

Parenting problems

Mergers and acquisitions

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Simon Kew and Tom Partridge offer guidance to trustees on managing the relationship between the employer covenant and an overseas acquirer

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In a nutshell:

- Companies within the UK were the most sought after targets for acquisition in Europe in 2015 and the outlook for 2016 remains buoyant
- A corporate transaction involving an overseas business may, at first glance, appear to herald a period of great uncertainty for trustees of DB schemes
- Trustees should approach the possibility of an acquisition, from overseas or domestically, by being balanced, diligent and proactive

Much has been written lately on the rise of mergers and acquisitions, particularly the increase in activity from the US and Asian deal corridors. Little, however, has covered what this means for the sponsors and trustees

of defined benefit (DB) pension schemes and what can be done to protect the beneficiaries of these schemes.

2015 activity

2015 saw an unprecedented value of mergers and acquisitions (M&A), with global volumes reaching US\$4.7trn. This is only the second time the \$4trn mark has ever been passed and an increase of around \$1.4trn on 2014 levels.

Recent Deloitte research* shows that international investment in Europe is strong. For example, the majority of the money which Chinese (\$66bn) and Japanese (\$56bn) companies had spent on acquisitions by mid-November was invested in the EU. We wait to see what effect recent fluctuations in Asian markets will have on this activity.

Narrowing all of this activity down to “home shores”, companies within the UK were the most sought after targets in Europe, with \$313bn in M&A investment from both Eurozone and overseas acquirers.

Outlook for 2016

2015 was the first year that Asian M&A deals exceeded those in Europe. Looking to 2016, Chinese and Japanese investment overseas is expected to continue, plus a stronger US dollar will make some foreign investments appear more attractive. These factors, along with favourable debt market conditions, attractive valuations and a positive growth outlook, will continue to offer opportunities for dealmakers.

Level of commitment

All of this activity poses the question for the trustees of DB pension schemes: “What might an overseas acquirer mean for me?” The level of commitment to the UK business is important to understand. It may be that a particular brand, licence or product was the key driver for the acquisition and is one part of a long term programme of investment. The scheme sponsor may find itself with access to new products,

services and markets as a result of the deal. Alternatively, there may be plans to reduce costs by relocating offshore.

Proposed intra-group funding and treasury arrangements could be significant. The new parent may introduce inter-company loans that might place a higher burden on the sponsor. Exposure to potential fluctuations in foreign exchange should also be considered, especially in the context of any transfer pricing measures or cash sweeping facilities that draw funds to another country at the end of the working day.

The scheme may gain access to greater resources from an overseas parent or group, opening up the possibility of a parental guarantee, cash in an escrow account, asset backed contributions or even positive/negative pledges.

As part of the transaction, an acquirer may prefer the certainty of removing fluctuations in pension deficits by foreshortening the current schedule of contributions and reducing the recovery plan length. There have even been instances of a new parent buying out benefits with an insurance company to take all pension related ambiguity off the balance sheet.

Conversely, if the benefit is being passed through the group, the UK Pensions Regulator may find it more difficult to enforce its authority in certain territories – especially piercing the corporate veil using their “moral hazard” powers.

Gaining an understanding of the overall risk profile of the acquirer can be more complex when they are based overseas. The risks to the new parent and even their existing benefits arrangements can be of vital importance, especially when considering overarching strategic or political influences – for instance, a state owned business.

As you can see, there can be many elements to every transaction and, therefore, making an efficient and accurate assessment of business deals can be challenging, especially if the trustees are not experts in the business, sector or even culture of the acquirer. This is where open discussions with the sponsor (who will probably be asking similar questions to the trustees) and access to sector and jurisdictional expertise, from a covenant adviser with global reach, is absolutely essential.

Paternalistic approach

As with any corporate activity, involving an overseas party or not, it is essential to assess the position before and after the transaction – primarily the changes to the employer covenant. The sponsor may alter or become part of a much wider group, which may bring opportunity or adversity.

Occasionally, a purchase leads to noteworthy changes of personnel on the board of the sponsor. When a senior executive, who may be a member of the DB scheme, leaves, there may be a significant strategic change of direction – perhaps moving away from a previously paternalistic approach.

A buyout may be leveraged, meaning debt has been raised to fund the purchase. Understanding where that debt sits within the group and how it may impact on the various entities is a must.

Trustees should revisit any existing guarantees or pledges, which could fall away or become diluted as a result of a transaction, and check the proposed principal and participating employers. This is another fundamental pillar of the scheme funding process, namely where the legal obligation to fund the scheme sits.

Strong relationship

The groundwork starts in building a strong relationship with your sponsor, well in advance of any transaction. If there is a regular flow

of information between both parties, via information protocols or standing items on a trustee board agenda, the likelihood of being involved in any corporate activity is increased. It is not unheard of for employers to request trustees to sign a non-disclosure agreement to help facilitate the exchange of information – particularly likely if the data shared is “market sensitive”. That said, it will be rare for an employer to share full details of a transaction, as business deals are rarely constructed around the pension scheme.

Information received should be evaluated, understood and questioned to appraise trustees of the complete picture. It is especially important that trustees are diligent in assessing the transaction, seeking robust support where required.

Where sponsors and acquirers are aware of the hurdles that are faced by trustees in assessing corporate activity – not least discharging their duties to beneficiaries – they may be more willing to involve trustees if they are confident that they will remain objective and balanced in their approach. This is why it is worth the trustees raising points that are important to the scheme.

These may include the various regulatory demands and expectations, effects on existing guarantees/pledges or even the powers that trustees may hold under the trust deed and rules.

We emphasise objectivity and balance because with many aspects of the scheme funding process looking at issues holistically, rather than taking an entrenched positional view, offers a significantly increased prospect of a positive outcome.

Trustees should explore with their advisers and through discussions with their sponsor what aims, concerns and interests each party has, with the intention of finding common ground

in addressing the pension liability. There will naturally be concerns where a sponsor is involved in corporate activity, not only from trustees and members but also vendors, purchasers and lenders. What is important to each of these will provide valuable insight into the transaction as a whole.

Continuing support

A corporate transaction involving an overseas business may, at first glance, appear to herald a period of great uncertainty for trustees of DB pension schemes. With levels of M&A expected to remain buoyant during 2016, this may be an issue that affects you in future.

The process remains the same for most deals, though, regardless of the location of the proposed parent: trustees should be pro-active in building relations with the sponsor; diligent in their assessment of the transaction; and balanced in their approach.

An overseas element can add complexity and ambiguity, which can be overcome by seeking support from a well resourced adviser with sector experience and knowledge of the relevant region. This is especially important, as any corporate representatives on the trustee board may have to step away from the process due to conflicts of interest.

The prospect of an overseas parent company will raise myriad questions. It is essential that trustees remain calm and objective, mitigating any detrimental effect on or crystallising improvements in covenant to ensure their scheme receives continued support for years to come.

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