Summary
- Companies with large pension liabilities in relation to their total assets tend to attract a lower valuation.
- A large pension deficit can have considerable impact on a board's decision-making process.
- The new TPR code, which requires trustees to consider the sustainable growth of the sponsor, has shifted the balance between sponsors making pension contributions, investing in future growth or paying dividends.
- Due to the total cost of pension liabilities constantly fluctuating, investors implicitly add around 20 per cent to reported pension liabilities.
- Investors generally see pensions de-risking as positive news, as the uncertainty of the cost of the pension has been eliminated.

Paying the price

Lynn Strongin Dodds explores how a company's pension deficit can affect investor sentiment

The deficits of defined benefit pension funds can send shivers down the collective spine of investors, as witnessed in June after BT, which houses the UK's largest corporate plan, announced that its shortfall jumped 50 per cent to about £6 billion. This, among other reasons, sent the telecom giant's share price falling 2.5 per cent to 384p. Companies with smaller gaps may not feel the same scorn but the magnitude of the liabilities should not be underestimated in the investment decision-making process.

In fact, size matters, according to a recent study analysing the FTSE 100 over the past five years. The influence of DB pensions on the market valuation of the pension plan sponsor, conducted by Llewellyn Consulting and sponsored by Pension Insurance Corporation, shows that investors not only consider the girth of the deficit but also the scale of the liabilities when assessing a company. It found those with higher gross pension liabilities in relation to total assets will tend to attract a lower market valuation. Crunching the preliminary numbers, the overall company values were reduced by about £160 per £100 of pension deficit.

"The pension scheme deficit can be seen as a volatile loan with uncertainty around the future funding requirements," says Barnett Waddingham associate Gavin Markham. "The big question is whether the risk is properly reflected in the share price. If you ask equity analysts, DB pension schemes are considered a significant issue and typically viewed as a negative factor, particularly if the scheme is large relative to the size of the company."

KPMG pensions partner, Mike Smedley, agrees adding: "It depends on the circumstances but the general

view of shareholders and equity analysts is that the pension is a long-term factor and they are often more interested in the short-term results and trading environment of the company. They are less worried about pensions that will crystallise in the future except when the liabilities are large relative to the size of the company and there needs to be significant cash injections to cover the payments. If it is profitable and generating a lot of cash then there is less concern.”

> **“Corporates have to walk a fine line between filling the pension coffers with money slated for future developments or the intended rewards for shareholders”**

A recent study from JLT Employee Benefits showed that the total deficit in FTSE 100 pension schemes dropped by £16 billion to £60 billion in the year to 31 March 2014. However, their total disclosed pension liabilities jumped from £515 billion to £557 billion, with 15 companies shouldering burdens of over £10 billion, the largest of which was Royal Dutch with £54 billion. These liabilities are thought to have weighed heavily on boards and had a considerable impact on their decision-making process and strategies.

Shifting the balance

In general corporates have to walk a fine line between filling the pension coffers with money slated for future developments or the intended rewards for shareholders. A study two years ago by Professor Ian Tonks and Weixi Liu of the University of Bath School of Management found that FTSE 350 companies with large pension deficits opted for the latter and offset their funding gaps by paying lower dividend payouts, rather than cutting back on investments.

Companies though have recently been given more latitude, thanks to The Pensions Regulator’s new code, which came into effect in the summer. It is a move away from the approach of repaying deficits as quickly as possible to a more measured one that considers the appropriate period in view of the risks to the scheme and the impact on the employer.

“Companies have to choose between making contributions, investing in future growth or returning cash to shareholders in terms of dividends,” says Markham. “The new regulator code has shifted the balance to companies and allows them to make the case for using their cashflow to invest in areas that would support the sustainable growth of the business. In the end, the best support for a pension scheme is a strong employer.”

Calculating deficits

Although negative pension news may cast a cloud over a company, it can be short term and shareholders are advised to look more carefully behind the headline accounting numbers as they do not always paint

a true picture. Plans are required to report under the International Financial Reporting Standards (IFRS) or UK/US generally accepted accounting principles (GAAP).

"Investors want to factor in the true cost of deficits when valuing a company," says Pension Insurance Corporation head of business origination Jay Shah. "This often stops them investing if the cost is too high or too uncertain.

One problem is that the deficit is not a hard number and moves around. There is awareness that the accounting disclosures understate the true deficit and I think there should be more information in company accounts about the drivers behind the figures."

"Although negative pension news may cast a cloud over a company, it can be short term and shareholders are advised to look more carefully behind the headline accounting numbers"

This perhaps explains why the Llewellyn study showed that investors implicitly added around 20 per cent to reported DB pension liabilities valuations over the five year review period. Many did not apply formal calculations to the inconsistencies in assumptions and market discount rates.

These inherent problems were also highlighted in Barnett Waddingham's most recent FTSE 100 pensions accounting assumptions survey, which warned companies to "carefully consider" their approach towards suppositions, particularly as those using an index yield approach may overstate their accounting liabilities. The key is in selecting an appropriate duration for scheme liabilities.

The Barnett Waddingham report revealed that 46 of the 51 top companies that disclosed discount rate assumptions applied a rate between 4.4 per cent and 4.6 per cent per annum with the full range ranging from 4.0 per cent and 4.7 per cent. Meanwhile, yields on the iBoxx and Merrill Lynch over 15-year AA-rated corporate bond indices were both 4.4 per cent p.a. in 2013, up from 4.1 per cent in 2012. Most companies maintained the same discount rate as last year, with the small 0.1 percentage point increase reflecting improving yields.

"The accounting information available on UK DB plans is only one measure and is typically optimistic because the discount rate reflects AA-corporate bonds irrespective of the strength of the employer covenant," says investment bank Lincoln International UK chief executive officer and head of pensions advisory, Darren Redmayne. "It is not the measure used when agreeing cash funding between trustees and companies [which is called technical provisions]. This makes it difficult for shareholders to get their arms around the pension risk because they do not necessarily have access to all the information to make a fully-informed decision. For example, information around other measures such as solvency, the technical provisions agreed with the trustees and details of the recovery plan to fund any deficit are all effectively voluntary disclosures."

Removing the risk

JLT Employee Benefits chief actuary Hugh Nolan believes another problem is the varied nature of

the pension fund landscape. "For example, the FTSE 100 has a multitude of pension funds with different magnitudes, locations and liabilities and this is all wrapped up under one single disclosure note that is not well understood. There can also be confusion around the de-risking process and there is some evidence that shows share prices will rise after a company announces a deal regardless of the price that is paid. This is because the uncertainty is being eliminated and analysts as well as shareholders have a fear of the unknown."

Markham agrees that investors generally see de-risking as positive news. However, he says: "It can be hard to unpick share price movements tied to these actions from general market moves. I think it can have an impact over time as de-risking deals with future volatility and shareholders do not like uncertainty or surprises. Activity that does not require any additional upfront costs such as closure to new entrants or accruals can be easier to understand than buyouts where liabilities are secured by an insurance company or liability driven investment, which may have a higher implied cost due to a lower risk strategy and lower expected returns. I am not sure how well shareholders appreciate this and so a clear business rationale can be important."

Written by Lynn Strongin Dodds, a freelance journalist