



June 2011



Employer covenant and refinancing

In brief:

- The amount of debt that will need to be refinanced in the next few years is expected to reach unprecedented highs
- Pension scheme trustees and sponsors should fully understand the implications of the refinancing on the employer covenant supporting the pension scheme
- Mitigation should be considered if the refinancing leads to a significant weakening in the scheme's security position
- Support from independent advisers can be useful in assessing the impact of the refinancing, including its materiality, and identifying appropriate mitigation, if required
- The covenant advisory services team at Punter Southall can assist trustees and sponsors in this area too

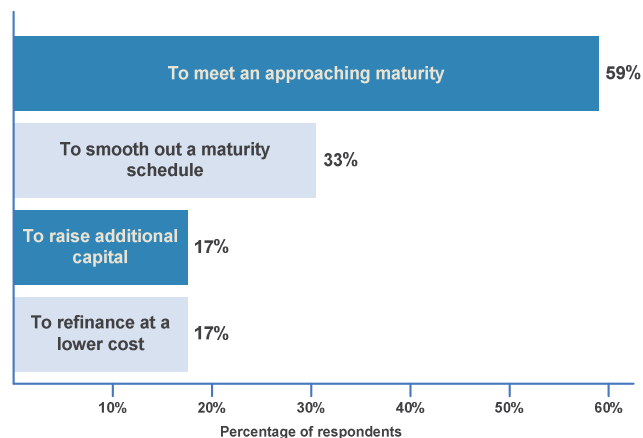
Having survived the onslaught of the credit crunch in 2008 and the challenges of obtaining credit during the post-crisis period many companies are now returning to the task of reviewing their financing arrangements. This note explores the covenant implications of refinancing for pension schemes and how trustees and sponsoring employers can prevent the covenant becoming weaker, including the scheme unintentionally slipping down the priority order of creditors.

Background

Corporate refinancing refers to the situation whereby debt is replaced or repaid with money that is raised, for instance by issuing new debt or entering into a new borrowing arrangement.

Latest research indicates that there is a mountain of maturing debt in the corporate world that companies will have to deal with fairly soon. This is in part explained by the high level of transactions activity between 2005 and 2007 which saw a surge in highly leveraged, low interest deals. Much of the debt used to finance transactions during that period is due to reach maturity in the next few years and therefore for many companies 2011 will be the year to begin revisiting any existing financing arrangements.

The following chart indicates the main driving forces behind refinancing exercises based on a recent survey carried out in the borrower community.



Source - Debtwire, "Refinancing 2011: The Scramble to Refinance European Debt"
Please note: respondents may have chosen more than one answer

Implications for the pension scheme

Any significant business activity undertaken by a sponsor should be on the radar of the pension scheme trustees, since these activities can affect the strength of the employer covenant provided to the scheme. Trustees should fully understand the financing arrangements of the sponsor, including the relevant terms, security provisions, maturity dates, interest rates, and banking covenant.

Changes in these terms can alter the financial position and prospects of the business, as well as the trustees' security position. Since the trustees are expected to act as unsecured creditors, they need to understand what other creditors the business has, the rights of these creditors, and their relative positions to the scheme.

Ultimately the trustees should also be alert to the likely refinancing terms that the sponsor will achieve as it approaches its next round of refinancing and whether the terms likely to be provided in the market will be more or less favourable than those currently in place. This will depend on an array of factors both specific to the business of the sponsor and prevailing in the general economic environment.

As the survey data indicates, the objectives and triggers, as well as the forms and circumstance of refinancing, vary widely and can include:

- Working with existing creditors to extend the terms of the loans in place which are close to maturity
- Reorganising the overall business and replacing any outstanding debt with new debt obligations with different attaching interest rates, covenants or terms to maturity
- Issuing shares to pay off some of the outstanding debt with funding from the shareholders
- Restructuring existing financing arrangements if the company is unable to meet its current obligations or is about to breach its banking covenants
- Reducing cost if new terms for borrowing become available in the market, for example, debt becomes cheaper to service due to lower interest rates.

Working with our clients

We have considerable experience not only in assessing the covenant implications of various corporate events, including refinancing, but also in assisting with the communications related to these activities to ensure that potentially sensitive and complicated financial messages are correctly understood by all parties.

Where a significant weakening of the covenant occurs it will be necessary for the trustees and sponsor to arrange for mitigation to be put in place for the pension scheme. Once the sponsor and trustees have agreed on the appropriate amount and form of mitigation, the sponsor also has the option to consider whether to seek clearance from the Pensions Regulator in order to obtain certainty that the Pensions Regulator will not use its 'moral hazard' powers by issuing a contribution notice or financial support direction in relation to that particular corporate activity.

The decision to seek clearance from the Pensions Regulator should not be taken lightly by the sponsor. Our extensive experience with the Pensions Regulator on a variety of cases enables us to clearly identify the risks and benefits of seeking, or not seeking, clearance for our clients.

The sponsor should also recognise the pension scheme could be affected by the refinancing and the trustees need to understand its covenant implications. Therefore the sponsor should keep the trustees informed of their plans and needs for refinancing and any progress that it makes in that process. They should also share with the trustees as much information as appropriate. This may include details of any existing arrangements that are in place, as well as covenant tests and reports that are being provided to the lenders (be that part of the regular monitoring of the banking covenants or a one-off report supporting the refinancing exercise).

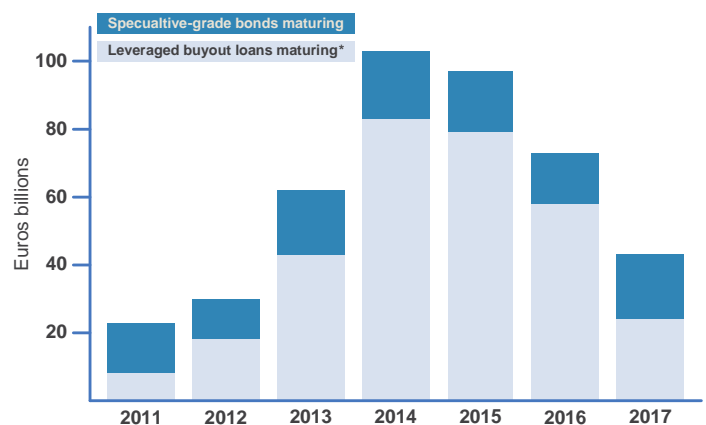
“Employers and trustees should work openly together. Employers are required to provide to trustees such information as they or their professional advisers reasonably require for the performance of their respective duties. In order to promote openness, trustees should be prepared to commit to confidentiality in respect of the supply of any information that might have price sensitive implications if released into the public domain.”

The Pensions Regulator’s guidance on monitoring employer support

Since refinancing can involve various parties sharing confidential or commercially sensitive information, the sponsor and trustees may wish to review any confidentiality agreements they have in place to ensure that any sensitive information is kept out of the public domain, at least until an appropriate time. Both the sponsor and the trustees should look at the impartiality of the information and advice being given and received.

The refinancing mountain

As the chart indicates, around €430 billion worth of speculative-grade bonds and leveraged buy out loans are expected to mature over the next 7 years, reaching the peak in 2014 when maturing debt is forecasted to exceed €100 billion.



* Includes all senior and subordinated issuance assuming repayments in line with Standard & Poor's European Leveraged Loan Index. Europe covers EU-27 countries, Iceland, Norway and Switzerland.

Sources – Dealogic and Standard & Poor's Leveraged Commentary & Data.

Highly leveraged companies are in the most challenging position and it is anticipated that they will need to start addressing their refinancing requirements well in advance of the actual maturity date. Therefore, for many companies, consideration to debt maturing in 2014 and 2015 could begin in 2012.

Case study : Jarvis – a casualty of the recession

Jarvis – once the biggest construction company in the UK with a £1 billion market capitalisation – had seen big contract losses and reductions in its business after the beginning of the recession in 2008. The directors and secured lenders of the rail maintenance and support service company placed Jarvis and certain subsidiaries into administration in March 2010.

The company had significant secured bank debts and embarked on a long program of restructuring and refinancing activities. Ultimately, however, it was unable to secure the support of its lenders to continue operations and prevent the company from entering administration.

Three sections of the Railways Pension Scheme sponsored by the company entered the Pension Protection Fund's assessment period in November 2010. As a result, members continue to wait to hear whether the company's pension liabilities will be passed to the Pension Protection Fund (the lifeboat scheme established to provide compensation to pension scheme members of companies who become insolvent).

Refinancing is standard practice and a common part of financial management of businesses, however, the credit market and the way lenders view their exposure have changed following the credit crunch. The banks have become much more cautious about lending and this has been reflected both by a reduction in the amount they are willing to lend and the tighter conditions attached to loans. The most apparent example of the latter is the increase in requests for security. As a consequence to this, refinancing may now prove to be a different and more challenging experience than before for many companies.

There are also signs now indicating that credit markets have been improving since the challenging conditions created by the credit crunch. The general trend means more attractive terms for companies who may wish to enter into refinancing arrangements early in order to take advantage of the current climate.

Research by Deloitte indicates that the corporate debt maturity patterns appear to be similar worldwide with a total of \$11.5 trillion of corporate debt being scheduled to mature over the next five years with three times as much debt expected to mature in 2011 compared with 2010. Just to illustrate the sheer magnitude of this maturing debt, it is worth pointing out that it is several times larger than the overall market capitalisation of the FTSE 100 index which, in mid-June 2011, was approximately \$2.5 trillion.

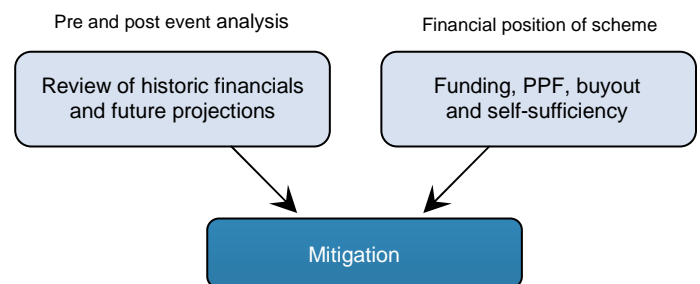
This increased volume of demand for capital is likely to serve to increase competition and may make the refinancing task a daunting one for some businesses. The terrain is further blighted by further potential sovereign debt crises and global political and social unrest which are likely to continue to create volatility in financial markets.

Undoubtedly, this is likely to be a testing time for many businesses as they seek to find the most favourable terms for servicing their debt whilst remaining aware that if appropriate terms cannot be found then the future viability of the business, both in the short and long term, may be under serious threat.

Options available to sponsors and trustees

Refinancing is now a regular feature of most businesses but it is important to make sure that the pension scheme does not get overlooked in this process. The trustees, in their position as a creditor of the business, may wish and need to take a seat at the negotiating table. However, trustees should not rush into seeking such a position without fully understanding the existing covenant position, the expected impact of the refinancing and its materiality, as well as their powers bestowed on them by the pension scheme's trust deed and rules.

The most significant issue for trustees is whether the refinancing materially alters the strength of the covenant supporting the pension scheme and whether the trustees should seek mitigation for any weakening in support. Therefore - as the first step in the process - trustees need to examine and compare the covenant positions pre- and post-refinancing in order to determine whether the strength of the covenant has been materially impacted or not.



Should the refinancing weaken the covenant materially, the trustees need to seek mitigation. The types of mitigation provided by the sponsor may include:

- Making a one-off cash contribution to the scheme
- Granting the pension scheme equal or second ranking security along with the banks, or some priority relative to other unsecured creditors
- Providing a contingent asset to the pension scheme, for example a wider group company guarantee
- Making negative pledges to the trustees (e.g. limiting the increase in debt or the extent of future dividend payments)
- Ringfencing some non-cash assets and transferring them to the pension scheme via a Special Purpose Vehicle.

The sponsor and trustees may also wish to consider the appropriateness of entering into performance threshold agreements whereby the sponsor undertakes to make payments into the pension scheme in certain circumstances. Similarly, agreement may be reached whereby the sponsor makes additional funding available if certain, non performance related, events occur.

The trustees and sponsor should also consider whether it would be appropriate for the trustees to be a party to the credit arrangements agreed.

Each refinancing arrangement is unique and therefore the type of mitigation that will be appropriate will vary for each pension scheme. Bespoke advice from specialist covenant advisers is essential in this area.

The success of Tata's recent refinancing exercise proves that it is possible to successfully refinance corporate debt in such a way that benefits all parties. A healthy and efficient capital structure will always be beneficial to all stakeholders of the business including the pension scheme.

"The best support for a pension scheme is a viable employer."

David Norgrove, former chairman of the Pensions Regulator

Case study : Tata – a successful outcome for all stakeholders

In October 2010 Tata Steel Europe successfully negotiated a £3.5 billion deal with a world-wide consortium of banks to pay off a three-year debt.

This refinancing created certainty for Tata over its debt arrangements and allowed it to reduce its short-term cash commitments. Further, Tata agreed to inject £100 million into its pension scheme as part of the refinancing exercise.

Consequently, both the business and the pension scheme appear to have benefited from the refinancing. This highlights the benefit to businesses of being able to successfully negotiate beneficial refinancing

Tata is clearly not the only success story in this area, other recent examples where the parties seemed to successfully tackle both the refinancing and pension issues include TUI and HMV, although the deal struck by the latter is still conditional on clearance from the Pensions Regulator.

A pathway up the mountain?

Businesses change all the time, and so do their financing needs and arrangements. It is important for trustees to be aware of these changes, monitor the employer covenant and assess the impact of one-off events.

The Pensions Regulator also expects trustees to keep the strength of the employer covenant under regular review and be alert to any changes in the covenant supporting the pension scheme. In particular the Pensions Regulator sets out the practice that he expects trustees to follow in assessing, monitoring and taking action on employer covenant in its guidance on "Monitoring Employer Support". Case studies are provided to illustrate the principles set out in the guidance.

We have developed some simple yet effective monitoring conventions for many of our trustee clients that enable them to keep alert to any changes in the strength of the covenant on a regular basis without the use of overly complex and time consuming metrics.

Trustees with significant reliance on the sponsor can also learn from other creditors, in particular the banks. The way banking covenants are defined, measured and monitored should provide some useful guidance to trustees.

Summary

An expected feature of the business environment over the next few years is the need for businesses to refinance their existing debt. Whilst it may be hoped that the terms available in the market will be more favourable than those prevailing in the post-credit crunch era the implications of any refinancing and the security offered to the pension scheme, as an unsecured creditor of the business, should be kept under careful review by all parties.

We are able to assist with this process by assessing whether any proposed refinancing exercise will materially impact on the strength of the employer covenant supporting the pension scheme and advising on the most appropriate form of mitigation that should be put in place.

Where can I get further information?

For specific advice, please get in touch with Lorant Porkolab on 020 7004 0074 or by email via lorant.porkolab@pstransactions.co.uk

Alternatively, speak to your usual Punter Southall contact.

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