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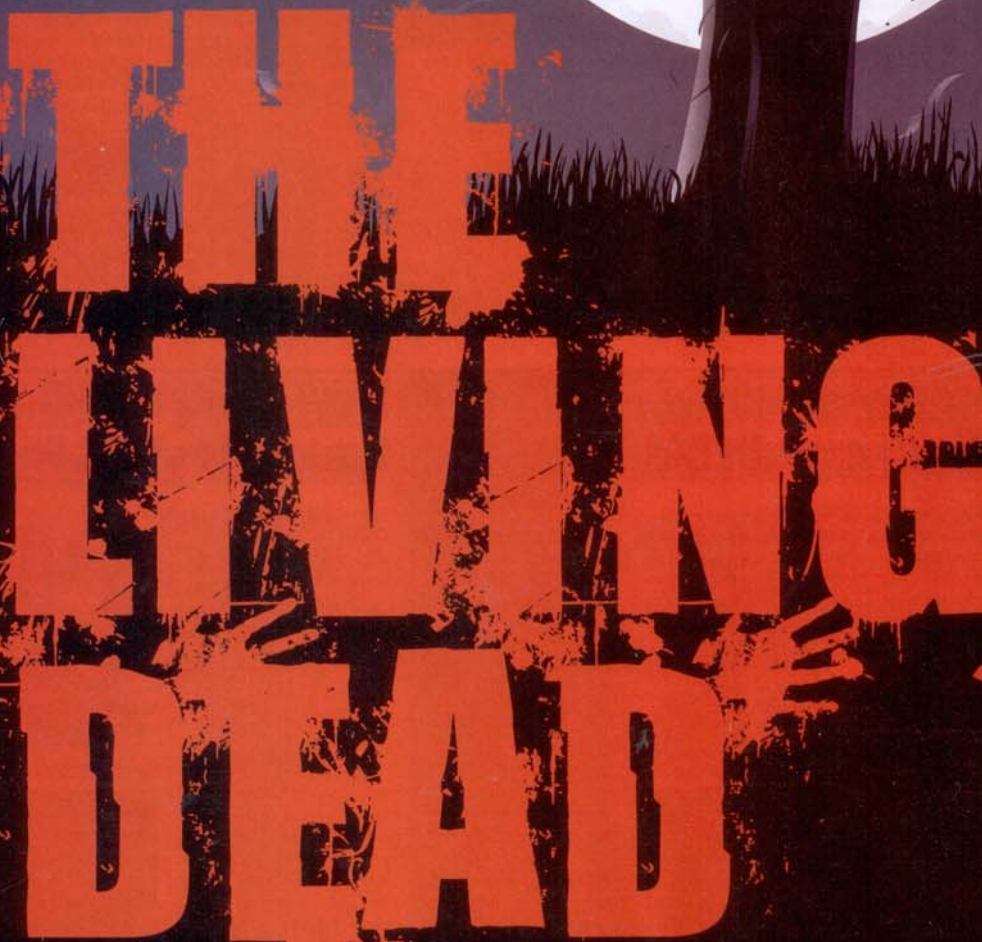
PENSIONS

Massive pension liabilities are draining companies of their lifeblood. Rob Brown and Ivan Castano ask how grocery players avoid joining...

THE LIVING DEAD



hey are the pensions zombies – firms paralysed by yawning pension deficits and unable to deliver dividends or finance their own expansion. This week a report by Pension Capital Strategies (PCS) revealed that the rot is spreading, with 10% of FTSE 100 companies now burdened with pension liabilities far in excess of their equity market value and representing a "material risk to the business".

Although grocery's biggest players are not among the 10%, few would argue that consumer goods retailers and manufacturers have not been seriously constrained by pensions liabilities in the past few years. The most dramatic example is that of Uniq, whose £736m liability (more than 50 times the firm's market capitalisation) could theoretically push it into administration. It's still waiting on the Pensions Regulator to approve a strategy thrashed out with its fund trustees to rescue the plans.

But how many other grocery players have pension burdens posing a similar risk? And what, as the economic uncertainty continues, can they do to avoid joining the pension zombies that are emerging from the fog of the last financial crisis?

PCS MD Charles Cowling defines companies at "material risk" from their pension schemes as those with liabilities greater than the size of their market worth. In the FTSE 100, these companies are usually the privatised relics of former public sector organisations (PCS puts British Airways' pension liability as of 31 March at 747% of its market value; BT's at 430%) that inherited generous pension promises to former public sector workers. In the grocery industry, such massive liabilities are often the legacy – as was the case with Uniq – of pension schemes attached to subsidiaries that have long since been sold. But there are other factors beyond their control.

"Increases in life expectancy have added perhaps 20% to pension liabilities in the past 10 years," says Cowling. "If you've got a pension scheme that's five times the size of your business, you are therefore facing growth in a liability that is big enough to wipe out the value of your business. That's what we mean by 'material risk'."

The pensions liabilities of the 12 grocery players present in the FTSE 100, although still huge, present less of a risk than those of many of their peers because of the relative size of the businesses. To find the real zombies one must delve deeper.

Cowling points to smaller companies for evidence of those that run the risk of joining the undead [see table on page 38]. While Uniq tops the list, Premier Foods is identified by PCS as having liabilities more than six times the size of its business and Northern Foods' liabilities are more than four times its market value. This month, Premier shut its final salary scheme to new entrants while it attempts to de-risk its four funds. In its annual results last month, Northern said it would encourage deferred members of its schemes to take advantage of the £15m it has put aside to help them get out of the company scheme and buy a new plan. But it's going to take more than that to reduce Northern's £149.7m deficit – which is twice what it was a year ago.

Commentators agree that a prolonged struggle lies ahead if companies are to bring their pension liabilities under control. During the recession, many were unable to address their pension problems, but progress is now being made. The PCS report noted a significant increase in the funding of the pensions deficits of FTSE 100 companies, with total funding climbing from £4bn last year to £11.8bn [w/e 30 June 2010]. The report estimates that the total deficit of FTSE 100 pension schemes stood at £73bn on 30 June – £17bn less than it was 12 months ago.

The influx of record amounts of cash into pension black holes is undoubtedly a good thing for scheme members, but it 38 »»

10%
of FTSE 100 firms have pension liabilities greater than their equity market value

THE GRIM REALITY

- The total disclosed pensions liabilities of FTSE 100 companies stood at £434bn on 30 June, up 15% from £378bn the previous year
- The number of businesses at "material risk" from their pensions liabilities is growing, with 10% of FTSE 100 companies now labouring under liabilities greater than their market value
- Despite the economic climate, cash-strapped companies last year pumped £11.8bn into their pension deficits, up from just £4bn in 2008
- The cash injection has helped narrow the total FTSE 100 pensions deficit. As of 30 June the deficit was estimated at £73bn, down 19% year-on-year
- The average pension scheme allocation to bonds now stands at 49%, level with last year. This represents a halt in the switch from equities bonds [in 2007 average bond allocation was 35%], though the flight is expected to continue at a slower pace in coming years
- There's been a marked decline in the provision of defined benefit pension schemes, representing a 15% decline in employee pension provision

Source: FTSE 100 and their pensions disclosures, July 2010, Pension Capital Strategies

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ZOMBIE NATION?

	Pension Liabilities (£m)	Liabilities (as a % of company worth)	Deficit (£m)	Deficit (as a % of company worth)	Company worth at 30 June 2010 (£m)	Pension Assets (£m)
Uniq	736.4	**5,223%**	–235.1	**1667%**	14.1	501.3
Premier Foods	2,958.5	**643%**	–428.5	**93%**	460.2	2,530.0
Northern Foods	915.6	**449%**	–146.4	**72%**	203.9	769.2
Finsbury Food Group	17.0	**213%**	–1.3	**16%**	8.0	15.7
Dairy Crest Group	822.5	**168%**	–142.4	**29%**	488.5	680.1
Marks & Spencer	5,299.5	**101%**	–350.9	**7%**	5,263.9	4,948.6
Sainsbury's	4,658.0	**78%**	–421.0	**7%**	5,939.0	4,237.0
Tate & Lyle	1,328.0	**65%**	–156.0	**8%**	2,054.7	1,172.0
Britvic	547.0	**53%**	–85.1	**8%**	1,031.7	461.9
Associated British Foods	2,452.0	**32%**	–79.0	**1%**	7,718.0	2,373.0
Morrisons Supermarkets	2,128.0	**30%**	–17.0	**0%**	6,997.7	2,111.0
Unilever	14,515.2	**26%**	–1,722.7	**3%**	54,871.5	12,792.5
Diageo	5,789.0	**22%**	–1,197.0	**4%**	26,698.4	4,592.0
Tesco	6,536.0	**22%**	–1,840.0	**6%**	30,222.1	4,696.0
Compass	1,861.0	**20%**	–336.0	**4%**	9,527.3	1,525.0
Imperial Tobacco	3,592.0	**19%**	–794.0	**4%**	19,103.6	2,798.0
British American Tobacco	5,370.0	**13%**	–752.0	**2%**	42,656.0	4,618.0
Reckitt Benckiser	1,064.0	**5%**	–263.0	**1%**	22,475.6	801.0
Cranswick	17.1	**4%**	–5.4	**1%**	401.1	11.8
SABMiller	335.6	**1%**	–108.8	**0%**	29,647.4	226.8

Source: Pension Capital Strategies **Notes:** Figures are of date of companies' last published accounts

<<< 37 is not without its risks to business. Workers' gain could be shareholders' loss. "It's certainly the case that if the companies are pumping record amounts into their pensions, they will not be in a position to pay dividends and invest in their businesses," says Bob Scott, partner at Lane Clark and Peacock. "It's a necessary drag on the recovery because the companies have the obligation to fund these pensions."

BRAND VALUE

Injecting of money into funds is just one option, however. As pension scheme trustees digest the impact of the financial crisis and ponder the possibility of a double dip, they are turning to the assets of the supporting companies to use as collateral to plug their shortfalls. And increasingly the star brands of grocery are being eyed as the sugar daddies. "The food business has a great number of fantastic consumer brands that can be secured towards a pension scheme," says Stuart Whitwell of consultancy Intangible Business. "Rather than paying just cash, a company can establish a special purpose vehicle (SPV), place the brand in the new vehicle and secure the asset in favour of the pension scheme in case of default."

Such schemes allow companies to lower and extend their cash payments. In return, trustees receive the income generated from the brand's royalty payments and can take the brand's rights and ownership in the event of default.

"I'd be surprised if most of them haven't considered it," says Cowling. "It is a way of putting off having to fill a deficit but they don't provide a panacea. They give you an alternative and some breathing space. Most of the key advisers, us included, are talking to companies with strong brand value or strong assets, like property, that are available, to discuss their options."

£434bn the total disclosed pensions liabilities of the FTSE 100

While Diageo will not comment on the actions it will take to address its pension headache before a review in 2012, the company has a crop of valuable brands it could chose from [the Johnny Walker label is worth £2.7bn, according to Crampton] if it were to take this novel approach to avoiding future pension-related paralysis.

Diageo has other tricks up its sleeve. In July the drinks giant pledged to roll out millions of barrels of Scotch whisky to pension trustees as collateral for a possible default on its obligations. The cargoes have a book value of £430m and will

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FTSE 100 companies disclosed deficits last year. Just five were in surplus.

provide a regular income stream for the pension vehicle over 15 years.

Under the accord, Diageo has the option to buy back the whisky as it matures, providing the pension pot with £25m a year in addition to the payments it previously agreed to make. The company will also invest £200m cash into the fund.

Other deficit-busting strategies, more frequently used by retailers, include pledging property as a bond against default.

Perhaps the most innovative of these schemes was that of hotel and restaurant group Whitbread, announced in May. The company and its pension trustee partnered to form a company that will hold £100m of hotel and restaurant assets to provide income to the pension scheme and allow Whitbread to free up cash for other operations. It was described at the time by Whitbread group FD Christopher Rogers as "a very effective and efficient use of our property assets and benefits Whitbread in terms of cashflow".

In July M&S took note and announced it would divert £300m of property assets into an £800m funding plan to lower its £1.3bn pensions deficit. Sainsbury's has announced a similar scheme.

Deloitte, which advised Whitbread on its strategy, says it is advising many FTSE 100 companies looking to fund more than £2bn of UK corporate pension deficits by collateralising a mixture of property, brands and investments.

Brands remain grocery players' trump card, according to Sarah Abraham, a consultant at specialist pensions consultants Aon. "Brands are definitely a better tool than property for the food industry," she says. But giving away the family silver is never a decision to be taken lightly. Property appears more clearly on the balance sheet while a brand has a more abstract and timeless value that can be hedged for greater returns. This is a big decision, as they are giving away a really important asset for the company, so unless they really have to get rid of it, they won't."

Another way of avoiding the pensions jeopardy is by shifting investments to bonds from equities. "If you've got a pension scheme that's twice the size of your company and 50% is in equities, then you've got an equity exposure equal to the size of your business. If equities go down 25% in a year, you've effectively lost 25% of the value of that business," explains Cowling.

According to PCS, the average pension pot is invested 49% in bonds, a proportion level with last year's but up from 35% three years ago. Clearly, equities present the greater risk. Tesco and Unilever's pension schemes have some of the lowest allocation to bonds in the FTSE 100 [29% and 28%, respectively, according to PCS], making them among those most heavily reliant on equities. Compared with the multiples' market value, their pension liabilities are a manageable 22% and 26%, respectively. "Their pension schemes are much smaller than the size of their business, so they're much more able to ride out the problems in the equity markets," says Cowling.

But, overall, he predicts a move out of equities towards bonds as final salary schemes enter their dying days and the liabilities that are left are mainly tied up with former employees - albeit living longer than originally forecast. Companies dealing with these so-called "legacy liabilities", according to Cowling, will be more risk averse, pushing the continued shift to bonds.

Many, like Northern, are also encouraging retired workers to move out of company pension schemes and funding insurance policies to help them if the payout falls short of expectation. "Companies realise some people prefer to have their pension in hand than tied into an organised scheme, so by offering a lump sum they can encourage some of their older workers to exit the fund," says KPMG's Rob Smedley.

Even as companies tackle the deficit backlog, there is the spectre of future change to pensions legislation that could cost them another £2.5bn a year [see box, right]. "We could see many more companies completely swamped by their pension liabilities," warns Cowling. "M&S, for example, had a very generous pension scheme. How can it afford to offer very generous pension schemes when its competitors are not? The likes of Tesco cannot afford to be complacent, either. No business wants to see unexpected losses arising in non-core business activities, including pensions."

Given the threat of a double-dip recession, it's likely we haven't seen the last pensions zombie wandering the business landscape. ■

THE HORIZON

2010

Commentators suggest the government decision to link pension contributions to consumer price rather than retail price inflation – unveiled last month – could help cut the deficit by up to 15%. Further details are expected later this year

2011

The pensions industry is to provide the Treasury with an extra £3.5bn a year from 2011. In return, the Chancellor has pledged to work with the industry to find alternatives to Labour's proposal to lower tax relief for high earners

2012

New rules forcing employers to enroll all workers in schemes could cost UK companies a further £2.5bn a year, says DWP, although commentators suggest firms will offset extra pensions expenses by cutting existing benefits. The abolition of Money Purchase Contracting Out – allowing pension schemes to effectively buy out members with a lump sum – will require many large schemes to rethink their benefit design and will cause headaches for industry

2013

The timetable for a second phase of changes is expected to be announced. This is expected to include changes to how returns are expressed, from predicted to actual returns. Additional changes to the valuation of scheme liabilities are also expected