

Pensions issues in M&A

Deal planning continues despite the 'credit crunch' creating a lull in headline grabbing M&A. Pension issues are centre stage in many deals.

New and recent legislation and a change in focus and attitude from trustees mean that pensions have the potential to break or, in some special cases, even make the transaction.

Watson Wyatt's corporate consulting group seminar on pension issues in M&A (4 December 2007) was attended by 65 delegates, comprising senior finance, treasury and pensions executives, and their legal and financial advisers. This note summarises the survey voting results gathered during the seminar. Key points to note are:

- **pensions are a significant factor in deals** with almost 90 per cent rating their pension scheme as an issue, and almost half saying it is a major factor or potential deal breaker
- **accounting measures are no longer the automatic benchmark** for pension funding in deals, with almost all delegates anticipating targets above 100 per cent of the IAS 19 accounting measure if they were a buyer (admittedly with a vested interest in arguing for a high figure!)
- **deal structures influence perspectives on pensions** with leveraged buy outs likely to see demands for significant extra pension funding or guarantees compared to trade buyers – delegates suggest an average 'demand' of perhaps some 5 to 10 per cent greater
- **pension scheme trustees are increasingly well prepared**, and advised, on employer covenant issues and the implications of deals, with more than two-thirds of delegates reporting ongoing monitoring in place
- **trustees are willing to negotiate** and have clearer goals in terms of funding or security in mind – almost 50 per cent have considered in advance how they would respond to a bid
- **corporate sponsors and potential bidders need to be on top of pension issues** from the planning stage – delegates' number one action priority is getting the board fully up-to-speed on pensions.

Figure 1 | If your company was a bid target how significant an issue would your pension scheme be in the deal?

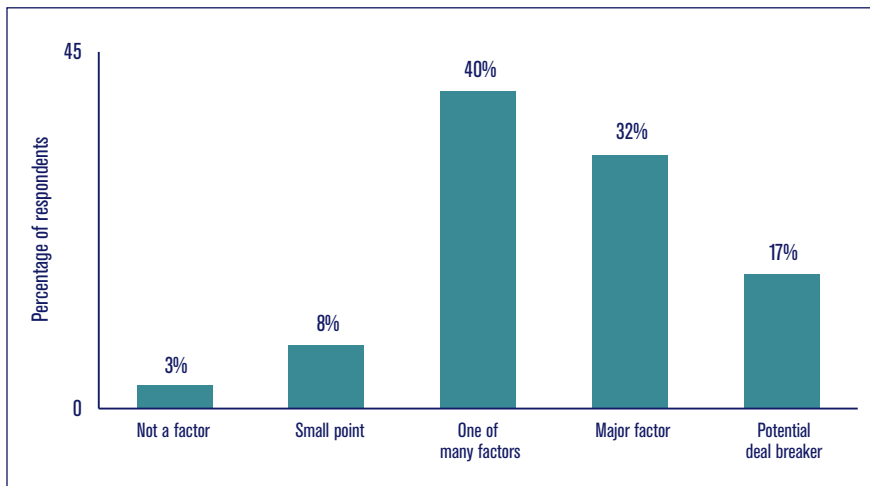


Figure 2 | Comparison of the quantification expected to be made for DB liabilities in the purchase price by investment grade and leveraged buyers



Pensions have very definitely arrived on the M&A scene, whether as a potential deal breaker or, for some specialist buyers, as a key reason for the deal. Pension scheme trustees, supported by the Pensions Regulator, are increasingly prepared to flex their muscles and seek to negotiate with bidders – corporate sponsors and potential bidders need to be prepared accordingly.

How significant are pensions in a deal?

It is clear that pensions are an issue in deals – 49 per cent of delegates view their pension scheme as either a major factor or a potential deal breaker in a bid situation, with a further 40 per cent seeing it as a factor that needs to be addressed (see Figure 1).

Impact of deal structure

While the first round of scheme specific funding valuations shows a trend for many funding targets to be set at or around the IAS 19 accounting measure, in an M&A situation (perhaps not surprisingly) delegates expect a higher level of funding to be factored in to prices by buyers. A recent internal survey indicated that these wishes may not come to pass – in most cases, the allowance for pension liabilities in the purchase price is at around the accounting level.

Significantly, while pensions is an issue in almost all deals, there is a clear difference of perspective for a strong, 'investment grade' purchaser versus a leveraged buy out (LBO) bidder. Figure 2 illustrates the higher pension funding target that delegates expect to see demanded by the bidder in an LBO. This higher amount clearly could have a material effect on deal pricing or even viability.

Trustees' view on covenant is a key driver

In the new pensions regime, pension scheme trustees are encouraged to consider the impact of an M&A on the sponsoring employer's covenant. Not all trustees have yet had to focus on a deal but the scheme specific funding regime has also concentrated attention in this area.

Over two-thirds of delegates reported that their trustees now have in place regular monitoring of the employer covenant, with almost all the rest having undertaken a one-off review. This puts trustee boards in a much better position to undertake a 'before' and 'after' assessment of the covenant in an M&A situation to consider what action, if any, is necessary.

It is also noticeable that slightly more have relied on an internal assessment, based on the knowledge and skills present in the trustee group, than have appointed external advisers (see Figure 3).

Whilst almost all trustee boards have made some form of covenant assessment, delegates believed that fewer (slightly under two-thirds) have considered what action they would take on funding in the event of a bid emerging, with 28 per cent proposing stronger funding or additional security (see Figure 4).

Priority actions ahead of a bid

If a bid is on the horizon, what steps should you take to prepare? Delegates' clear priority was to ensure that the company board is fully up-to-speed on pensions. An illustration, perhaps, that even with many companies having undertaken their first scheme specific funding valuation there is still room for board members to gain a stronger grasp on wider pension issues, and particularly their significance in a deal situation (see Figure 5).

Figure 3 | Has your scheme's trustees carried out a covenant assessment, was this one-off or do they monitor it on an ongoing basis, and do they use internal expertise or an external covenant assessor?

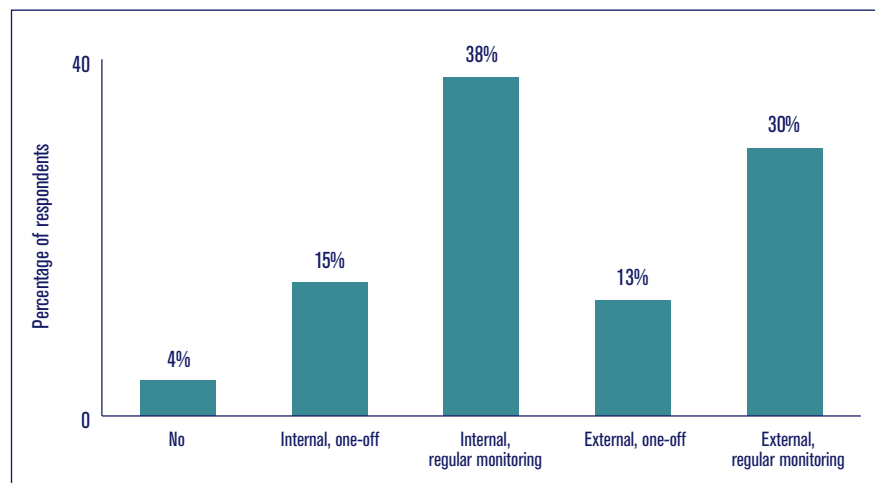


Figure 4 | Has your scheme's trustees thought through the implications of a possible takeover and considered what measure of liabilities they would focus on in discussions with a bidder?

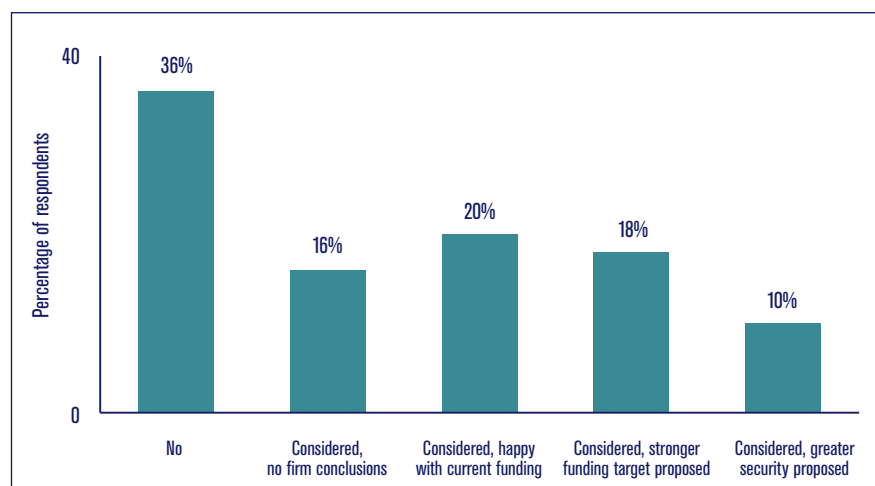
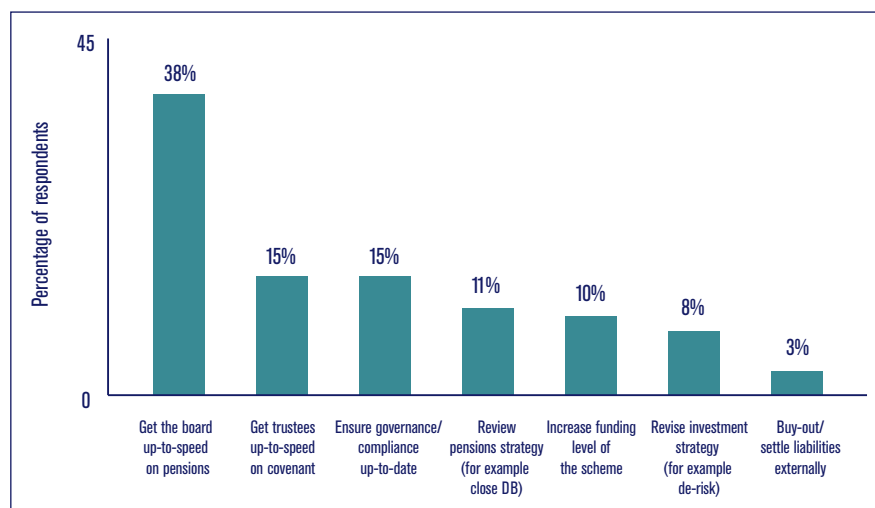


Figure 5 | If your company was going to be a private equity bid target in a year's time what would be your top priority action to take in the meantime on pensions?



Conclusions

The key themes emerging are:

- pensions are a significant factor in M&A, whether as a potential deal breaker or, for some specialist buyers, as a key reason for the deal
- pension scheme trustees, supported by the Pensions Regulator, are increasingly well prepared to understand the implications of deals and seek to negotiate directly with bidders
- corporate sponsors and potential bidders need to build pensions into their planning from the outset and be prepared to engage with trustees at an early stage to avoid delays and difficulties at a critical stage of the deal.

Watson Wyatt's corporate consulting group

Watson Wyatt's corporate consulting group helps companies optimise the risk and reward management of their pension and employee benefit arrangements, on an ongoing basis and in M&A situations.

Companies are faced with increasing costs and risks, decreasing control over their obligations, and full settlement of the problem can be (at least in the short term) unaffordable. The issues that need to be addressed lie on a spectrum between managing the legacy (dealing with past obligations efficiently and effectively) and strategy for future business (implementing solutions to drive the business forward).

We offer practical, business-focused advice to clients across this spectrum of issues.

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