Zombie funds need touch of voodoo

When Ericsson acquired the majority of Marconi's business in 2005, the treatment of the Marconi UK pension scheme was a key feature. The Pensions Regulator required an immediate cash injection into the scheme of £185m and the creation of a £450m escrow account for the scheme. The scale of the additional support caused some surprise when viewed against the estimated FRS 17 *Retirement benefits* deficit of £140m, but less so in comparison with the estimated buy-out deficit of £1.2bn.

The detailed methodology used to estimate the buy-out deficit has not been generally disclosed, but it may not have taken into account a report[1] presented to the actuarial profession in November 2005. The report suggests that the guidance historically provided to pension actuaries in estimating buy-out values may consistently have underestimated liabilities (through a combination of factors including mortality, discount rates and reinvestment risk), although the leading actuarial firms have generally tended to use more conservative values. The paper does not provide a rule of thumb for correcting for such factors, but if we were to assume an average increase of 10%, this would raise the Marconi buy-out deficit at the time to £1.56bn, although this obviously leaves aside the fact that the deficit will probably have increased over the last few months as a result of falling bond yields.

It is generally accepted that for closed pension schemes the economic liability will approach the buy-out liability over time, so why did the Pensions Regulator agree to a level of support less than the then buy-out value? Presumably, the parties to the transaction argued successfully that the residual Marconi business (renamed Telent) had sufficient resources to continue to fund the scheme and that winding-up was neither necessary nor appropriate. Marconi's directors estimated that Telent's pro forma annual turnover would be around £330m, but even so it is difficult to see how the value of this business could have been estimated at more than £200m or so. This would still have left a shortfall of almost £400m compared with the then buy-out value (or, to look at it another way, a buy-out funding level of around 90%). The Pensions Regulator may simply have thought the Ericsson bid the best outcome for the foreseeable future as it provided a level of funding safely above that required for Pension Protection Fund (PPF) purposes.

The Marconi directors also said they believed a more competitive secondary market for pension fund assets and liabilities might develop, allowing Telent to dispose of them while continuing to protect member entitlements. The market for pension assets – largely quoted securities – is already highly liquid; the real issue is whether a liquid market will also develop for pension liabilities.

At the time of the acquisition, the media and investment banking community forecast the rapid development of 'zombie' funds to buy up the liabilities of pension schemes. After all, the purchase of closed life companies is now commonplace. Since then there has been further speculation that high-profile individuals from the life assurance sector are developing such vehicles, perhaps to be announced very soon. But if zombie funds are brought to the market, who is likely to do so and what might they look like?

There are several problems with this, which can be divided into two categories: technical and regulatory.

Any company managing a portfolio of pension liabilities has to deal with interest rate, inflation and mortality risks. The manager can choose to take on other risks, such as market risk, credit risk and currency risk, but does not have to do so. Interest rate risk can be hedged by choosing an appropriate bond portfolio and, if necessary, overlaid with a derivatives portfolio to fine-tune duration and convexity. Inflation risk can also be hedged by choosing appropriate bonds and derivatives, although the market for such products is less deep and many would argue that this is not the right time to be buying index-linked gilts given that real yields are close to an all-time low.

The more difficult risk to manage is mortality. Aggregate historic mortality data for pension schemes (as opposed to life offices) are hard to come by, and future mortality trend models are poorly developed. There is still no market in bonds with mortality features and the market for mortality reinsurance is limited. Surprisingly, the UK government's Debt Management Office has said it detects no real interest from institutional investors in mortality-linked gilts.

At least two parties could be involved in regulating zombie funds – the Financial Services Authority (FSA) and the Pensions Regulator. Since any fund of this type set up as an insurance vehicle would be subject to the normal rules on minimum capital, the temptation must be to try to avoid these rules, but is this feasible? The public response to the attempted purchase of a pension scheme by a special purpose vehicle deliberately structured to avoid FSA regulation is unlikely to be positive. The alternatives would have to be considered in any specific situation, but in cases where the existing sponsor is in financial stress, the existence of the PPF will provide an automatic benchmark for members at a buy-out funding level probably between 70% and 80%. It is hard to see the Pensions Regulator sanctioning any such transaction where the combination of initial funding, future cashflows, contingent funding and sponsor creditworthiness did not approach a significant proportion of a buy-out level of funding in the long term. Financial engineering may provide some scope for arbitraging between the costs of contingent and actual capital, but the fact that nobody has yet managed to do so suggests it is not an easy task. And if the Pensions Regulator were to sanction a deal that required less than buy-out funding, would the scheme members have any way of influencing the decision?

So where does this leave putative zombie masters? In truth, they are currently likely to be working for a life assurance company and will probably remain there. This could either be one of the two existing large-scale players in bulk annuities, or one of the several firms that have said they would like to enter this market on a larger scale – there is some evidence that the bulk annuity market is becoming more competitive, with up to five firms now providing serious quotations on a regular basis. For anyone else to enter in a significant way is going to take something more than voodoo, although stranger things have happened. Venturing out into the pensions night could soon become a lot scarier for scheme members.

1. *E McAulay, S Newby and D Morton,* Estimating the cost of securing benefits with insurance companies.

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A controlling influence

With London in the grip of unprecedented major merger and acquisition activity, it is not surprising that one of the deals of the year – even so early in 2006 – became the subject of a change-of-control clause to ensure bond investors would not get catastrophically short-changed.

Just days before **BAA** was due to close a highly successful multiple-tranche bond issue to finance the £1.25bn acquisition of 75% of Budapest airport in Hungary, it was announced that Spanish construction giant Ferrovial was eyeing up a bid for the operator of London's Heathrow, Gatwick and Stansted airports.

But after news of the putative takeover bid broke, the late-stage insertion of a change-of-control clause in BAA's £1.9bn bond issue to enable investors to be repaid at par in the event of a takeover was, in the words of one BAA adviser, "a no-brainer".

"The bonds were to be issued with the covenant or there would be no bond issue," said the adviser. "It was discussed fully and frankly with bondholders. It was as simple as that.

"The key issue is that BAA has a long-term relationship with the debt market and will be coming back again, accessing sterling, euro and dollar long-term and short-term markets. It is key that its reputation with the market stays intact."

The BAA treasury team – though constrained from commenting publicly on the issue because of takeover code rules during a potential bid process – is understood to have been extremely happy with the take-up of the issue.

While Finance Director Margaret Ewing and Group Treasurer Kim Holdsworth led the two weeks of roadshows in London and Paris, Treasury Director Nick Roach took the message to investors at a series of presentations in Frankfurt, Munich, Amsterdam, Glasgow and Edinburgh (BAA also runs the main airports in the two Scottish cities).

The issues were vastly oversubscribed with orders for as much as €9bn for the three tranches of bonds on offer. In the event the spreads tightened and BAA issued €1bn of 2012 stock paying 3.875%, a €750m 12-year Eurobond yielding 4.5%, and a £750m 17-year sterling-denominated bond at 5.125%. The sales, managed by ABN Amro, Barclays Capital, Morgan Stanley and Royal Bank of Scotland, raised more than €2.85bn (£1.9bn) in total.

Of that, £1.3bn replaces the 364-day bridging facility in place to pay for Budapest airport and leaves a little more than £600m of pre-funding for BAA's ongoing large-scale capital expenditure programme, including the construction of the vast Terminal 5 facility at Heathrow due to be ready in 2008.

The European junk bond market has been set alight by the largest high-yielding bond issue yet seen this side of the Atlantic. The fast-growing privately owned UK chemicals giant **Ineos** cemented its position at the end of last year as a global player with the $9bn purchase of Innovene, the petrochemicals arm of BP, which the oil giant had previously looked at floating. The acquisition itself was close to breaking records for the size of a leveraged deal.

The success of a €1.75bn 10-year bond yielding 7.875% – less than the previously guided 8% – and of a separate $750m 10-year bond at 8.5% to help refinance bridging loans on the Innovene deal pleased the company and the market. "This is a robust marker for what is expected to be a busy few months in new high-yield European corporate bond issues," said one adviser to the sale.

The issue led by Merrill Lynch, Barclays Capital and Morgan Stanley beats the previous European junk-bond record of €1.3bn by Italian directories business Seat PG. Assigning Ineos a positive B2 rating, credit agency Moody's said: "The stable outlook continues to reflect an expectation that the current momentum in petrochemical pricing will continue to benefit cash generation of the group over the next one to two years."

Strength of bond market sentiment despite the fears of mobile phone company executives that their industry remains in the grip of challenging times enabled **Vodafone** to come into the market with its largest euro-denominated bond in three years.

A €1.25bn floating-rate note was priced to pay 13 basis points over the three-month Euribor rate – a little tighter than the initial guidance – after investor clamour suggested the issue could be nearly twice subscribed.

BNP Paribas and WestLB – working for Vodafone on a bond issue for the first time – plus Barclays Capital advised on the sale, which syndicated debt chiefs said was put together in a day such was the demand. The issue was Vodafone's first floating-rate note denominated in euros.

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INTERNATIONAL EQUITIES

ISSUER	DEAL VALUE	TYPE	NO OF SHARES	OFFER PRICE	PRICING DATE	EXCHANGE	FEES (%)	BOOKRUNNER
EUROCASTLE INVESTMENT LTD	$465m	FO	11,667,000	$36.28	27/1/2006	Amsterdam	–	Deutsche Bank, Goldman Sachs, Morgan Stanley
MAPELEY LTD	$195m	FO	3,669,725	$48.24	23/1/2006	London	–	Lehman Brothers, Merrill Lynch, Deutsche Bank

FO = Follow-on (secondary) issue