Sweetening the deal

By rights, clear rules and tight regulation should make life simpler. You know where you stand when you have rules written down and a regulator to tell you if you are doing things right or wrong.

In theory, this is why modern societies legislate. But the reality is often very different. Clear examples of this reality are all too apparent in light of the Pension Act 2004 and the establishment of the fledgling Pensions Regulator.

Just over a year since the Act and Regulator came into force we are only now beginning to see the knock-on effects of the new pensions regime on business transactions. But those involved in mergers and acquisitions (M&A) have been aware of it for a lot longer than most.

DEAL BREAKERS Where in the past a pension fund was always looked at in due diligence, it rarely became a deal breaker. Now however, although no one has yet to publicly admit it, a pension fund in deficit (as many are) has stopped deals before the ink got close to hitting the paper.

No one will confirm it but many observers in the City suggest that the pensions regulation recently put paid to the Daily Mail and General Trust's (DM>) attempt to sell off its Northcliffe Newspapers' business division. As it turned out, DM> carried out a swift about-turn, withdrawing the whole division from sale and selling just one publication, the *Aberdeen Journal*, to DC Thompson for about £105m. As part of the deal the *Aberdeen Journal* was required to pay £27m into the DM> pension scheme.

Had DM>'s attempted disposal of the Northcliffe arm proceeded, the trustees of the pension fund, which was still open to new members but also in deficit, would have held a very influential card in deciding by how much the fund should have been bumped up.

It is understood the scheme had an FRS17 deficit of £100m, although going by recent cases put before the Pensions Regulator, it is likely a great deal more than £100m would have been required had the buyer been a private equity fund.

The collapse of the original sale of the staple of publications, say commentators, is one example of many more about which we will not know the full truth. And many deals aren't even getting that far.

Raj Mody, partner in pensions at PricewaterhouseCoopers, says: "It's as much about the uncertainty, to which you can to some extent get a handle on. It's about the uncertainty of it all and the risks. It's created nervousness."

Executive summary

- With so many pension funds in deficit, they are starting to become deal breakers.
- Using clearance procedures can reassure companies about later cash calls.
- But corporates using this process can be required to plunge funds into the target scheme.

The new rules are complex and it is still unclear to many what the powers of the new Regulator are, making it difficult to assess the potential impact on any given transaction.

Added to this is the uncertainty around the new responsibilities of pension trustees, making many of them extra cautious when negotiating pension funding.

Tim Keogh, worldwide partner at Mercer, says: "It's having a significant effect on some categories of M&A. If you have M&A activity driven by debt then it's tricky. But if you have equity driven M&A it's not such a big deal."

Still, can the blame be laid at the door of the new legislation and the Pensions Regulator? Certain transactions have collapsed recently

MICHELLE PERRY ASKS HOW PENSION LEGISLATION IS AFFECTING MERGERS AND ACQUISITIONS.

because of concerns over pension liabilities and the power of trustees to intervene in the deal well before the new pensions legislation took effect.

In 2004 the private equity firm Permira cancelled its plans to take over retailer WH Smith because of the size of the company's pension liabilities, and the venture capitalists realised the trustees could block the deal.

Trustees of WH Smith's pension scheme were said to have considered the transaction wrong, because pension fund members would effectively be helping to fund a leveraged acquisition.

When WH Smith sold its publishing subsidiary Hodder Headline in August 2004, management ploughed £120m into the scheme. A year later the trustees changed their investment strategy to a liability driven approach to limit volatility and reduce risk.

As Mody says: "If there's a strategic rationale for the deal, it's right to be mindful of the pension situation, but it doesn't have to be a show stopper.

"Reflecting on that a year on, there have been solutions to the pension challenges. The first is understanding what price adjustments there will need to be. Working with pension trustees to achieve a mutual agreement and coming up with innovative and creative ideas is essential."

Last year Ericsson became the first high profile case to seek confirmation from the Regulator when it bought the UK-based telecommunications and international services business Marconi for around £1.2bn.

The deal, a highly complex transaction because of Marconi's pension liabilities, involved creating a new company, wholly owned by Marconi shareholders, called Telent. As part of the deal Marconi's board paid a cash contribution of £185m into the scheme now under Telent. An additional £490m was put in an escrow account for the scheme.

FUND BOOSTING Perhaps the most interesting aspect of this deal was the size of the cash contribution into the fund, despite Marconi's declared pension deficit of £109m.

Using the clearance procedure with the Regulator can provide some assurances that sponsoring companies will not be subject to cash calls. This procedure, which is voluntary, allows the parties in a transaction to seek approval from the Regulator that no action will be taken against them if a particular deal goes ahead.

But many argue that the price for seeking clearance can be high. Recent examples such as the Ericsson/Marconi deal show that the Regulator often requires the acquirer to agree large increases in pension contributions, or security for the scheme, over the company's assets. It is unlikely the Regulator will agree to a transaction unless it has full backing from the trustees.

Mody says: "Treasurers can help the deal team understand the parameters of the deal and what's available in terms of cash. It's about coming up with innovative cash solutions and the treasury function has a role in that."

Nevertheless most agree that the new regulation is having a major impact on corporate activity in the UK.

John Hawkins, author of the ACT certificate on pensions and risk management, points out: "A few years ago no one would have dreamt of agreeing to top up the pension fund as part of an acquisition deal."

It is difficult to say exactly how great an impact the new pension regime is having on corporate activity as most of the deal making or breaking goes on behind closed doors. And if a deal isn't to be sealed then few outside of those involved in the proceedings will ever really know what caused it to collapse.

Hawkins adds: "Pension regulation is putting off deals but we won't know about many of them."

It was rumoured recently that venture capitalists were putting together a bid for BT. To do so they would have had to do some due diligence first and crucially that would have involved looking at BT's pension liabilities, which run into billions.

Little more has been heard of that particular deal, as if it had gone ahead the scheme trustees would almost certainly have required a large cash contribution and that would have meant less for shareholders if cash was being funnelled into a pensions' black hole.

Again, no one can be sure that BT's pension fund deficit was the reason behind the venture capitalists pulling out of a potential takeover, but it is certainly a huge factor today in any decision making.

POWERFUL TRUSTEES A glance at the limited information on the Dubai-P&O deal also highlights the power of trustees in deals nowadays.

The $3.3bn bid by DP World, the Dubai-based ports operator, was only allowed to go ahead on the basis that DP pay £200m in two tranches to cover the deficit in its company scheme. Of this, £125m

will be paid immediately and £75m over the next five years. It seems the Pension Regulator's approval was sought, although there is no public mention of this. What is unclear is whether the trustees had the right to call for the clearance of the deficit over five years under the terms of the trust deed, or whether they were simply able to negotiate this.

There is some good news for companies. Deficits of the FTSE 100 almost halved recently, thanks to some consistent increases on the London stock market, which has made some of its biggest leaps seen the dotcom boom. Fortunately, there is no indication we are heading for a collapse like that which followed the crazy days of the internet bubble.

Deloitte actuaries found that the combined black hole in the pension funds of the UK's 100 largest listed companies fell from £110bn to £60bn in just two months. The drop was attributed to a soaring shares market and easing of pressure on bond markets due to government proposals to lend over longer periods.

Earlier this year the opposite was happening: deficits rose when demand from pension schemes for long-term bonds pushed up their price, producing the knock-on effect of raising the cost of meeting pension promises.

If predictions are correct and we are heading for a period of stock market strength then we should see deficits fall even further. In the meantime, management is wising up to the fact that it must deal with pension liabilities – if they exist. Sadly most schemes are in deficit, despite massively increased cash contributions and one-off payments.

In March Diageo became the latest in a long line of high profile public companies to tackle its large pension scheme deficit.

Diageo, one of the world's largest drinks producers, said it had agreed a plan with the trustees of the UK company pension scheme to fund the UK pension scheme deficit over a seven-year period, starting in the 2007 financial year.

The value of the deficit, to be calculated using the trustees' actuarial valuation of the scheme, will be assessed every three years starting from this March. Once the valuation is completed later this year, the company estimates its initial annual cash contribution will be around £100m. It expects to

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pay an additional £50m cash contribution into the scheme by June.

At 31 December 2005 Diageo's deficit, calculated under IAS19, was £653m.

Announcing the company's plans, Diageo Chief Executive Paul Walsh said: "It follows the sale of our shares in General Mills and our full exit from Burger King and provides further clarity in relation to Diageo's balance sheet."

Many sectors in society would argue that the reforms to pension regulation are long overdue.

Hawkins says: "Justice is being done because there are cases in the past where companies have gone bust leaving pensions fund holders without their pensions. There's no reason why a company should have a deficit. It's poor financial management."

The only consolation for deal makers and trustees at present is that life will get easier. As more precedents are set and examples formed – both for the Regulator and those involved in mergers and acquisitions – both will have better ideas about what to expect and how to deal with situations.

"No one has said that the new rules are bad. If you hear criticism of the new regime it's more about the fact that the rules haven't bedded down yet. The Regulator is looking at transactions on a case-by-case basis," says Hawkins.

What should be clear, however, is that attempts at clever structures in transactions will only draw more attention from trustees and regulators who have their own set of duties to fulfil. It will not help avoid an increase in contributions if a pension scheme is in deficit.

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