Understanding the strength of the Employer Covenant

7 June 2005

Today's speakers

Neville McKay – Human Resource Services
- Fellow of the Institute of Actuaries with twenty years experience in the pensions industry
- Member of Actuarial profession working party - reviewing strength of employer covenant
- Works closely with PwC's Credit Advisory Team
- Currently involved in advising trustees on sponsoring employers' covenant strength

Jonathon Land – Credit Advisory Specialist
- Completed a secondment to The Pensions Regulator
- Advised The Pensions Regulator when looking at the practical implication of Clearance Processes, Moral Hazard Powers and Notifiable Events
- Recent projects include MyTravel and the BoxClever receivership
- Three years advising US technology companies in Seattle and San Jose
- Industry experience founding, raising finance for, and selling a technology business

Agenda

1. Impact of transactions on covenant strength
2. Trustees as active negotiators
3. How do other creditors behave?
4. Measuring and monitoring the strength of the employer covenant
5. Actuarial & wider considerations

Key messages

- The corporate veil has been broken
- Key parties' roles will have to evolve
- The pension creditor has the priority and power of a material unsecured creditor
- The strength of the employer covenant will affect trustees' negotiation strategy
- Understanding the strength of the employer covenant is increasingly important

S&P default rates

	1 year %	10 years %	15 years %
AAA	0		
BBB	0.3		
BB	1.2		
B	5.7		

S&P default rates

	1 year %	10 years %	15 years %
AAA	0	0.4	
BBB	0.3	6.1	
BB	1.2	19.2	
B	5.7	33.8	

S&P default rates

	1 year %	10 years %	15 years %
AAA	0	0.4	0.6
BBB	0.3	6.1	8.7
BB	1.2	19.2	22.6
B	5.7	33.8	38.6

Employer covenant

FT - The Lex Column – Monday June 6 2005

"In most cases pension fund trustees or the actuaries to the trustees control the level of contributions into the fund. If they believe the company's covenants would worsen in the event of a buy-out, they can demand increased or one-off payments from the company, as well as requiring the deficit to be moved up the creditor queue."

FT - Front Page – Tuesday June 7 2005

"The proposed rule…requires trustees, after negotiation with the employer, to be "prudent". There is no definition of the meaning of prudence."

What's changed?

	BEFORE		NOW
***pension deficit**:*	contingent liability	⇨	significant "unsecured creditor"
***actions that reduce security of pension "unsecured creditor"**:*	so what?	⇨	corporate and individual liability
***regulator's power**:*	insignificant	⇨	pierce corporate veil to impose penalties and cross-company guarantees
***control of cash contributions, etc**:*	company (often)	⇨	trustee negotiation

How is the employer covenant measured?

- It is what we do for a living
- Some times call an Independent Business Review (IBR)
- Usually for key stakeholders eg bank creditors
- Involves an objective and independent assessment of
  - The overall financial health of the company / group
  - Company projections
  - Key financial ratios
  - Likely effect of proposed transactions
- Delivered in a report format
- Including a set of recommendations for the recipient

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Objectives of the Pensions Act

- Objectives of Anti Avoidance powers
  - Protection of pension scheme benefits
  - Protection of the PPF
  - Improved confidence in DB schemes

- By issuing Clearance Statements which allow commercial activity to take place
  - Protection of jobs
  - Deal activity

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Pension schemes in deficit are like any other material unsecured creditor

"Pensions are a form of deferred pay and, therefore, schemes in deficit are an unsecured loan by scheme members to the company. Pension schemes in deficit should be treated in the same way as any other material unsecured creditor"

David Norgrove

Chair of the Pensions Regulator

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Does an event affect the pension creditor?

1 – Creditors with fixed charges

2 – Preferential creditors

3 – Creditors with floating charges

4 – Unsecured creditors

5 – Subordinated creditors

6 – Equity

Classification of events

- Those that do
- Those that don't
- Those that might do

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Events that affect the pension creditor ("Type A")

- Priority
  - Fixed charge / Floating charge
  - Leveraged finance transaction
- Return of Capital
  - Share buy back / Dividend / Dividend strip / Distribution in specie / De-merger
- Control Structure
  - Change of Principal Employer
  - Change in control group structure of the DB scheme

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Priority - Granting of Fixed or Floating Charge

1. Does an entity within the group have a pension "deficit", if yes
2. Is an entity within the group of companies granting a fixed or floating charge over assets, if yes
3. Is granting the fixed or floating charge security material:
   - More that 25 percent of the total assets of the group?

- If yes, it is a type A event which requires notification and clearance is optional

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Return of Capital - Payment of Dividends

1. Does an “employer” entity within the group have a pension “deficit”, if yes
2. (a) Does the “employer” entity have negative P&L reserves after reflecting the deficit or (b) does a dividend put the “employer” entity in this position, if yes
3. Is an entity within the group of companies making an eventual dividend to an entity who is outside the group or outside the UK or to an entity who would not be subject to an FSD, if yes

Return of Capital - Payment of Dividends

- Is the dividend material
  - Large or unusual test - more than 2 times the average of the last 3 years dividend excluding any large or unusual dividends which have been paid in the last three years; or
  - Is the dividend cover of less than 1.25
- If yes, it is a type A event which requires notification and clearance is optional

This test applies to any capital reduction transaction

Has the Change in Control materially weakened the Employer Covenant?

- Does the employer within the group have a pension “deficit”, if yes
- Is there a full or partial change in the control group structure of the employer including
  - Change in one of the ultimate parent or an intermediate holding company of the employer, or
  - Change in connected or associated parties who could be subject to an FSD, if yes

Has the Change in Control materially weakened the Employer Covenant?

- Does the change in control structure materially weaken the Employer Covenant?
  - This can be measured by looking at the effect on key financial ratios, including the ratio of
    - Company's credit rating
    - Contributions to EBITDA
    - Contributions to free cash flow
    - Contributions to interest payments
    - Total group assets to S75 debt
- If yes, it is a type A event which requires notification and clearance is optional

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Contribution Notices ("CNs") & Financial Support Directions ("FSDs")

CN	FSD
At fault – by act or failure to act	No fault
Companies and individuals	Companies only
Any Connected or Associate (33%+)	Any Connected or Associate (33%+)
Reasonableness to impose: Relationship, Involvement, Purpose (jobs), Benefit	Service companies
Backdated to 27 April 2004	Insufficiently resourced
6 year look back	The 50% test of S75 debt test
	From 6 April 2005
	9 month look back

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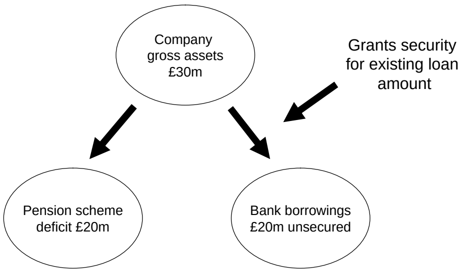
Contribution Notices



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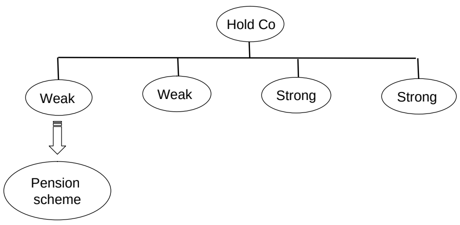
Financial Support Directions – Groups



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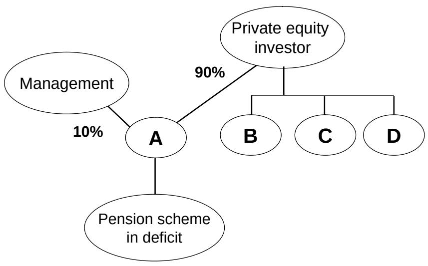
Application of FSD's in VC structures



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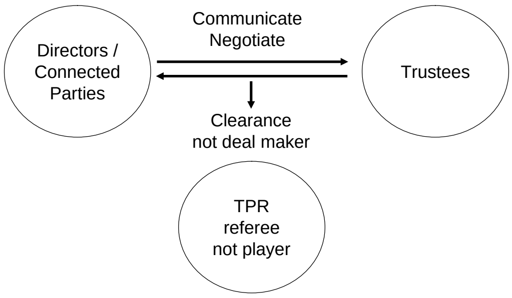
Key parties in a Clearance Request



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The pension creditor should negotiate in the same way as any key material unsecured creditor

- Additional cash or other assets
- Credit Default Swaps / Letters of Credit
- Escrow/Deposit up front
- Improvement in priority eg additional security
- Equity return
  - Equity
  - Profit share (expressed as a contribution)
  - Priority on equity return
- Information
  - Monitoring
  - Covenants
  - Negative pledges

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Example covenant review - scope

- Understand the commercial drivers behind the business
- Review the financial forecasts
- Look at the capital structure
- Comment on the terms of debt obligations
- Compare the available cash to service the pension scheme - pre and post the proposed transaction
- Compare gearing and other key financial ratios, pre and post the proposed transaction
- Sensitise the key financial drivers
- Prepare an entity priority model
- Recommendations / Options analysis

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Case study 1

- Ungeared UK business - about to acquire US business for $180m
- PwC report covered:
  - Comment on available cash flow and contribution cover
  - Benchmark analysis – gearing pre and post
  - Insolvency analysis – downside analysis
  - Sensitivity analysis – pre and post
  - Pros and Cons of deal (for the Trustees)
  - Menu of negotiating tactics and minimum ask

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Case study 2

- £1bn disposal – Trustees being asked to consent to change in Principal Employer via a Venture Capital debt funded acquisition
- PwC report covered:
  - Summary of complex transaction (the deal changed 5 times in 5 days)
  - Comment on gearing and contribution cover – pre and post
  - Insolvency analysis – downside analysis – the same under both scenarios
  - Identified that Trustees were in a very weak position both before and after the deal
  - Supported Trustee ask for substantial contribution from both Vendor and Acquirer – to be spread over 10 years

Actuarial & wider considerations

- Predictable nature of actuarial valuations compared with unpredictability of type A events
- Trustees should seek cash at times of strength
- It's not just about cash
  - security
  - covenants
  - negative pledges
- Ratio of free cash flow to pension contributions
  - sustainability of pension contributions
  - correlations in sensitivity analyses
- Entity priority analysis
  - calculation of deficit
  - split of deficit by employers

Key messages

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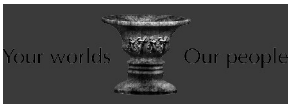
Your worlds
Our people