal incapable of being supported
- TPR considered unlikely to provide clearance given trustees' opposition

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A Restructuring and Refinancing Problem

Issues

- Detailed business review undertaken by Top 4 firm on behalf of the employer... and reviewed by another Top 4 firm on behalf of lenders...
- Where to begin??
- Super priority on future equity proceeds - £85m
- Advantageous security – First Charges
- Arrangement fees - £15m
- Cap on contributions to scheme
- Company unwilling to commit to future funding levels despite valuation in progress
- Proposal incapable of being supported and unlikely to receive TPR clearance

Solutions

- Distillation of complex financial reporting to enable lay trustees to be "negotiation ready"
- Identified extent of detriment and calculated mitigation required to maintain security "stand still" relative to Banks
- Established core levels of free cash flows and reasonable apportionment between scheme and lenders
- Equitable share in first charge security
- Agreement on future funding

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An FSD and CN Challenge

Overview

- TPR alerted to a potential scheme abandonment following a pre-pack insolvency
- Independent Trustee wished to pursue recourse under moral hazard powers

Issues

- Prior to insolvency, the principal employer made significant losses and the holding company made significant profits
- Investigation revealed that in December 2005 the Group had been restructured, purportedly for tax purposes
- Assets of a participating employer company transferred to profitable sister company (non-sponsor). Employees transferred to the principal employer
- Transfer Inducement Exercise conducted two years previously was found to be invalid. Re-inclusion of all liabilities into the scheme a possibility

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An FSD and CN Challenge

Issues

- Use of moral hazard powers in respect of principal employer
- Restructuring in 2005 moved assets from participating employer to non-participating employer.
- Invalid Transfer Inducement Exercise
- Cost of further work likely to be significant in context of small scheme

Solutions

- Insufficiently resourced/'rich uncle' calculations prepared.
- Researched whether an FSD may be appropriate
- Investigation highlighted potential transaction at undervalue
- Potential s75 claim also identified against participating employer
- Determined "rich uncle" may not have sufficient assets, depending on outcome of TIE investigation
- Recommended concluding TIE exercise, settlement of s75 debt before further work re moral hazard powers.
- Costs approved by tPR.

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An Apportionment Scenario

Issues

- Group Restructure of communications business
- Closure of loss making division. High proportion of scheme liabilities
- Desire to avoid s75 liability
- Remaining business cash rich and acquisitive
- Group trading performance historically volatile
- Currently achieving high profits and cash generation
- Exit plan of owners uncertain
- Scheme considered vulnerable to change in ownership
- Trustees facing opportunity to improve funding

Solutions

- Review to establish whether financial test are met
- Remaining group companies were capable of funding the scheme at the time
- Funding test met, but is this sufficient?
- Trustee reached agreement
- Proportion of s75 liability paid on withdrawal
- Agreement to reduce current deficit (ongoing basis) within 5 years

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Final Thoughts

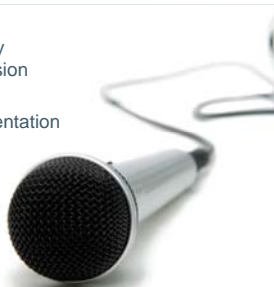
- Since 2006 there has been a growing awareness, acceptance and appreciation of the value of employer covenant assessment
- As UK and Global recessions end (or if we get a double dip), there is likely to be an increased requirement for covenant related support
- Many applications, not just valuations and affordability
- Service providers should focus on working in partnership with fellow professionals and continually refining their products

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Questions or comments?

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