Pension-driven restructuring

Key considerations for stakeholders

Pension deficit recovery plans are becoming longer and more complex. Despite increasing innovation in this space, the ongoing viability of some businesses is being threatened by the very existence of a defined benefit pension scheme.

Our team has seen a rise in the number of companies which cannot produce a credible recovery plan. Often, the underlying business itself remains profitable, but it is simply overwhelmed by its financial obligations to its pension scheme.

We have been at the forefront of developing methods to maximise the value accruing to the pension scheme as the major unsecured creditor, whilst recognising the only way for the business to survive and to be competitive is to relieve it from its pension burden.

In this paper we explore some of these methods and draw out the key considerations for stakeholders as they embark upon a pension-driven restructuring.

As a result of historically low UK gilt yields we are seeing pension deficits at an all time high.

Pension obligations are threatening the ongoing viability of businesses.

EY’s restructuring team has recently been involved in a number of assignments in which we have worked with our employer covenant and pensions actuarial experts to advise both corporates and trustees in delivering innovative solutions.
Background and current context

Gilt yields are at historic lows, as a result of quantitative easing and investors being driven to a ‘safe haven’ in the UK by Eurozone dynamics. These low yields mean that low discount rates are being used to discount pension scheme liabilities, thereby pushing up deficits.

As a consequence of these dynamics, the combined UK pension scheme funding position on the Pension Protection Fund (PPF) basis is at an all time high.

UK historic gilt rates

The EY ITEM Club expects a slow, uneven economic recovery. The Spring forecast announced expectations for the Bank Rate to remain at 0.5% into 2014, before increasing very slowly thereafter. In its most recent Spring forecast, it pointed to the continued expectation for long-term interest rates to remain low in the short term due to subdued growth prospects, forecasting yields on 10-year UK gilts to move just above 2% through 2013, before gradually rising as investors become more confident about economic recovery.

PPF scheme funding position

In light of burgeoning deficits and the apparent creation of zombie companies unable to fund their liabilities, management teams are looking for solutions to address capital structures.
Regulatory context

In response to growth in deficits, the Pensions Regulator (tPR) issued guidance in April 2012 which recognised that current economic conditions will put pressure on pension scheme funding and that the ability of employers to afford deficit repair contributions now varies widely. With respect to recovery plans it concluded:

► Irrespective of the current economic climate, recovery plans should still be based on what is reasonably affordable without compromising the employer’s long term ability to support the scheme.

► Current levels of deficit repair contributions should be maintained in real terms, unless there is demonstrable change in the employer’s ability to meet them.

► If deficit contributions are to be reduced, trustees need to justify the change.

► Most significantly, where employer covenant has weakened and it cannot afford to continue contributions at previously agreed levels or is unable to pay more in respect of a larger deficit, trustees may need to agree to a longer term recovery plan.

tPR’s guidance encourages trustees to remain pragmatic in not forcing companies into financial difficulty as a result of pension obligations. However, affordability remains key.

Despite this, many schemes face upcoming actuarial valuations with significant concern. A growing number of trustees are now questioning whether the sponsoring employer has the ability to recover the deficit, no matter the period given.
Key points to consider in assessing the appropriate solution

Is the business worth saving and is insolvency otherwise inevitable?

For a pension-driven restructuring to be viable, the business must be well placed to trade successfully without its pension scheme. Solvent pension-driven restructurings are generally effected through a Regulated Apportionment Arrangement (RAA). Such a solution ensures regulatory buy-in to any proposal. The basic mechanism for a RAA is set out below.

Common drivers for corporates and trustees towards a RAA solution may include:
► The lack of funding for the business in light of its pension obligations.
► The need for the operating business to remain solvent to preserve value.

Pre-conditions for a solvent solution

The Pension Protection Fund (PPF) has issued guidance which sets out a number of preconditions which must be met for a solvent compromise to be approved:
► The company will inevitably become insolvent, within 12 months, unless a solution is reached with regard to the pension scheme.
► The value to the PPF for entering into a RAA is ‘significantly greater’ than it would achieve in an insolvency.
► Use of moral hazard powers (Financial Support Directions or Contribution Notices) by tPR would not yield a better outcome for the pension creditor.

A key benefit of a solvent RAA solution is the regulatory buy-in achieved. This ensures that moral hazard powers will not be used retrospectively in relation to the transaction, which can be a key driver of stakeholder behaviour (particularly shareholders).

Illustrative structure

1. Newco is made insolvent
2. Thereby enabling the scheme to drop in to the PPF
3. In return for taking the scheme the PPF will take:
   a) A cash contribution (one-off); and/or
   b) An equity stake in the trading business
a) Cash contribution potentially augmented by actual or deferred contribution from the trading company
b) Furthermore there may be negotiation over the equity stake, with the PPF taking 10% if the owner is new and 33% if the ownership structure remains as before
Multiple stakeholders

Distressed businesses will, in most cases, have a multitude of stakeholders, all interested in achieving an optimal outcome for themselves and each other with varying agendas.

- **Management**
  - Want ability to grow the business
  - Need to be able to attract new capital to do this
  - Management incentivisation

- **New customers**
  - Interested in creditworthiness and reputation
  - Focus on the financial health of contractual counterparty

- **Existing customers**
  - Reliance on the business for supply and ability to find new provider
  - Will want business to deliver on any existing contracts
  - Relevant procurement rules may be a factor

- **Existing owners**
  - Keen to see return on investment
  - Will assess likely financial performance without the scheme vs. historical performance
  - Need platform to enable growth to achieve return
  - Unlikely to have appetite to introduce new capital (sweped away by the scheme)

- **Employees/members**
  - Protects the interests of scheme members
  - Duty to minimise calls on the PPF
  - Will be willing to listen to solutions
  - Has powers to ‘force’ connected parties to contribute through Contribution Notices or FSDs
  - Provides compensation to pensioners whose sponsoring entities have become insolvent
  - Seeking to minimise the PPF deficit of the scheme as it enters

- **The PPF**
  - Must act in best interests of members
  - Cannot jeopardise PPF entry eligibility

- **The Pensions Regulator**
  - Retain jobs
  - Best possible benefits from pension

- **Trustees**
  - Must act in best interests of members
  - Cannot jeopardise PPF entry eligibility

- **Optimal solution**
  - Protects the interests of scheme members
  - Duty to minimise calls on the PPF
  - Will be willing to listen to solutions
  - Has powers to ‘force’ connected parties to contribute through Contribution Notices or FSDs
  - Provides compensation to pensioners whose sponsoring entities have become insolvent
  - Seeking to minimise the PPF deficit of the scheme as it enters

- **Contribution Notices or FSDs**
  - Keen to see return on investment
  - Will assess likely financial performance without the scheme vs. historical performance
  - Need platform to enable growth to achieve return
  - Unlikely to have appetite to introduce new capital (sweped away by the scheme)
Deal structure and price

The price of an acceptable solvent compromise must be ‘significantly more’ than insolvency. However, in our experience this can often be difficult to define and a somewhat subjective basis for determining value. Often a company will look at a ‘worst case’ insolvency scenario and offer a one-off cash contribution which looks good in that context. However, the PPF are inclined to start from the position of the value created for shareholders by the removal of the pension scheme and negotiate from that point.

We have seen significant differences between these figures, which are often hard to reconcile and/or bridge. However, we believe that having an appreciation of the other side’s position is always helpful in entering these negotiations.

A significant development in this arena is the use of a scheme ‘deficit-for-equity swap’. This approach is demonstrated by the Uniq plc pension scheme compromise agreement reached in 2011. Uniq, its Trustees and the Pensions Regulator worked to put a structure in place in which c.90% of the sponsor’s equity was transferred for the benefit of the pension scheme. In this case the PPF did not want the scheme to hold the equity risk for any significant period. It therefore gave the scheme a finite period to sell the equity stake and unlock value in the underlying business, which was successfully completed after a £113mn bid from Greencore. This solution was successful in:

► Unlocking the value in the underlying profitable business through removal of the pension obligation.
► Delivering sufficient value to the pension scheme, through the sale of the shares, to keep the scheme out of the PPF.
► Providing an improved return to pre-existing shareholders as the 10% ownership which they held post transaction realised more than the market capitalisation of Uniq plc prior to the pension restructuring.

There is a growing recognition that there can be significant value in the equity of these companies immediately following their being relieved of their pension obligations. There is also a trend towards recognising the commercial reality of these situations – that as the largest creditor for the scheme is effectively the beneficial owner of the business. This may lead to more weight being placed on the value of the pension scheme’s equity share in restructuring situations and, consequently, more involved negotiation around what this should be.
Case study 1: Liberata, a solvent solution

EY acted as financial advisor to Liberata Limited during 2010 as it sought a solution to the fundamental issues caused by its overwhelming pension deficit.

Liberata is a business process outsourcing business servicing both central and local government. It was seeking relief from its pension scheme liability (c.£160mn on an ongoing basis), which was significantly in excess of its turnover (£112mn) and EBITDA (£5–6mn). It was also a significant factor in a balance sheet net liability position of £67mn (based on an FRS17 deficit of £58mn).

The key issues driving the need for a solution were as follows:

Business issues:

► Historic issues — the reduction in size of the business had resulted in the scheme being disproportionately large.

► Long term contract business — customers were reluctant to enter long term outsourcing contracts due to balance sheet weakness caused by the pension deficit. These contracts were subject to EU procurement rules and were terminable upon insolvency. As such, any solution involving an insolvency of the trading business was unpalatable.

► External financing — banks had withdrawn facilities a number of years ago. Liberata's PE sponsor was the only provider of debt. Liberata was also experiencing a tightening of credit terms from its suppliers.

Pension scheme:

► The scheme was a legacy of a larger business, and a number of employees transferred from the public sector on generous benefits. Furthermore the investment strategy of the scheme was a heavily 'return seeking' one.

► Recovery plan requirements — after the scheme valuation, the trustees approached management with a 20 year recovery plan requiring £6.3mn per annum of cash contributions and 3.25% over gilts in equity outperformance. This was considered unaffordable and too risky in the context of Liberata's EBITDA.

The required solution needed to secure the future of the business and facilitate growth, and in so doing take into account the positions of the key stakeholders.

It was apparent that the 'ideal' solution from a Liberata perspective would be a solvent compromise. The PPF deficit was too great for the business to fund and the PE sponsor was unwilling to fund the deficit. Furthermore there was a need for a solvent balance sheet, with no residual deficit deemed acceptable. Also, the EBITDA multiple value of the business was significantly less than the scheme deficit, meaning ‘deficit for equity’ ideas were not considered viable.

Throughout this deal we observed clear parameters for negotiating with pension stakeholders, notably:

► Trustees must be engaged throughout the process and, agreement with the trustees is required before tPR/PPF will enter negotiations.

► tPR/PPF can often be driven by a concern for setting precedent in their decision making.

The business was successfully sold to private equity firm Endless with a contribution to the PPF of £12mn. In completing the transaction, the EY solution successfully navigated a complex negotiation involving multiple stakeholders with competing agendas and ensured the survival of the company and a large number of jobs, leaving Liberata well placed to trade profitably going forward.

EY role

- Feasibility study
- Detailed independent business review (common platform)
- Lead Adviser during negotiations with pension stakeholders
- Lead Adviser in accelerated M&A process
- Company voluntary arrangement (CVA) of 'NewCo'
How appropriate is the use of insolvency?

Insolvent solutions are a viable alternative to a RAA, and are often effected through the use of a ‘pre-pack’. Insolvency results in the scheme entering the PPF but without the need for lengthy negotiation around value. The key factors in determining if a pre-pack solution is appropriate will generally include:

► Whether the business, financially and reputationally, could withstand an insolvency event.
► The availability of a buyer for the business.
► ‘Moral hazard risk’ should be considered low (we discuss moral hazard in greater detail later in this paper).

Under the UK insolvency framework there are stringent requirements which must be met to enact a pre-pack:

1. A robust marketing process must be undertaken in the context of pension deals and appropriate parties must be given appropriate access and information. This makes it impossible for a deal to be done completely ‘behind closed doors’.
2. An ‘Administrator in waiting’ must be comfortable that the process will be in the best interests of creditors (under Statement of Insolvency Practice 16).
3. The sale must be of business and assets rather than equity to leave the pensions scheme behind.
In the case of Silentnight the pre-pack solution was deemed the most appropriate as a result of the following considerations:

- The limited impact of insolvency on key contracts and the reputation of the business.
- The debt value being greater than the enterprise value of the business (including the pension deficit).
- The debt providers being of the view that they were willing to pay most for the business in an accelerated disposal situation.
- Moral hazard risk was considered low.

Attempts to arrive at a solvent deals with the PPF had failed, for example a high profile CVA proposal was ultimately not pursued.

Whilst the attempts to arrive at a solvent compromise were being made, an ‘Administrator in waiting’ simultaneously undertook an extensive marketing process for the business. This allowed the ‘Plan B’ pre-pack solution to be implemented promptly, with the business and assets sold to a NewCo. As part of the transaction the pension deficit remained in the old Silentnight entity, along with other creditors, the proceeds of the sale and some residual debtor balances. This allowed the NewCo to continue to trade without any disruption and free of the constraints previously imposed by its pension scheme.

The pension scheme entered the PPF assessment period by virtue of the insolvency of the sponsoring employer and its return depends wholly on the insolvency process. As there was no regulatory buy-in to this course of action there remains at least a theoretical risk of moral hazard power being used. Albeit this risk will have been at the forefront in stakeholders’ minds as the decision to enter insolvency was taken.

**EY role**

- Advised debt holder – negotiation with pension stakeholders
- Advised on practicalities of alternate (solvent) options for buying business
- Debt holder (purchaser) support through pre-pack process
Moral hazard

Are there entities in the group that have benefited from their relationship with the pension scheme’s sponsors? These entities could be at risk of receiving demands for financial contributions towards a scheme’s deficit under tPR moral hazard powers. The structural complexity of the employer covenant and sponsoring group will impact on the risk of moral hazard powers being applied by tPR. tPR will assess the potential realisations from such entities before assessing the appropriateness of, or price for, a solvent compromise.

Key benefits and issues of pension restructuring solutions

Stakeholders need to determine the appropriate solution for the financial constraints imposed on a business by its pension scheme. Our experience shows that despite challenging circumstances, positive outcomes can be achieved.

### Solvent solution (RAA)

- Cash contribution to scheme, significantly below deficit
- No insolvency event (reputation/value)
- Current shareholder can retain controlling stake and management remain in place
- PPF tends to be a silent shareholder – business as usual:
  - Potential to buy PPF out dilutes over time
- Clearance Statement has to be obtained from tPR – reduces risk of use of moral hazard in future
- Pre-conditions must be met
- Need to reach agreement with tPR and PPF – complex process which may be challenging
- Requires a cash sum which is ‘significantly greater’ than that which would be received under an insolvency outcome:
  - PPF focus on ‘value created’
- Sacrifice of equity stake
- PPF will have certain rights that it could exercise as shareholder
- Contingency plan required – if deal fails business enters insolvency
- Risk of negotiations leaking to market

### Insolvent solution (pre-pack)

- Pension deficit left behind – subject to tPR moral hazard powers
- Shareholders/management could retain 100% control of the business if successful in pre-pack sale process
- Potential for pension to be removed from the company for less value than under a compromise agreement (both in terms of cash contribution and giving up equity)
- Existing debt holders or shareholders can have advantage in accelerated bidding process due to knowledge of the business and ability to credit bid
- Business will have to be actively marketed to the satisfaction of the administrator:
  - Third-party buyer could emerge
  - Business could be split up
  - Competitors may get a ‘look at the books’
- Which legal entities are being pre-packed?
- Management would need to find funding for the acquisition
- Ransom payments usually necessary
- Moral hazard risk ongoing

Merits

Issues
**Summary**

We foresee an increase in the number of situations where pension schemes themselves create distress within the sponsor.

There are accepted solutions which may offer the corporate a way out from the grip of its pension deficit, whilst preserving the underlying business. This can involve a complex decision-making process with challenging negotiations and multiple stakeholders. It will also require an appropriate ‘pricing’ exercise, which amounts for both stakeholder news and market testing; and deal structuring to be completed in order to execute a solution.

EY has experience in dealing with these dynamics, both in terms of taking a company through the process to a solvent compromise and advising clients around insolvency-related options.

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