



GAZELLE PENSIONS ADVISORY

The Takeover Code now offers trustees a right to a separate published opinion – what are the implications?

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The pension-related changes to the Takeover Code now give trustees the right to a separate opinion. In theory, such an opinion could set out the trustees' view of how a successful public offer would impact scheme funding arrangements taking into account changes to the covenant. Such an opinion might be expected to comprise the expected impact on investment policy, Technical Provisions and recovery plan and, where the impact represents a material detriment, a statement to that effect outlining whether mitigation is being provided by the acquirer. This could galvanise offerors into reaching agreements with trustees so as to avoid the uncertainty and risk to acquisition financing that might result from published trustee opinions. In practice, trustees will face a serious amount of work for which costs will not be recoverable and trustee boards which place considerable value on strong long-term employer relationships may find themselves in an awkward position.

A concern is therefore that trustee boards may not find it easy to step into the limelight and express their concerns publically with opinions carefully supported by detailed actuarial and covenant analysis. If this happens, the Takeover Code changes may not provide much benefit to trustees compared for example to requiring offerors to state that they have the ability to fund the schemes they take on.

Forming an opinion on the pension impact of a transaction places a high 'burden of proof' on trustees whereas current analytical methods at the disposal of trustee boards are limited. A quantitative approach to covenant assessment may be necessary to enable trustees to express well considered and well supported opinions on how a public takeover will impact scheme funding arrangements.

Key changes to the Takeover Code

The Takeover Panel has now published changes to the Takeover Code (the “Code”) which, for the first time, establish a formal framework within which the effects of an offer on a company’s defined benefit pension scheme can be considered.

The framework essentially grants information sharing rights to pension scheme trustees on a par with those of employee representatives:

- It gives trustees similar rights to those of employer representatives to be provided with offer-related information;
- It requires the offeror’s formal offer document to state the offeror’s “intentions with regard to employer contributions into the offeree company’s pension scheme(s) (including with regard to current arrangements for the funding of any scheme deficit), the accrual of benefits for existing members, and the admission of new members”;
- It gives trustees the right to have a separate opinion published on the effects of the offer on the pension scheme(s). The offeree company must pay for the costs of publication, but not the advisory costs in producing the opinion - unlike the case for employee representatives whose costs are covered;
- If an agreement is reached between offeror and offeree company trustees on funding, then, if material to the offer, it is to be treated as any other material contract.

What the changes do

Consistent with the Code being aimed primarily at the protection of offeree company shareholders, the focus of the amendments is on DB schemes sponsored by the *offeree* company (or subsidiaries). No framework has been created for the trustees of the offeror company’s DB scheme, although in some cases the impact could be considerable.

It is important to recognise also that these changes are about extending the Code’s framework for equality of information to the pension scheme as a stakeholder, and are not intended to change the balance of power between pension trustees and other stakeholders in a bid. The Panel is clear in its comments that lack of agreement with a bidder on the future funding of the scheme cannot stop a bid from becoming or declared unconditional.

The changes do for the first time provide the trustees with a formal right to express their opinion on the effects of the bid on their scheme(s). This right to be heard gives the trustees a legitimate role in the process and should be welcomed by trustees - currently many bids take place without consideration of the position of the pension scheme, although on occasion the trustees have become involved where pension funding is clearly a material pricing issue. Trustees are often placed in a difficult position, particularly on a hostile bid, in deciding whether, when or how to engage with the bid process, and whether with an offeror or the sponsor or both. This framework deserves to be welcomed by offerors and offerees equally in terms of providing greater clarity.

What the changes don't do

The changes do not bring Code offers closer to the reach of The Pensions Regulator: the Panel has noted that there is no provision to refer an offer to TPR. Any decision to seek clearance from The Pensions Regulator is a matter for an offeror (and associated or connected parties) and it is for employers and trustees (but not for the Panel) to engage with The Pensions Regulator if they so wish. The regulatory "gap" therefore is still there – if trustees are unhappy about the impact of a takeover on the security of their pension scheme, recourse is not through the protections of the Takeover Code, but to The Pensions Regulator; and if (as is often the case) clearance is not sought by the offeror, then there is no formal way for the trustees to engage.

At the consultation stage Gazelle proposed that offerors should be held to a higher disclosure obligation than that set out in the draft amendments, in terms of requiring a statement by the offeror (by extension of the "cash confirmation" requirement) that it was also able to fund any existing pension deficit, at the least to the level of the ongoing Technical Provisions and, if it were not, then it should be required to *reach agreement* with the trustees. The rationale for this proposal was that the true cost of pension funding, just like bank financing, should be priced into the bid economics for shareholders to assess; engagement with the trustees might complicate the bid process but this ensures that issues are addressed and should help avoid problems down the line.

The Panel has not gone this far and it remains to be seen whether the changes to the Code will facilitate better quality disclosure by offerors, or will lead simply to a “box ticking” approach. Given the high level of responsibility for statements made in offer documents (and the potential publicity arising from such statements) it is reasonable to assume that offerors will make only limited statements in their offer documents on pensions rather than giving “hostages to fortune”, particularly on funding commitments.

High burden of analysis to support the trustees opinion but no cost recovery

Considerable legal, actuarial, investment and financial advisory covenant related work may now be involved in supporting the proposed trustee opinion to the levels expected in a Code offer document but, unlike employee representatives, trustees have very significant fiduciary obligations and some trustee boards may take the view that this should not be borne by the scheme. It is to be expected that some companies will now decline to support trustee advisory costs in this area, possibly for tactical reasons where pension funding is a material pricing matter. This could prove an unfortunate and illogical omission and may need to be revisited in due course by the Takeover Panel if trustee boards in practice feel either unable to provide opinions properly supported by advice or only able to put forward very general opinions.

What is the basis for trustee opinions?

As well as not being allowed to recover costs generated by a public takeover situation designed to further shareholder interests, trustees arguably have inadequate analytical “tools” to deploy to support their stated opinion in public takeover situations. Traditional covenant assessments are weighty reports with fairly subjective conclusions that are time consuming to prepare. In addition TPR provides limited guidance on how covenant should actually be reflected in scheme funding arrangements.

Advantages of quantitative covenant assessment in supporting trustee opinions

In these situations Gazelle's new quantitative covenant risk modelling approach (Mousetrap) provides detailed analysis to enable trustees to form precise, accurate and well supported opinions on exactly how public offers would affect their scheme funding arrangements and the quantum of mitigation required to make good a material detriment. Mousetrap can be deployed quickly in bid situations to give a wealth of evidential information about the covenant and scheme funding impact of a public takeover. It is also economical compared to traditional covenant assessment bearing in mind the costs issue highlighted above.

Gazelle has acted as financial adviser to a number of pension trustee boards on public takeover bids including the offer by Kraft Foods for Cadbury and the offer by Vodafone for Cable & Wireless Worldwide.

For further information on the Mousetrap quantitative covenant risk model please contact Simon Willes on Simon.Willes@gazellegroup.co.uk or visit our website

http://gazellegroup.co.uk/downloads/Introduction_to_Covenant_Risk_Quantification.pdf



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