TO DEFICIT OR NOT TO DEFICIT?

THAT IS THE

POST BREXIT QUESTION.

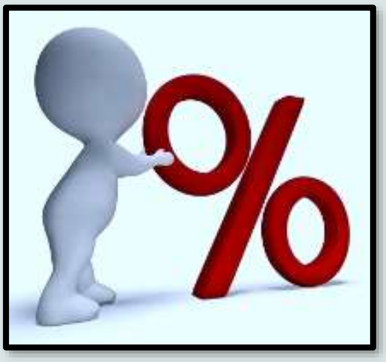
Whether 'tis nobler on the balance sheet to suffer

The slings and arrows of outrageous deficit volatility,

Or to take arms against a sea of pension uncertainties,

And by opposing end them? To fund: to eliminate;

No more; and by eliminate to say we mean eliminate now.



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With sincere apologies to William Shakespeare on the 400th anniversary of his death, in the current uncertain economic and political climate should sponsors and scheme trustees address defined benefit deficit issues or continue with the status quo.

In other words:

To deficit or not to deficit?

That is the question.

What is the current economic and political outlook?

In an unparalleled referendum result on 23 June, the voters of the United Kingdom opted to leave the European Union. The result raised concerns concerning the future of the British economy. The full economic outcome of the leave vote will not be clear for some time, but it is anticipated that the country will experience a prolonged period of uncertainty until new trade and political agreements are ratified.

The leave vote prompted a collapse of the financial markets and the pound slumped to its lowest level for over 30 years. There are other ramifications of the vote to leave the EU. Political risks such as the revival of the Scottish independence issue, increased tension within the Conservative party, despite Theresa May's election as leader and Prime Minister; and continued Labour party turmoil are predicted to threaten political stability in the medium term.

Pure economic forecasts vary widely, trade negotiations with the EU and globally will take time. There appears only one common theme. The result in the short to medium term will be bad news for the UK economy. Forecasters predictions for the effect on GDP, the national debt and confidence are all pessimistic.

Economic experts in some quarters have long suggested the UK economy is too dependent on consumer spending fuelled by consumer debt. Economic and political uncertainty is almost certain to reduce confidence, which in turn virtually guarantees a downturn in consumer spending.

Equally, the UK economy is dependent upon foreign inward investment. These uncertainties are more likely to reduce investment than to keep it at the current levels or even grow.

Opinion about the effects of the potential loss of access to the single market again vary widely. There can be little doubt that there will be delays in investment decisions until the single market position is much clearer, especially in the vital area of financial services.

Whilst the Bank of England did not reduce interest rates in July, recent data left virtually no alternative in August. The re-introduction of QE was likely; the introduction of corporate bonds was viewed as surprising. The bank funding programme looks to be trying to reduce average WACC to ensure interest rate cuts are passed onto borrowers, again with new money. In some quarters the action was seen as the Bank of England's last dice throw. If this were unsuccessful it would be left with the Government to provide stimulus.

The attempted coup in Turkey, and the latest terror attacks in France and Germany will not have a positive effect on European or global economic confidence.

What is the future for Trustee boards?

The UK has some 6,000 defined benefit schemes in the private sector. Pension liabilities cover approximately £2 trillion of accounting pension obligations.

Schemes are likely to be faced with the prospect of higher inflation, and an expected reduction in asset values over the short to medium term. Government bond yields will almost certainly stay artificially low, for longer, keeping pension liability values high.

The result, pension deficits are likely to increase and be more volatile.

The PPF index at the end of July indicates nearly 85% of schemes in deficit. The total deficit of schemes not fully funded is £440 billion, giving a 76% funding ratio.

Extended deficit reduction plans will only heighten the issue of cashflow.

Virtually 50% of defined benefit pension obligations are due in the next 18 years, this could result in forced asset sales.

Investment returns may be steady over time, but they are not consistent year on year. Underfunding, and underperforming assets due to economic and political uncertainty could result in underfunded mature schemes actually running out of money.

Some of the highest dividend paying stocks in the UK, such as BP and Shell, the lifeblood of cashflow to pension schemes have multi billion pension deficits.

Recent data shows that the median dividend pay-out ratio of FTSE 350 companies with defined benefit schemes is now 53% of net income, up 13% in just five years.

Is it possible to sustain these levels?

Looked at from the opposite perspective, profit available for re-investment has fallen to 47%, down 13% in just five years. In the current economic and political climate can this reduction in re-investment still produce enough income to maintain dividend levels, aside from scheme deficits?

Trustee boards will doubtless be looking to monitor events closely and will be assessing the impact of market changes on scheme funding, sponsor covenants, their financing and investment strategies.

Trustee boards have been addressing low interest rate, asset return and deficit issues for several years. It is likely that a growing number of sponsors will look to renegotiate deficit reduction plans to longer terms, increasing covenant and investment risk.

Focused investment strategies can alleviate many of the issues they face, but Trustee boards know need to start from having a well-funded scheme.

In addition, they face a new issue. For possibly the first time defined benefit deficits and pension schemes are headline news, highlighted by schemes such as BHS and British Steel. The Commons select committee report into BHS, published on 25 July, putting deficits back on the front page again. This could put more pressure on Trustee boards as they will face not only ongoing investment and funding issues but potential media intrusion and greater member awareness of deficit dangers.

It is not inconceivable that the Government introduces legislation, the same BHS committee report references doubts about existing company and pension legislation, to enforce minimum funding levels. There are a number of investigations and committees studying the pensions issue, including defined benefit deficits. Whilst legislation could assist Trustee boards, it could easily create issues between the Trustee board and the sponsoring employer, especially if the legislation put a strain on the employer's finances.

The Work and Pensions Committee in the House of Commons has launched an inquiry into the regulation of defined benefit schemes, so legislation could be closer than anticipated.

What does the current position, and future prospects look like for employers?

From an economic and commercial perspective, the obvious factors are share prices for quoted companies and the exchange rate across all sectors. It is appearing that the initial drop in share prices was short lived, indeed the FTSE100 is above pre Brexit levels. However, some would argue that with the constituents earning over 75% of income abroad, that the exchange rate changes mean it is effectively down. The more UK focused FTSE250 index remains near pre referendum levels. The cut in interest rates assisting these rises.

The drop in the value of sterling will be a major concern to all businesses excepting those that export UK sourced and produced goods and services.

Employer boards will be concerned about the effects on the UK vote to consumer confidence, and the global economy generally. Uncertainty, both at home, the EU and globally is much more likely to reduce both consumer spending and corporate investment than result in an increase. The consumer and business alike hate uncertainty.

The pension deficit problem is unlikely to disappear, and could worsen in the short term with the prospect of further interest rate cuts and the reintroduction of quantitative easing bringing gilt yields even lower.

Trustee boards will be aware of the issues facing employer sponsors and will be willing to assist where possible. However, they will be aware that any reductions in deficit contributions, or lengthening of deficit recovery plan terms will adversely affect their cashflow and investment problems. Trustees will doubtless help where they can, but that help is likely to be limited in nature. Deficits will remove a highly volatile element in company finances and their risk to the company is more likely to increase than decrease.

It is believed approximately 2,000 companies face reviews of scheme funding in the coming year. The crystallisation of old and growing deficits will doubtless increase the demands for cashflow to go to shrink deficits. Pension freedoms and the proximity of a majority of pension obligations will increase the cash outflow of schemes, which in turn will likely increase the cash outflow from employers to pension schemes. The alternative is the schemes facing forced sales of assets, or in a worst case scenario actually running out of cash.

It used to be said that banks could bring a company down but a pension scheme could not. Is that still true?

Many would say No.

In common with Trustee boards, many employer sponsors will for the first time face the prospect of a vastly greater interest and concern about their pension scheme deficit from former, retired and existing staff at all levels.

The recent British Steel and BHS pension scheme issues have shown quite clearly that pension scheme deficits can, and do have a negative effect on businesses. The recently published Commons Select Committee report saying that BHS pension deficit was a major element of the firm's failure. The BT share price has dropped by as much as 10% after the Brexit vote as concerns were expressed about the £10 billion pension deficit, in comparison rival Vodafone only dropped 5%.

At least one company has, effectively, been brought down by pension liabilities. That was a company whose business was in essence providing defined benefit pensions, Equitable Life Assurance Society. The correlation between the issues that essentially closed the society and the deficits of today's corporate defined benefit schemes is clear.

Legislation cannot be ruled out. The pension deficit issue has been front page news, and resulted in some almost soap opera like headlines. In times of economic and political uncertainty companies will not want to be forced into eliminating deficits, but the possibility cannot be written off. No Government will want to see headlines about vulnerable workers and pensioner's incomes at risk too frequently, especially if it appeared they were not holding big business to account.

In a worst case scenario, failure to fund a defined benefit scheme could be regarded as a credit event, triggering numerous financial ramifications.

For probably the first time since newspapers were printed a company CEO could wake up on a Sunday morning to see his company's pension deficit on the front page, or the object of a television newspaper reviewer's comments!

Currently, virtually 58% of the net income of FTSE 350 companies with a defined benefit pension scheme is paid out in either dividend or pension deficit reduction plans. However, in the last five years the pension contribution has actually fallen 2% as a percentage of net income, despite rising deficits. In reality the amount of money available for re-investment has fallen 10%.

Can falling re-investment produce the profits to clear deficits or pay dividends that maintain share prices?

The outlook for employers with deficits would appear to be more of the same. More cash or assets into a rarely shrinking deficit hole.

Is there an alternative to the existing strategies, that have largely tried to treat; not cure?

In short the answer is **Yes**.

Employers are experienced professionals, they know the businesses they manage are at their best when well-funded and investment maintained for growth and profitability. They will know that in essence the pension scheme is the same.

Leveraged & Equity Investment are designers and suppliers of financing structures and finance, we focus on three market sectors and three alone. One of those is Employee Benefits. Over two years has been spent creating financing structures to address the multi-billion defined benefit deficit problems faced by UK business. We now have a range of unique financing structures recently put in place and offered by advisers and providers.

The fundamental financial structure is off balance sheet, non interest/debt bearing and without affecting existing financing or future availability. Alternatives, include, but are not limited to, Scottish Limited Partnerships or other Special Purpose Vehicles; all clearing or reducing the deficit immediately.

Leveraged & Equity Investment deficit financing solutions provide an immediate injection into the pension scheme. The injection will either clear or substantially reduce the deficit, alternatively it could finance a full buy out or a partial buy in through a specially created option.

From a Trustee perspective full, or near full funding, will enable them to focus on a cashflow and liability based investment programme that will reduce risk and volatility. Employer covenant risk will be substantially reduced as Leveraged & Equity Investment take the covenant risk for the lump sum injection, there is no recourse to the scheme.

The risk of forced asset sales will be eliminated. Investment risk can likely be reduced as the need to invest in high growth, high risk, assets to eradicate some of the deficit by investment returns will have been removed.

In summary, the structures increase scheme income, reduce or eliminate immediate deficit, whilst cutting or eliminating some volatile outgoings, such as PPF levy or LDI cash security.

The benefits to the sponsoring employer are substantial.

The risk of deficit volatility and contribution volatility has been removed, or at least substantially reduced. The pension scheme as a business risk will have been reduced. Staff, past and present, will have been given the confidence that their pensions have been further safeguarded. Additionally, some of the issues previously outlined will be eradicated.

Reductions in deficit contributions and elimination of other charges related to pension scheme deficits will increase the funds available for re-investment. In turn increasing future net income for dispersal.

From a financial perspective the fundamental financing structures are cashflow, profit and tax efficient. They can also aid key financial ratios whilst increasing the business net asset value.

In brief comparison, using the financial data from the latest PPF 7800 index of July 2016. A typical 76% funded scheme could become fully funded on a s179, or IAS19, basis immediately, whilst the gross annual cashflow cost to the sponsoring employer, by matching repayments to average pension duration or a term of the company choosing, would be between 50% and 70% of that of a typical deficit recovery plan, and fixed.

A basic Leveraged & Equity Investment solution could increase net income by 5%, purely on a gross cashflow basis, this before other benefits are included.

One UK public company recently placed in the public domain a restructuring of their deficit recovery plan. It extended the recovery term to 12 years, from a close date of 2022 to 2028. This has possibly exposed the Trustee board to a greater covenant and the funding risk, and may well result in a more conservative investment risk profile.

With a scheme deficit the Trustee board might idea look to reduce the deficit by making higher risk growth assets, but the increased funding risk could negate this option. The company has agreed to make variable payments totalling just over £250 million, which using their scheme discount rate gives a present value of just under £200 million.

The structures and financing provided by Leveraged & equity Investment could have given the Trustee board a lump sum immediate investment of approximately £200 million. This would have enabled a more balanced investment programme, eliminated forced asset sales and £200 million of funding and covenant risk removed. From a sponsoring employer risk, the structuring over a realistic term would reduce annual payments to approximately 75% of the average contribution under the recovery plan as a starting point, additional benefits would further reduce real costs.

The sponsoring employer would also be free of funding concerns for probably twenty years at a minimum and have a known, fixed, cashflow. The reduction in actual pension scheme payments available for re-investment to create profits and pay dividends.

To summarise from an employer perspective, the financing solutions give greater certainty of cashflow, whilst reducing deficit contributions. Pension risk is substantially reduced or even eliminated. Future re-investment and financing plans benefit, whilst the pension financing structures are cashflow, profitability and tax efficient.

LEVERAGED & EQUITY INVESTMENT

Leveraged and Equity Investment funding solutions.

Leveraged and Equity Investments are financing specialists. Our financing expertise is entirely devoted to three areas of financing and equity investment, and only three areas.

Technology, Employee Benefits and bespoke project requests.

We have extensively researched the issues surrounding defined benefit pension funding issues. Not before conducting this research, that took over two years, have we produced our funding solutions.

Over thirty years experience of creating bespoke financing solutions has enabled us to create a range of offerings that are cashflow, tax, profit and pension scheme efficient.

The solutions we offer are individual, designed to maximise pension scheme security at the lowest net present value to the sponsor.

Contact Leveraged & Equity Investment

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