Independent Employer Covenant Reviews

Providing Trustees with an assessment on the strength of the employer

Independent Employer Covenant Review ('IECR')
Key Messages

- Trustees need to be fully engaged with management to ensure that its DB scheme is adequately funded,.
- The purpose of an IECR is to provide trustees with an independent assessment of the strength of its employer's covenant
- This information will be critical when the employer is contemplating corporate activity, in particular if this involves a Type A event:
  - a charge in control,
  - a charge in creditor priority, or
  - some form of return to equity or subordinated debt holders.

Independent Employer Covenant Review ('IECR')
Purpose

- An IECR should also play a critical role in
  - shaping funding and investment decisions in steady state situations
  - in helping to anticipate any impending financial difficulties

Independent Employer Covenant Review ('IECR')
Typical contents

- Contents are tailored according to the particular circumstances of
  - a given situation
  - knowledge & information
  - independence of trustees
- Focus would be to assess the strength of the employer's covenant from three perspectives:
  - current position
  - future prospects
  - tactical planning

Independent Employer Covenant Review ('IECR')
1. Current position

Your agenda		Our approach
What is the current financial position of the Group? The Group already has significant off-balance sheet liabilities on its operating leases. But how would the financial position change once the FRS17 deficit is brought on-balance sheet?	→	**Credit analysis** An assessment of current financial position as set out in the most recently available balance sheet. Analysis also done assuming FRS17 deficit is brought on balance sheet.
In the event of an insolvency, what would happen to the pension scheme deficit? How would competing creditors fare in an insolvency? Can you improve your position without additional funding?	→	**Entity priority analysis** An analysis of the debt structure and creditor priorities including any parent company or cross guarantees Modelling potential outcomes in a hypothetical insolvency

Independent Employer Covenant Review ('IECR')
2. Future prospects

Your agenda		Our approach
You have material exposure as an unsecured creditor to the employing companies, and are expected to form your own view on its future prospects – how should you do this? How much cash is available to clear the deficit? – and what would be the impact of the risks materialising?	→	**Financial review** Review of business plan to identify cash generation and profitability – to identify 'Cash Available for Deficit Clearance' Identification and modelling of sensitivities and risks
What does cash flow look like after Scheme Funding and PPF levy are introduced?	→	**Impact of changes in pensions regulatory environment** Modelling impact Scheme Specific Funding accelerated deficit clearance and the PPF levy

Independent Employer Covenant Review ('IECR')
3. Tactical planning

Your agenda	Our approach
How should you react if the Group needs to clear dividend payments with The Pensions Regulator?	**Dividend analysis** Analysis of distributable reserve hurdles the Group may need to go through before it can resume dividend payments to shareholders
How would an unsecured lender manage loans of £1.5bn loan to the employing companies? What protections would a lender require that the pension creditor may seek? How should you monitor your exposure going forward?	**Exposure management** Identification of protections in similar Group unsecured facilities that place the lender in a superior credit position to the deficit Review / proposal of monitoring programme Impact of refinancing the deficit in the credit markets
Is the Group proposing any transactions requiring TPR clearance? How should you respond?	**Regulator Clearance** Analysis of the impact of any proposed transaction on the deficit

Case study – XYZ plc
Background – acquisition by ABC Inc

ABC Inc

ABC Inc op co's

XYZ plc

XYZ Holdings

Pension Scheme

Acquisition funded in part by £6.4bn of debt

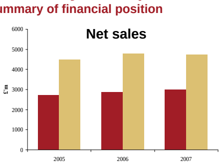
Debt unsecured – but guarantees from XYZ plc and XYZ operating companies

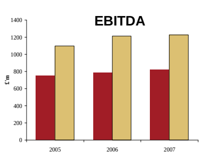
ABC Inc market cap - £6.4bn + XYZ £7.3bn = £13.7bn for enlarged group

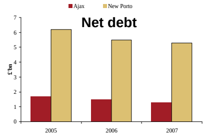
ABC Inc offers the XYZ Trustees:

- additional £50m of funding into the scheme over two years (£25m pa)
- result = deficit cleared by 2015

Case study – XYZ plc
Summary of financial position







Case study – XYZ plc
Summary of financial position – market response

- **Rating agencies**

  "Takeover would be funded by debt on terms highly adverse to bondholders" (Fitch, 5 April)

- **Credit research**

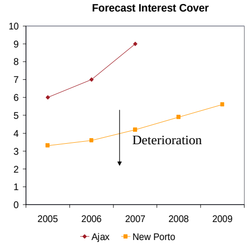
  " At first sight, the implications for XYZ plc's bondholders are pretty grim, given the increase in leverage and the fact that bondholders do not benefit from any protection in the event of a change of control"
  (BNP, 14 April 2005)

- **Bond prices**

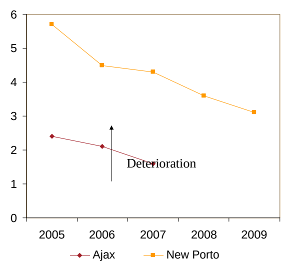
  2009 bond yield moves 3.4% (4 April 2005) to 4% (11 April 2005); a 17% reduction in price

Case study – XYZ plc
Summary of financial position

Forecast Interest Cover

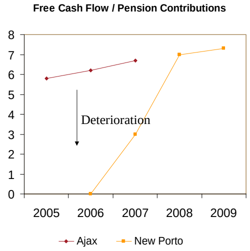


Forecast Net Debt / EBITDA

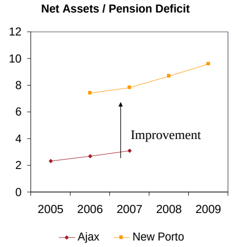


Case study – XYZ plc
Summary of financial position

Free Cash Flow / Pension Contributions



Net Assets / Pension Deficit



Case study – XYZ plc
Issues to consider

ABC Inc wants to make an announcement to the market in one week's time…

What do the Trustees think of ABC Inc's proposal? How should they respond?

Potential options:

1. Accept the proposal from ABC Inc
   - Benefit of enhanced contributions and guarantee for buy-out deficit
   - BUT does this adequately compensate for deterioration in employer covenant?
2. Consider further time to evaluate, discuss and negotiate the proposal
   - Impact of failing to reach agreement before proposed announcement?
   - Is the timeframe afforded to the Trustees reasonable?
3. Seek enhancements to the terms offered

Consider funding proposals, employer covenant, creditor priority

Case study – XYZ plc
The "answer"

- Outcome of clearance process with The Pensions Regulator:
  - ABC Inc to inject additional £200m on top of existing £50m on offer
  - Pension scheme to share in all guarantees offered to ABC Inc's lenders
  - In the event of a covenant breach – equivalent to "cross default"
    - Trustees can renegotiate funding plans
    - If bank loans accelerated, equivalent acceleration of deficit
  - ABC Inc to share cash flow information with Trustees, commitment to accelerate funding if needed

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  - some form of return to equity or subordinated debt holders
- But what about Scheme Funding?
- Can the Employer do it for them?