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Grant Thornton Pensions Advisory podcasts

3. Pensions schemes and transactions: transcript

Welcome to this series of Grant Thornton's Pensions Advisory Podcasts.

In this edition, we will be looking specifically at Transactions and some of the key issues and challenges they present to pension scheme trustees.

To make sense of those issues, I'm joined by my colleagues from the Pensions Advisory team, **Phil Green** and **Paul Heeley**, both of whom are very experienced pensions specialists who have worked over many years on a large number of employer covenant assignments where a transaction has been at the centre of the work.

Russell **My first question Phil to you is a simple one. When we say 'transactions', what specifically are we talking about?**

Phil A transaction is really any corporate activity which involves some change to the covenant which is being experienced by a pension scheme and provided by the employer.

We fall into two main categories: we've got third party transactions where someone is maybe coming in and buying part of a business or a business is being sold to a current employer; and internal restructurings. Today we need to concentrate on one so we'll look at the third party transaction issues more today than anything else.

Russell **Paul, what types of transactions have you seen in the last 6-12 months?**

Paul I've seen several leveraged buy-outs of the sponsoring employers of DB schemes where at least some of the transaction funding was sourced by placing additional secured debt onto the balance sheet, which had a detrimental effect on the covenant and mitigation was required.

One of the larger scale ones I've seen this year was the internal re-organisation of a manufacturing company, where the business streams were separated out. One was transferred away into the wider group and the other was allowed to stay in with the employer. This was done as a precursor to the sale.

We then had a subsequent piece of work where we looked at the actual sales transaction itself. Now in terms of the initial reorganisation, we had to check that the remaining part of the business to stay with the employer could generate sufficient profits and cash flow in order to support the covenant. Also there was the question as to whether the assets and the secured debt that remained with the employer would adversely affect the scheme's position as a creditor.

When it came to the sale itself, that was a straightforward exchange of shares for cash, so you would think there would be no problem with that. However, the current owner wished to redeem a large tranche of preference shares immediately prior to the sale and this actually caused a detrimental effect on the covenant. The employer in the end did not want the complication of getting involved with the regulator as part of the Clearance process, so they were willing to be flexible and they deferred the extraction of the cash from the employer for the preference shares over time and that was sufficient to address the detriment.

Russell **Phil are there any other kinds of key issues that are likely to impact the trustees in a situation like this?**

Phil Generally, you find if you are talking about corporate activity, as I said earlier, it's either an acquisition or a sale. You would generally expect an acquisition - because you're bringing an additional business into the current employer - to be a good thing. You're getting a greater business activity trying to support the pension scheme. There are a couple of things you need to think about in more detail, when you're looking at those. For example what else is coming with the business? If there's another pension scheme which is already attached to that business, you've got an additional funding requirement which is coming in to be met, so you need to consider whether or not the combination of the two businesses provides as strong a covenant for the two schemes as the single business on its own would against your own scheme.

You've also got to look at how is that acquisition being funded? If by bringing a business in, you are actually going to put a lot more leveraged debt on the balance sheet, that could have a huge detrimental impact on the covenant. Likewise if you are selling a business, you would normally expect that to be detrimental to the covenant, but is it going to be materially detrimental? For example if the business is lossmaking, it might actually enhance the covenant, because you're removing something which at the moment is providing some huge cash strain on your business.

The other thing to think about if you're selling a business is what's going to happen with the sale proceeds, because it's all very well and good to say we're losing a business but if it's sold at market value, you should actually be exchanging a business for a pile of cash. So what's the employer then going to do with that pile of cash? If you're going to whisk it all out and take it as dividends then that's not a good thing for the covenant. If however it's going to be invested, either in improving the current business and therefore making it more profitable, or even paying dividends or paying a distribution out to the pension scheme, that could actually enhance the covenant. So you need to look at just more than the big picture and actually get down to the detail; and the minutiae of what's happening to understand exactly what the impact is.

Russell **What about transactions where there is no re-financing element? Have we noticed any key issues there trustees should be aware of?**

Paul There are several things trustees should be aware of, because on the face of it, a straight forward exchange of cash for shares in an employer should be very easy to deal with. There's no impact on the covenant, particularly if there's no alteration of the financing structures attaching to the employer. In this case the trustees have to be alive to what the plans of the new owner are for the employer's business. Does it intend to grow the employer's business *in situ* by investing? There's then the question of how is that investment to be executed? Is it to be executed by the introduction of debt onto the balance sheet, which will doubtless be secured and may therefore have an adverse impact on the covenant, at least in the short to medium term.

Alternatively, does the future owner of the business have plans to hive off parts of the employer's business? I've seen instances where businesses have been transferred away from the legal entity of the employer, which has been retained purely to maintain the use of the trading name, but it's destroyed the covenant. I think in this case, trustees have to be aware of what the prospective owner of the business' attitude to is towards pension scheme funding. For example, does the new owner see the pension scheme as something that should be put on a de-risking flight path, with a view to eventually achieving full funding in a buy-in or a buy-out? Or does the new owner see the pension scheme as a potential nuisance and therefore wishes to keep return-seeking assets as high as possible in the scheme's portfolio, keep deficit repair contributions to a bare minimum and just kick the can down the road.

Russell **I'm assuming the Regulator gets involved at all levels here? They must have a very close interest?**

Phil Well the regulator is obviously very concerned by any type of transaction, but where there's a material detriment there is a process called Clearance, whereby you can go to the regulator and effectively ask him to confirm that he wouldn't use any of his moral hazard powers. The issue with Clearance though is who applies for it? It's normally the acquirer of the business, who wants to make sure they're not picking up anything they're not aware of or are they going to get hit with a request from the regulator to provide further funding to the scheme over and above what they were already expecting to get. Or by the seller, who actually wants to get a clean break from his previous obligations to fund the pension scheme so he can move on and do whatever he's going to do after the sale, with a fairly clean pair of hands and an understanding that someone's not going to be knocking on his door a couple of years down the line saying "oh by the way you've got put some more money back into that pension scheme you used to own". So they do get involved, the regulator in particular is keen to make sure trustees take appropriate advice and they are just trying to regulate as much as anything and make sure there are no issues that haven't been thought about or considered.

You don't have to go for Clearance, because if in the discussions between the parties, detriment is recognised and appropriate mitigation is put in place, then you don't have to go for Clearance, but going for Clearance is probably the only clear way you can actually get an understanding of whether the regulator is going to use his powers at a later date.

Russell **Paul, Phil mentioned moral hazard. What are the key issues there that trustees need to keep in mind?**

Paul Well, the two main powers the regulator has under its moral hazard provisions are Contribution Notices and Financial Support Directions, both of which without going into far too much detail are designed to address a detrimental effect on the scheme's covenant as a result of a transaction.

The use of these powers though has to be reasonable and if the regulator considers the facts and doesn't think it's reasonable to exercise those powers, then it will step back and avoid doing so. For example, although a transaction may be considered to be materially detrimental to a covenant of a sponsoring employer, if, for example, parties to the transaction have had no material benefit from that employer over the past few years, then the regulator may consider that it is not reasonable to exercise its powers.
As Phil said, the Clearance process should be used when all parties are sure that there is a material detriment to the covenant and when they want assurance from the regulator that the mitigation that is proposed to address that detriment is sufficient, and all the regulator is saying by granting Clearance is that it will not use its moral hazard powers

Phil Reasonableness is a commercial stance in effect, as Paul said, it is looking at the flows of benefit that have gone to and from the parties and trying to weigh up whether or not a party has had an unnecessary level of benefit out of the employer, which has left the pension scheme in a distressed position. It is very much a commercial view being taken, it's fairly wide, it can go out to any associated or connected parties and the regulator has fairly extensive powers as well for requesting information when it's undertaking moral hazard to see whether or not it can assess whether or not that benefit and how that benefit has flowed. It's an issue and it's something which needs to be taken into account when considering any transaction.

Gentleman, thank you. Thanks for your time and thank you very much for watching. As usual you can find all the information you will need on this complex subject, including a transcript of this podcast, on our web pages at **http://www.grantthornton.co.uk/pensionsadvisory**

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