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PENSIONS M&A ADVICE – A YEAR OF CHANGE

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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

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

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?

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?

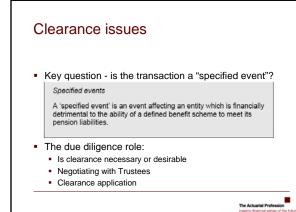
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Identifying key risks

- 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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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 overfunded 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

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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

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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"
- <u>But</u> sometimes weaker or stronger is justified....

