Concurrent Session C1
SPONSOR COVENANT

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Pensions Convention – St Andrews
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Background

- long established printing group
- proposed disposal to management of two sub groups
- tPR approached for clearance
- tPR recommended that the Trustees appoint independent accountants to review the proposals and the supporting information
- holding company Print Holdings Limited (PHL) with two operating subsidiaries
  - Leeds Print Company (LPC) – sheet/reel labels
  - German Security Printers (GSP) – sheet/reel stamps
- two principal schemes to be sectionalised between the two companies

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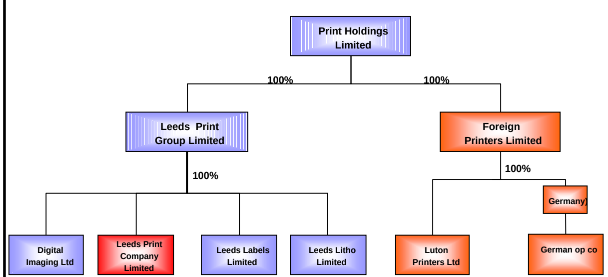
Group structure



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Group structure

- the pension scheme is currently an unsecured creditor – i.e. treated like any other trade creditor of the business
- schemes have deficits (per actuarial report at 1 April 2005) as follows

£m	Full buy-out	FRS 17	On-going
Other group	0.3	0.1	0.1
LPC	4.9	1.7	1.4
GSP	3.0	1.0	0.8
	8.2	**2.8**	**2.3**

Source: actuarial valuation

- PHL currently levies a significant management charge on the subsidiaries to cover salaries, rent and various other holding company costs (> £1m p.a.)

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Proposed deal

	LPC	GSP
Sale type	share	share
Excluded items	bank overdraft	**cash balance**
Consideration	£2.15m	£6.5m
- conditions	**fully deferred**	**fully deferred**
- security	**charge over shares and assets**	**charge over shares and assets**
Pension deficit acquired (FRS 17)	£1.7m	£1m
Management team investment	£50k	£100k

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Impact of the proposed transactions

- the table below demonstrates
  - the position of the Scheme in PHL (the current employer), pre-sectionalisation
  - the position of the sectionalised Schemes, post-deal, for GSP and LPC

	Pre-deal		GSP Post-deal		LPC Post-deal	
	High	**Low**	**High**	**Low**	**High**	**Low**
Dividend (pence in £)	100	44	-	-	15	-
Return to scheme (£'m)	8.1	3.6	-	-	.8	-
Shortfall to scheme (£'m)	**-**	**4.6**	**3.0**	**3.0**	**4.1**	**4.9**
	8.1	8.1	3.0	3.0	4.9	4.9

- we have used our experience and discussions with management to establish these subjective High and Low values
- the High valuation indicates sales achieved on a going concern basis (close to values reflected in the Company's balance sheet); the Low valuation reflects realisations on a break-up basis

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Impact of proposed transaction
LPC – estimated outcome statement

£'000	Book Value	Pre-restructuring Estimated to realise %	Best	%	Worst	Post-restructuring Estimated to realise %	Best	%	Worst
Assets subject to fixed charge									
Plant and machinery - net of finance	11		11		(18)		11		(18)
Assets subject to floating charge									
Other fixed assets	2,520	*100%*	2,520	*80%*	2,016	*100%*	2,520	*80%*	2,016
Stock	**1,278**	***80%***	**1,022**	***40%***	**511**	***80%***	**1,022**	***40%***	**511**
Debtors	983	*80%*	786	*40%*	393	*80%*	786	*40%*	393
Other	109	*0%*	-	*0%*	-	*0%*	-	*0%*	-
Cash at Bank	-		-		-		50		50
Available to preferential creditors	**4,890**		**4,329**		**2,920**		**4,379**		**2,970**
Employee arrears	-		(194)		(194)		(194)		(194)
Available to floating chargeholders	**4,890**		**4,135**		**2,726**		**4,185**		**2,776**
Deferred consideration	**-**		**-**		**-**		**(2,150)**		**(2,150)**
Fixed charge surplus	11		11		-		11		-
Available to unsecured creditors	**4,901**		**4,146**		**2,726**		**2,046**		**626**
Trade and other creditors	(2,217)		(2,201)		(2,219)		(1,286)		(1,304)
Pension scheme full buy out deficit	(4,877)		(4,877)		(4,877)		(4,877)		(4,877)
	(7,094)		(7,078)		(7,096)		(6,163)		(6,181)
Dividend rate (pence in £)	**69.1**		**58.6**		**38.4**		**33.2**		**10.1**
Return to pension scheme	**3,369**		**2,857**		**1,874**		**1,619**		**494**
Shortfall to pension scheme	**1,508**		**2,020**		**3,003**		**3,258**		**4,383**
Surplus available for shareholders	-		-		-		-		-

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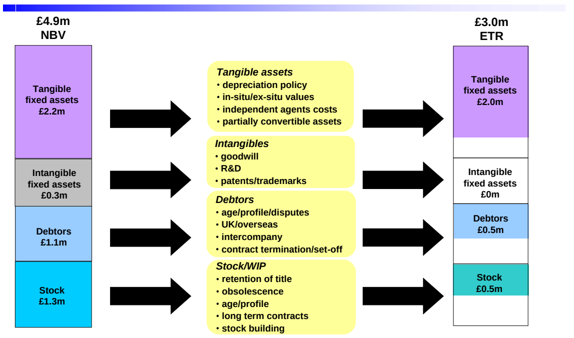
Estimated outcome statements
Valuing assets – pre & post restructuring



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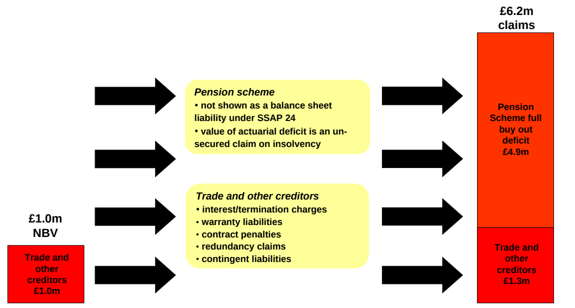
Estimated outcome statements
Growth of liabilities on insolvency



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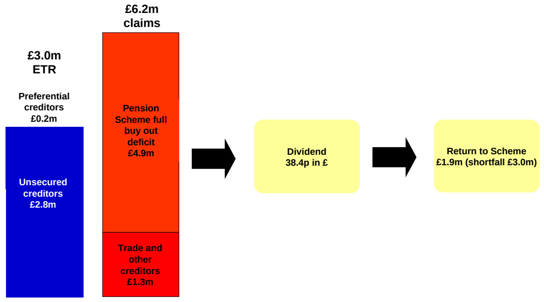
Estimated outcome statements
Return to the Scheme – pre restructuring



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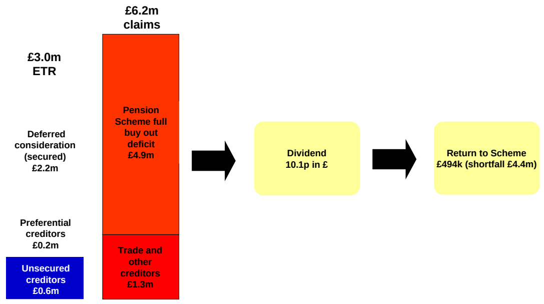
Estimated outcome statements
Return to the Scheme – post restructuring



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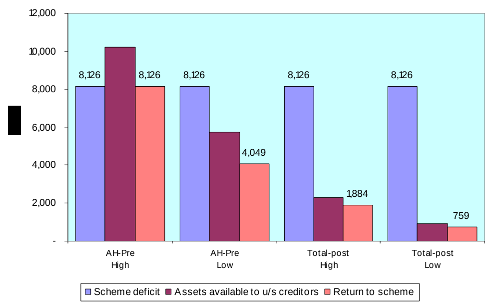
Impact of proposed transaction



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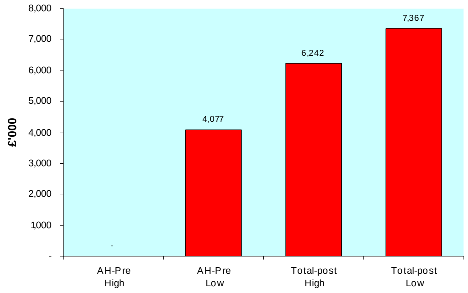
Impact of proposed transaction – loss to schemes



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Impact of the proposed transactions (2)

- should PHL enter insolvency proceedings now
  - if subsidiaries sold for value, Scheme is likely to be paid in full
  - if disposed of on a break-up basis, could be shortfall to the Scheme of £4.6m
- should MBOs fail, on a break up basis the shortfall to the scheme could total £7.9m (GSP: £3.0m; LPC: £4.9m) (less any monies that it has received from profits made by the businesses) – key reasons for the shortfall are
  - the exclusion of the freehold properties (c.£2m)
  - the exclusion of the cash balances (c.£2m) (partly absorbed by termination payments to director/shareholders totalling c.£600k; other notice payments of c.£400k)
  - the security taken by the shareholders for their deferred consideration

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Viability of on-going MBO businesses

- why look at viability?
  - to establish the future income available to continue contributions to the Scheme
  - to determine the approach of the Trustees
    - if businesses viable – FRS 17
    - if businesses not viable – full buy-out
- how do we look at viability?
  - review trading forecasts with the management team
  - understand and challenge the underlying assumptions
  - identify vulnerabilities
  - run sensitivities
  - gain sufficient information/understanding to form an overall view
- review focus - next 12 months trading – difficult to project accurately beyond this timeframe
- review of the FY07 forecasts may be appropriate in 12 months time

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Viability of on-going MBO businesses - LPC

- LPC forecasts challenging
- heavily loss making (even before management charge)
- turnaround of £1m+ to break even
- achievability of the trading improvements are uncertain
  - management team
  - efficiency gains
  - turnover gains
- price competitive market
- sensitivities suggest significant cash requirement
- represents a substantial risk to the Trustees

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Viability of on-going MBO businesses GSP sub group

- GSP appears viable
- retention of the key contracts critical
- significant trading improvements not required to hit forecast
- no management charge
- management team have stake in success
- the business is in a less competitive market than LPC
- price competition is less intense
- represents a more limited risk to the Trustees

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Our concerns

- transaction financially detrimental
- provides no immediate value – i.e. no further cash for the Scheme
- appears to prejudice members of the LPC and GSP Schemes
- Schemes denied access to certain key assets of PHL
- the shareholders of PHL benefit from notional value
- the MBO consideration is deferred, and secured ahead of the Schemes
- subsidiaries not marketed to determine true value
- LPC MBO – big risk of failure
- GSP MBO – vulnerable to loss of key customers
- deficit not eliminated 'as soon as practicable'

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Recommendations

- General
  - payment of a lump sum into the Scheme now from the cash available in PHL (projected cash at completion is c.£1.4m, including substantial notice payments to Directors)
- LPG
  - members dealt with by PHL
  - £265k buy-out contribution applied instead to LPC
- LPC
  - risk of failure high – therefore secure full buy-out benefits
  - security over freehold properties in PHL
  - fixed and floating charge over MBO assets
  - charge to rank ahead of deferred consideration
  - reduction in spread period to clear FRS17 deficit

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Recommendations

- GSP
  - appears viable (subject to key contracts) – therefore secure FRS17 benefits
  - reduction in spread period to clear FRS17 deficit
  - fixed and floating charge over MBO assets
  - rank at least equally with deferred consideration
  - charge over assets/shares of subsidiaries

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Outcome

- negotiated improvement of £6m - £7m
- LPC and GSP Schemes should be paid in full if PE fails
- members benefits protected

- BUT – latest developments
  - LPC in administration
  - PPF?
  - Trustees' position

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Lessons learned

- negotiations not straightforward
- first offer rarely the best offer
- will involve challenging the Directors/employer company
- will produce tensions not previously experienced
- get the Regulator's buy-in by sharing report and discussing issues early
- the cost of the process can be significant
  - initial investigation
  - protracted negotiations
  - legal costs

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SCHEME SPECIFIC FUNDING

What is the assessment of financial covenant seeking to achieve?

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What is sufficient and appropriate evidence to conclude on affordability and viability?

3rd party advice to assess viability and affordability

Type		Viability of sponsor	Affordability of recovery plan
	AAA		
NOT CONSTRAINED		**Prima facie viable, can clear deficit immediately**	
		Credit rating score gives sufficient comfort of viability. Minimum chance of failure in 1 year (technical provisions and recovery plan reassessed annually)	Assume affordability (at least in medium term)
		Assume viability (at least in short to medium term)	Credit rating is insufficient due to lack of assurance in forecasts. Accountants (skilled persons) report will be required for the determinations panel. Revised plan submitted
	BB+		
SOFT CONSTRAINED		**Competing demands for funds in the business**	
		Initial covenant assessment (ICA) is carried out by professional advisers - a report to assess the strength of the employer covenant (risk of failure of sponsor). Using historic data and general market knowledge it identifies issues that may impact of the strength of employer covenant and issues that require further investigation.	Review of forecasts to determine affordability of recovery plan to employer (assumptions, comparison to historic performance, external factors and sensitivities, performance drivers), assessment of competing demands on cash going forward
		Full scope report (finance professional) - historic data, estimated outcome statement, market information, assessment of management, cashflow, debt capacity	
		Extent/value of parent company or other group support	
HARD CONSTRAINED		**No finance available for necessary contributions to scheme**	
		Detailed viability review - profitability, trading patterns, benchmarking against competitors, projections, business plan, budget v actual, external factors effecting performance, sources of financial support, review forecasts	Estimated outcome statement - gives information of likely shortfall to PPF, risks to future performance, likely actions of other sponsor creditors and non core assets
		Assessment of future of sponsor (insolvency/recovery professional), likelihood of recovery and timescale of any insolvency, financial commitments attaching to assets	

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Any questions?

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Andrew leads our financial advisory offering to Pension Scheme Trustees and corporates. He has developed a national team to provide financial advice to Trustees of defined benefits schemes to assist an assessment of the financial strength of the employer and to negotiate improved security for the scheme.

This has involved advising on "clearance statements" and assessing the ability of the principal employer to meet proposed contributions.

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Darren is a Chartered Accountant and Insolvency Practitioner with 14 years' experience in corporate restructuring, including two years at RBS dealing with a portfolio of stressed and distressed positions.

Darren has recently returned from managing an assignment at the Pensions Regulator where he assisted the Regulator to formulate intervention strategy and approach to under-funded defined benefit pension Schemes and their associated sponsoring employers.

Darren has undertaken employer covenant review work for Trustees and Sponsoring employers to comply with the new Scheme Specific Funding Regime and for Clearance applications.

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