Mergers and Acquisitions
Market Developments

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## Agenda

- Agenda
- Introduction
- Market trends for valuation
- Valuation approaches for corporate transactions
- The Roles of the Trustees and Regulator in transactions
- Case studies




## Typical approach taken to valuing a business

- Multiple of EBITDA (depends on future prospects of business)
- Reduce valuation by any net debt

- Pension scheme deficits (and unfunded liabilities) are now generally regarded as being another form of corporate debt
- Treat past service and future service separately:
  - Transferring deficits/unfunded liabilities increase net debt
  - Allow only for cost of future service in EBITDA

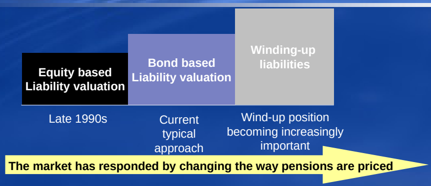
## Market trends in recent years

- The pensions environment has become ever less employer friendly
- Solvent companies cannot default on pension obligations
- In the event of insolvency, pension debts might pierce the veil of limited liability





## Market trends in recent years




- In recent years, increasing focus on accounting bases such as FRS17 and IAS19 as a starting point
- Then consider:
  - size and maturity of scheme
  - Power of the Trustees and lifetime of the business
- Other approaches remain possible e.g. rail franchises





## Impact on pricing of different bases


**Choice of valuation methodology has a significant impact**

## Other economic and demographic assumptions

Mortality

- Trend towards increasing prudence in mortality tables
- Whilst no (or short) cohort typical practice now, what about at exit in the future (for a PE house) or in future financial reporting (for a corporate)?

Commutation

- Reasonableness of factors and assumption

Withdrawal/salary scale

Are the assumptions reasonable when looking at the transferring pension scheme members?




## Other economic and demographic assumptions

Early retirements

- Is there adequate allowance for early retirements?

Other

- Price inflation
- General salary inflation
- Pension increases
- Redundancy costs




## A note about FRS17

- FRS17 is not a fixed measure
- ‘Flexibility’ within FRS17 – negotiation point
- Accounts often on optimistic side of permitted range

**Example**

| | Targets Last Accounts | Updated for market changes | “Middle of the Road” FRS17 Basis |
|---|---|---|---|
| Assets | £25m | £28m | £28m |
| Liabilities | £27m | £35m | £37m |
| Deficit | £2m | £7m | £9m |
| | | | |
| Service cost | £1.5m | £2.2m | £2.3m |
| Service increase | | | £0.8m |

## Choice of valuation methodology

**What is the correct methodology for calculating deficit and service cost?**

**It depends…..**





## What is an appropriate valuation approach?

Example 1

- Company valuation £1bn (before adjustment for pensions)
- Pension scheme assets £100m
- Pension scheme liabilities (IAS19) £120m
- Closed to new entrants, open to new accrual
- Trustees do not have power to unilaterally wind up or set contribution rate
- What would your recommendation for pricing basis be?





## What is an appropriate valuation approach?

Example 2

- Company valuation £200m (before adjustment for pensions)
- Pension scheme assets £50m
- Pension scheme liabilities (IAS19) £70m
- Highly leveraged buyout
- Closed to new entrants, closed to new accrual
- Trustees do not have power to unilaterally wind up but do set the contribution rate
- What would your recommendation for pricing basis be?

## What is an appropriate valuation approach?

Example 3

- Company valuation £100m (before adjustment for pensions)
- Company is a railway franchise. At the end of the franchise the Railways Pension Scheme section is passed on to the next franchise holder
- Pension scheme assets £200m, liabilities (FRS17) £250m
- Closed to new entrants, open to new accrual
- Trustees do not have power to unilaterally wind up but do set contribution rate
- What would your recommendation for pricing basis be?

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## What is an appropriate valuation approach?

Example 4

- Company valuation £20m (before adjustment for pensions)
- Pension scheme assets £30m, liabilities (FRS17) £55m
- Closed to new entrants and new accrual
- Trustees do not have power to unilaterally wind up or to set contribution rate
- How would you price this

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## The Regulator

- Pensions Regulator was introduced with effect from April 2005
- Statutory objectives:

| Protect members' benefits | Minimise claims on PPF | Promote better scheme administration |
|---|---|---|

- Extensive powers, including:
  - moral hazard clauses
  - ability to set scheme specific funding levels

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## Contribution Notices

- The Regulator can impose a liability to make a payment in respect of an act or omission which,
  - in the opinion of the Regulator,
  - had as its main purpose, or one of its main purposes,
  - prevention of recovery of a pension deficit
  - or prevention of a debt falling due
- Examples include:

SELLING ASSETS | TRANFERRING EMPLOYEES TO SHELL COMPANY | DIVIDEND STRIPS | INCREASING SECURITY

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## Contribution Notices

- Applies to the employing company
  - or any associated or connected party
  - who is a party to the act or omission
- In deciding whether to issue a notice the Regulator must:
  - consider a number of factors i.e. the motivation of the act
  - be satisfied it is reasonable to do so
- Provisions are retrospective i.e. from 27 April 2004
- 6 year time limit

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## Financial Support Directions

- Connected or associated parties can be required to put financial support arrangements in place

Give guarantee | Accept joint and several liability | Put cash into scheme

- Definition of 'associated' wide and onerous – individuals excluded
- An FSD can be issued where the employer is:
  - a service company, or
  - is insufficiently resourced
- Period of 9 months after ceasing to be associated or connected

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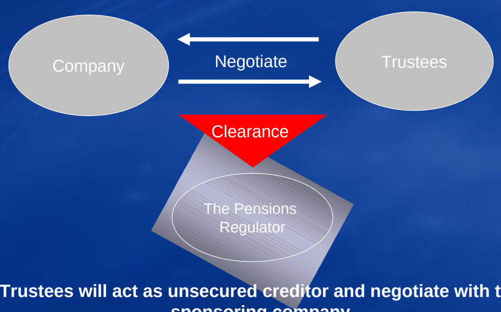
## Clearance

- Parties can apply for advance assurance that a particular event will not lead to action from the Regulator i.e. a CN or FSD
  - Clearance can be withdrawn if circumstances change
- The Regulator only expects clearance to be sought for specified events which:
  - impact on the pensions creditor
  - financially detrimental
- Regulator expects Trustees to be involved in the process and to take independent advice
  - likely to require additional funding or other guarantees



## Clearance




**Trustees will act as unsecured creditor and negotiate with the sponsoring company**



## Possible Clearance solutions

## Clearance solutions – case studies

Project A

- Remove £20m of the £40m FRS17 deficit immediately
- Pay-off remainder over 5 years
- Retain some equity exposure, but close it off to the extent that out-performance is achieved

Project B

- As Project A, however FRS17 deficit paid off over 10 years, but equivalent to paying off an equity basis deficit over 5 years

Project C

- No deterioration in the position of the pension scheme – Clearance given without additional funding/security

Project C

- Remove half of the scheme through transfers (at below FRS17 cost)
- Pay-off the residual FRS17 deficit immediately