Beware the deal trip wire

The only function of economic forecasting, the late American economist J K Galbraith once noted, was to make astrology look respectable. And knowingly or not, it is a belief endemic to the private equity industry.

The overriding concern is to find companies with hidden value – whether on their balance sheet or in their intellectual property – and extract it in the most efficient way possible. Every risk is carefully studied and where possible, mitigated. Lines of credit are negotiated at known terms to suit the investor's horizon. Capital structures are redrawn to maximise efficiency. Balance sheets are scrutinised line by line and operations are streamlined.

There is no obsession within the industry with predicting GDP or any agonising over the evolution of the labour market. These are nebulous questions for economic forecasters to ponder. For the seasoned private equity veteran the wider economy only matters insofar as it determines when the deal is done and when it is exited.

Yet hidden among that otherwise well-managed balance sheet there might be unconstrained liabilities that threaten to undo the most meticulous business plan and expose private equity firms to a whole host of unknown risks – all housed within an often overlooked defined-benefit pension plan.

Though their relationship in the past has resembled awkward teenagers staring mutely across the dance floor, private equity firms and pension funds can no longer choose to shyly look away. Their horizons may be very different – years versus decades – but increasingly, pension schemes are a growing factor in private equity transactions. A potentially attractive deal may come unstuck because of the pension fund or worse still, an existing investment may hit difficulties as the full cost of the pension obligation becomes known. The difficult takeover of retailer Boots and the recent troubles at music publisher EMI are but the most visible tip of the proverbial iceberg.

Like any other risk, these uncertainties can be measured and managed once understood

Any views on interest rates over the next five years? Your debt financing may have excellent terms and it may seem a moot point, but the pension fund's liabilities will swing violently and perhaps for the worse over the next few decades with whatever the prevailing interest rates are.

How about inflation – any thoughts on how it might evolve over the next decade or even the next half century? Many scheme members will likely have index-linked pensions and the burden of payments can quickly become onerous. Figures from the Office of National Statistics show that from 1970 to 2007, annual employer contributions into pension schemes went up a factor of 53 times, and trebled over the last seven years alone.

And what about people living longer? The latest estimates suggest longevity is increasing at the rate of more than a day a week. Nobody minds postponing that inevitable shuffle off the mortal coil but for every year that pensioners live longer, the scheme's liabilities increase by some 3%.

It is a complex basket of risks and in the short term, changing economic and demographic perceptions can materially alter the valuation of a pension scheme's liabilities from one day to the next. Even the assets are not immune as many UK pension schemes have over half their assets in equities. This year alone, Aon Consulting estimated that sharp falls in the FTSE caused UK pension deficits to rise by £15bn in a single day in January, and again by £9bn the following morning. In just one week, UK pension schemes lost £40bn, wiping out all the gains made in 2007.

It is a growing headache for many private equity firms, for whom such risks often lie far from familiar territory and who are charged with looking after a broad church of stakeholders, not just pensioners. As the corporate sponsor, they generally have an obligation to fund these unexpected growing costs and the waters are muddied further by sometimes out-of-date actuarial assumptions that can present a less than prudent valuation of the true costs of fully funding the pension scheme's liabilities. The impact can go far beyond the immediate cash-flow hit, filtering through to the profit and loss, lowering profits, increasing the liability on the balance sheet, reducing the net asset value, increasing leverage and ultimately, impacting the exit price.

The area is also coming under increased regulatory scrutiny, with the Pensions Regulator set to gain stronger powers to issue contribu-

Looking into the crystal ball: forecasting

For those who watch life from the sidelines, increased longevity is a good thing. But living longer also costs more and its impact on the finances of pension funds and their sponsors can be crippling, write *Andrew Lloyd and Amarendra Swarup*

In a field typified by extremes, the American Civil War veterans' pension fund – one of the earliest – is a case in point. Originally set up during the war to pay pensions to disabled veterans, the scheme was gradually extended to include all veterans and their dependents, making its final payment in 2004 – nearly 140 years after the war ended.

The poster child for this longevity was Alberta Stewart, who in 1927 aged 21, married an 81-year-old veteran. Although her husband died soon afterwards, Alberta carried on drawing her widow's pension right to the grand old age of 98. By then, the scheme had cost the US government hundreds of billions in today's dollars, well exceeding the original cost of the war, and at its peak in the early 1890s, had even constituted more than 40% of the annual federal budget.

It is a stark warning for many pension schemes and their corporate sponsors today. Ever since the German Chancellor Otto von Bismarck thought he had pulled a fast one in 1889 by promising pensions at 70 when the average German lived to less than 50 years, the continual improvements in life expectancies have rapidly unravelled the best laid of pension plans and now lie at the heart of the huge liabilities stalking many schemes.

The problem is particularly acute for defined-benefit schemes, as most of these pensions are index linked and can also be passed on to spouses. As people live longer – 15 minutes more for every passing hour, by some estimates – the immediate calculable costs can rise substantially as outdated assumptions are updated and the upwards trend shows little sign of levelling off.

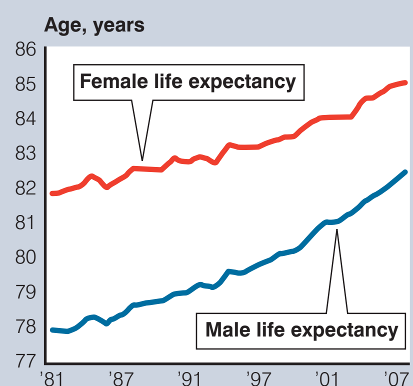
For corporate sponsors, the impact is doubly painful – there is an expectation that they will likely have to fund at least part of these unexpected costs, reducing their profitability and any distributions to investors; and the increased pension fund liabilities must also be carried on the company's balance sheet, reducing the net asset value and increasing financial leverage.

While the liabilities are often longer term than most investment horizons, private equity firms are particularly vulnerable as the uncertain command a company may have

Amarendra Swarup, Pensions Corp

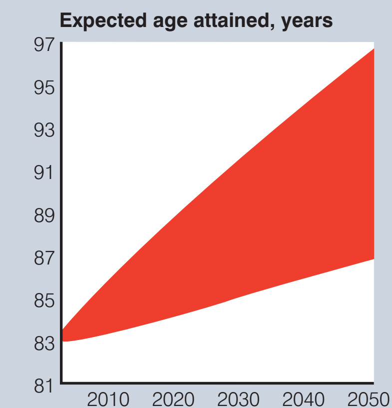
Hidden on balance sheets might be liabilities that threaten to undo the most meticulous plan

Increasing life expectancy*



*In the UK for 65-year olds
Source: Office of National Statistics

Longevity of 65-year-old men*



* In England and Wales *Source: Dowd et al (2007)*

tion notices and to take into account the resources of the whole group of companies when judging where funding should come from.

However, before we start decrying the paralysis of the private equity industry, there are options. Like any other risk, these uncertainties can also be measured and managed once understood. Moreover, developments in the marketplace mean that there are ways of reducing these risks and in some cases, removing them altogether.

The key is to have a proactive and realistic approach to the risks being carried on the balance sheet. Sponsors need to engage with trustees actively and walk that fine line between the investors' expectations and the funding needs for the pension scheme.

The ideal solution for most is a full insurance buyout, where the pension liabilities are transferred away to dedicated specialists. This can often improve the situation for pension scheme members as these specialist insurers are tightly regulated, operate within strict investment and asset-liability guidelines, and have to hold capital against any extreme losses.

It also helps troubled sponsors: securing pension liabilities away from balance sheets improves their ability to raise finance and removes the situation where, in a falling equity market with a commensurate fall in the valuation of a scheme's assets, a sponsor looking to invest in the business might also find trustees coming cap in hand. Above all, it enables management to get on with running the business, free from the peripheral distractions of administering a pension scheme.

However, insurance buyout valuations use more cautious longevity assumptions and paint a truer picture of the hidden arrears, increasing the liabilities and the premium required significantly. It is simply unaffordable for many companies.

But there are alternatives. Schemes can execute partial buyouts for some of their liabilities, such as current pensioners. If that overshoots the budget and the deficit is still too large, there are now innovative corporate solutions to help transfer risk, ranging from taking on the entire scheme and its myriad of liabilities to specific solutions for specific risks.

For example, trustees and sponsors can implement bond or swap-based hedging strategies to nullify the impact of interest rates and inflation on their liabilities and thereby, on the balance sheet. They can outsource the holistic management of assets and liabilities to a third-party fiduciary manager, which will manage them on a real-time basis. There is even a growing market in longevity swaps, allowing people to hedge this idiosyncratic risk.

It is a rapidly evolving environment and with new solutions appearing fast, private equity sponsors can be hopeful of finding innovative ways of managing these new risks on their horizon.

Most importantly, they can go back to finding and building businesses – not reading horoscopes.

life expectancy can be merely educated guesswork

over its own cashflow can significantly impact any potential mergers and acquisitions transactions and even cause a good investment to rapidly turn sour as the true cost of the pension obligations starts to emerge.

In recent times, the area has become all the more topical because of the increased regulatory scrutiny in the area. The Pensions Regulator is pushing schemes to adopt tougher mortality assumptions – a change that could significantly increase their total liabilities by 3% or more for every added year of life expectancy. For the private equity industry, this presents additional shorter-term risks as they may be ordered by regulators to divert extra cash into the scheme to meet these future liabilities or even investigated.

So how is an investor to manage this new idiosyncratic risk and cope with the additional burden of judging the lifespan of personnel – past, present and future?

The answer is a dark art. The current trend is unlikely to be your friend here – longevity improvements have repeatedly defied the hopeful shackles of successive actuarial models, despite the most Orwellian filtering of data by job, medical history and even postcode. The latest models – even if true – give scant comfort. By 2050, a 65 year-old UK male might live to be between 86 and 97 years old, up from 83 today.

However, there are ways of removing these risks. The gold-plated solution is a full insurance buyout of all liabilities to a dedicated insurer – often expensive but to be measured against future liabilities and a now uncluttered balance sheet. In the recently announced buyout of steel products group Delta, the pensioner liabilities of £450m (€569m) represented an effectively leveraged investment in longevity for the company, which had a rather more modest £200m market cap – a point not lost on the markets, which rewarded Delta with a 10% rise in its share price the following morning.

And other cost-effective options are appearing. For example, a product recently introduced by Pension Corporation allows pension funds to hedge their longevity risk directly, thereby removing the risk that liabilities and funding requirements will go up with future longevity improvements.

Whatever the route taken, with the problem of actuarial uncertainties removed, investors no longer have to stay glued to the crystal ball fretting about the tenacity of their pensioners' joie de vivre.