



Punter Southall
TRANSACTION SERVICES



Clear and pragmatic advice



Covenant advisory services

Experts in assisting pension scheme trustees form an objective view on the strength of the employer covenant, allowing them to make informed decisions on the scheme's funding and investments.

Why assess the employer covenant?

The covenant – defined as the employer's legal obligations to its pension scheme and ability to meet them – is a critical factor in securing members' benefits and making decisions regarding the scheme's funding and investments. The **financial strength** of the employer determines the **degree of prudence** trustees should use in the valuation of the scheme's liabilities and the **level of risk** that can be supported in the scheme's investment strategy by the covenant.

When to assess the employer covenant?

Covenant reviews are triggered by either employer or scheme related activities; the actuarial valuation being the most common example.

Corporate events

- Merger or acquisition
- Divestment
- Refinancing
- Restructuring
- Deterioration of trading performance
- Dividend payment or share buy-back

Scheme events

- Triennial actuarial valuation
- Investment strategy review
- Apportionment arrangements
- Withdrawal arrangements
- Transfer value calculations
- Scheme merger or scheme closure

These events require trustees to make certain decisions regarding the scheme, taking into account the strength of the covenant or any subsequent change.

How we can help

We assist trustees in reviewing the covenant provided to the scheme by the employer and assess the implications of various corporate activities on the covenant. In our advice we utilise and combine the actuarial, transaction, and corporate finance expertise that exists in our team.

The first stage in our process uses a **light-touch high level review** to either provide the required comfort to trustees, or identify any areas of potential concern that require a closer look. Our **flexible staged approach** allows us to tailor the scope of the review closely to our client's brief and budget, as well as to ensure that the assessment is proportionate to the size of the scheme and risk of the sponsoring employer.

As part of our covenant advisory services we:

Provide analysis of the employer's financial position and prospects

- Balance sheet strength, profitability and cash generation
- Credit quality, borrowing arrangements and industry prospects
- Recent trading performance and corporate transactions

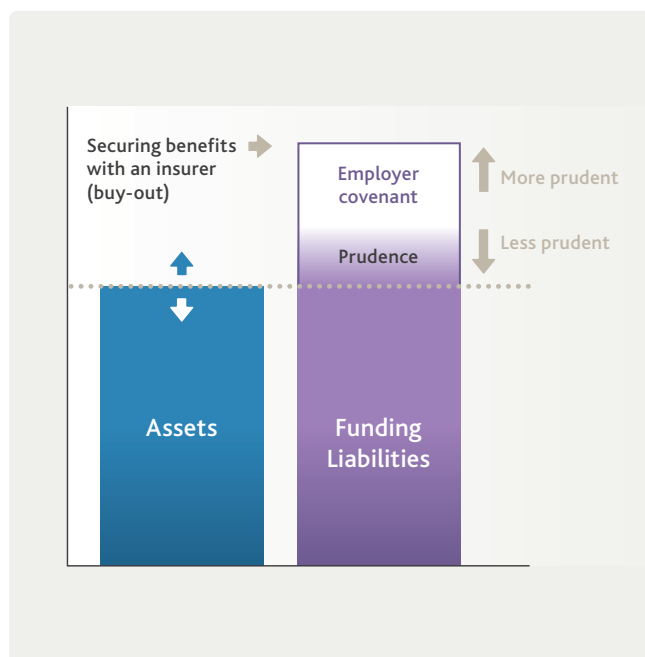
Support decision-making and negotiation in relation to the scheme's funding and investments

- Desired level of contributions and length of the deficit recovery period
- Use of contingent assets and conditional funding arrangements
- Design of covenant monitoring frameworks and related action plans

Enhance understanding and awareness of the wider regulatory context

The main areas where trustees seek our covenant advice are corporate transactions and actuarial valuations

Corporate transactions can lead to changes in the employer's corporate and capital structures, profitability, balance sheet strength or the priority order of creditors and therefore can also affect the strength of the covenant provided to the pension scheme.



We help trustees throughout the transaction process by assessing the covenant implications of the transaction, liaising with other advisors, and negotiating proportionate mitigation if required.

In the **actuarial valuation** context, trustees need to decide the level of prudence to be used in calculating the liabilities. This decision must be based on the trustees' view on the strength of the employer covenant.

We assist trustees in reviewing the strength of the covenant focusing on two key aspects: the scheme's security position, and the affordability of contributions. Based on the conclusion of the review we can advise trustees on the appropriate level of prudence to be used in the valuation and length of the recovery plan. We can also establish a covenant monitoring framework and provide trustees with regular updates. This enables them to decide if there is any material change in the covenant requiring further action.

Case study – Corporate transaction



Background

The trustee was informed by the overseas parent of the sponsoring employer that they intended to restructure the majority of their UK business which also included merging the sponsoring employer with a third party overseas company to create a joint venture. The restructuring was expected to result in a larger and more profitable business but the trustee wanted to develop a better understanding of the details and how the transaction affected the scheme.

Assessment

We undertook a full review of the transaction, which covered the proposed structure, financing arrangements and core financial projections. The review revealed that the existing unsecured debt of the sponsoring employer was expected to be replaced by secured loans.

The pre- and post-transaction analysis indicated that the introduction of the security provisions and the level of the new debt would lead to a material weakening in the trustee's security position. While the overall size of the new merged entity was expected to increase relative to the current sponsoring employer, the most profitable albeit a small division of the company was to be carved out from the sponsoring employer.

Outcome

We advised the trustee on the form and level of mitigation that would be both reasonable and adequate to protect the scheme from any dilution of security. The solution included providing an equal ranking security with the banks up to half of the buy-out deficit and second lien security for the remaining half. This allowed the company to proceed with the deal and protect the trustee against any weakening of the covenant.

Case study – Actuarial valuation



Background

A trustee body asked us to help determine the degree of prudence required in calculating the liabilities of their pension scheme and the affordability of any recovery plan contributions as part of the actuarial valuation process. The group structure was fairly complicated with a US parent and significant UK and European entities. They wanted to seek external advice to assess the key financials specifically from the scheme's perspective.

Assessment

We identified which companies the scheme could call upon for funding, reviewed their financial positions and assessed the long-term future prospects for the underlying businesses.

We determined a range that indicated the level of contributions that may be considered 'reasonably affordable' for the employers to pay into the scheme.

Outcome

Our review concluded that the overall covenant was strong. We confirmed that in light of the covenant strength provided to the scheme the initial assumptions considered by the trustees were sufficiently prudent. We also advised the trustee that the employers were able to eliminate that deficit over seven years, but the recovery plan could potentially be extended given that the scheme has a guarantee in place from the parent company of the sponsoring employers. We also established a set of simple monitoring conventions for the trustees to follow after the valuation.



Lorant Porkolab, Senior Consultant



Lorant leads the Covenant Advisory Services of Punter Southall. By background he is a Chartered Financial Analyst with several years of corporate finance experience. He advises both trustee and corporate clients, focusing on corporate transactions, covenant assessments, negotiation support and strategy.

Lorant has assisted trustees with assessing the implications of corporate transactions, reviewing

the strength of the covenant in the context of actuarial valuations, and monitoring relevant covenant risk indicators.

He has also helped trustees with identifying and negotiating proportionate mitigation for material weakening of the covenant, exploring the use of contingent assets and discussing deficit recovery plans with sponsoring employers.



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Richard Jones, Principal



Richard is the Managing Director of Punter Southall Transaction Services. He has worked in the pensions industry for over fourteen years and has spent eleven years at Punter Southall, including a spell in the US.

Richard has been involved in a large number of international mergers and acquisitions particularly

involving UK and US interests for both corporate buyers and private equity firms. Since establishing Punter Southall's employer covenant advisory services offering in 2008 Richard has provided employer covenant advice to a large number of clients in a wide range of industries.



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Jacqui Woodward, Senior Consultant



Jacqui is a qualified Actuary in Punter Southall Transaction Services with more than 10 years' experience in advising on employer covenant and pension issues, including a period in the US where she worked primarily on international transactions and accounting coordination.

Since returning to the UK, Jacqui has assisted a number of UK corporations with the management of their UK pension liabilities covering areas such as their PPF levy, negotiating with trustees during the Scheme Specific Funding process and providing advice on Clearance.



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