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PENSIONS M&A ADVICE – A YEAR OF CHANGE

STAPLE INN HALL, LONDON
10TH NOVEMBER 2006

Due Diligence and Pricing Issues

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Agenda

- Introduction
- Why are pensions such a big issue in transactions?
- The due diligence process
- Identifying the key risks
- Pricing issues

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The importance of pensions

- High cost of defined benefit provision
- Volatility on balance sheet and on profits
- Drain on management time
- Moral hazard provisions
- 69% of private equity firms have pulled out of a deal because of pensions

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Due Diligence?

- What are we buying?
  - size of deficit (and uncertainty)
  - future cash contributions (and variability)
  - key risks that we are taking on board
  - dealing with the Trustees/Regulator
  - what improvements can we make post-completion
- Scope depends on the client and buying process

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Funding calculations

- Cash contributions
  - to meet Statutory Funding Objective
  - benefit accrual and expenses
  - plus meeting any deficit
- Accounting under FRS 17 or IAS 19
  - using un-biased assumptions
  - including updates to mortality where necessary
- Worst case buy-out debt

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Demonstrating uncertainty

- Mortality
  - current funding/accounting allowance
  - "best estimate" updated allowance
  - prudent updated allowance
  - worst case allowance…. (very subjective!)
- Sensitivity to financial conditions
  - equity/bond mis-match
  - inflation risk
- How does the funding change and what impact does that have on contributions and accounting?

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Identifying key risks

- Balance of powers in the Trust Deed & Rules
  - contribution setting powers
  - timing of valuations
  - power of amendment
  - consents for discretionary benefits
  - winding-up provisions
  - existence of any special benefit terms
- What can happen that is not in the numbers?

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Identifying key risks

- Investment strategy – but can be changed
- Composition of Trustee body?
- Actuarial factors – particularly CCF
- Administrative expenses
- PPF levy – will the deal change the D&B rating?
- Options that the members have to select against the scheme

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Clearance issues

- Key question - is the transaction a “specified event”?

> *Specified events*
>
> A ‘specified event’ is an event affecting an entity which is financially detrimental to the ability of a defined benefit scheme to meet its pension liabilities.

- The due diligence role:
  - Is clearance necessary or desirable
  - Negotiating with Trustees
  - Clearance application

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Pricing a pension deficit

- An industry standard is emerging
- 90% of private equity buyers price transactions on an FRS 17 (or IAS 19) basis
- FRS 17 deficit effectively treated as a debt
- FRS 17 deficit, adjusted for deferred tax where applicable, deducted from the enterprise value
- Only partial credit be given for any FRS 17 surplus given the difficulty in extracting value from an over-funded pension scheme

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Why FRS 17?

- Used for accounting for pension obligations in the UK
- Very similar to IAS 19
- Lenders tend to treat an FRS 17 deficit as a debt in assessing provision of financing
- FRS 17 is the level at which an application for Clearance from the Pensions Regulator for a transaction is not required
- FRS 17 is often the target level of funding required to achieve Clearance

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Why FRS 17?

- The Pensions Regulator is using FRS 17 as a trigger for investigating a scheme valuation
- FRS 17 is a well understood methodology and a measure which is readily available in companies' accounts
- At 100% FRS 17 funded, a scheme can hedge its liabilities with relatively low volatility
- At 100% FRS 17 funded, a company would have to be 'unlucky' to not be able to run off accrued benefits with no further contributions

Not always FRS 17…..

- In certain scenarios worth considering different pricing
- For example:
  - Gilt matching might be appropriate for a very large pension scheme relative to enterprise value
  - Very mature pension schemes then gilts or buy-out
  - Buy-out might be appropriate for very high risk deals with significant "connected parties"
  - Infrastructure investments based on DCF modelling – is FRS 17 appropriate?
  - Very low equity values – option pricing?
- The client drives the pricing model

Summary

- Due diligence:
  - What are we buying?
  - What are the risks?
  - What can we do to mitigate risk?
- Pricing is generally FRS 17 on proper mortality with no "tweaks"
- But sometimes weaker or stronger is justified….