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Pension Plans: The $20 Trillion Elephant in the (Valuation) Room

By Dr. Susan Mangiero, CFA

Company pension plans are ticking time bombs that could have a devastating impact on enterprise value. Massive underfunding, along with complicated plan economics, makes it crucial for appraisers to have a solid grasp of the ins and outs of these plans and their potential consequences on value.

The objectives of this article are threefold: (1) shed light on the magnitude of the pension underfunding problem and the possible dire impact on enterprise value; (2) remind appraisers of the need to thoroughly understand and evaluate pension plan economics or engage someone to assist them; and (3) explain the adverse consequences on deal-making and corporate strategy when pension plan funding gaps are given short shrift.

While the need for a thorough analysis is no less important for other types of employee benefit offerings, this article will focus on pension plans. Equally important to note, there are countless fiduciary obligations that must be recognized by pension plan decision-makers. Even the hint of a failure to carry out fiduciary duties by appointed persons can be expensive. ERISA litigation is on the rise. In 2011, more than 11,000 cases were said to be making their way through the court system. The types of complaints vary, and the stakes are high.[1] In a recent matter, a judge ruled against a plan sponsor and decided on a damage amount in the neighborhood of $35 million.[2] The case is being appealed.

Background. With nearly $20 trillion at stake and gloomy predictions about a worsening retirement crisis, millions of Americans are starting to realize that they cannot afford to stop working any time soon.[3] Unfortunately, they are not alone with their fears. Investors and lenders have a lot to lose as well if pension problems occur. Low interest rates, longer life spans, new regulations, and higher market volatility have made it prohibitively expensive for some companies to offer a pension plan to employees. Higher costs in a competitive marketplace translate into lower profitability for countless businesses. This puts pressure on employers to rein in the costs of benefits, to the extent possible. With respect to pension plans, funding statistics are hard to ignore.

In a recent study conducted by Bank of America Merrill Lynch, companies in the S&P 500 Index with single-employer defined benefit plans are said to face a funding gap of almost $429 billion in 2013, "the highest funding deficit since 1996."[4] Credit Suisse analysts predict that multiemployer pension plans are underfunded by

1 www.institutionalinvestor.com/Article/2766226/Asset-Management-Pensions/ERISA-Class-Action-Suits-Shape-US-Retirement-Future.html.

2 *Ronald Tussey, et al., Plaintiffs, v. ABB, Inc., et al., Defendants,* Case No. 2:06-CV-04305-NKL, United States District Court, W.D. Missouri, Central Division, March 31, 2012.

3 "Retirement Assets Total $19.5 Trillion in Fourth Quarter 2012," Investment Company Institute press release, March 27, 2013.

4 www.valuewalk.com/2013/01/sp-500-pension-deficit-to-increase-by-429b-in-2013-baml/.

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$369 billion, with most of those IOUs belonging to companies not in the S&P 500 Index and "concentrated within the construction, transportation, and mining industries."[5] The Pension Benefit Guaranty Corp. (PBGC) announced a record deficit of $34 billion in 2012, potentially jeopardizing its continued ability to take over plans of troubled or defunct companies.[6] Whether a company or a government fails to meet its pension obligations, the story is the same. Participants, creditors, and shareholders may lose big.

Corporate finance impact. The adverse impact of pension deficits on cash flow, enterprise value, and attractiveness to potential suitors is understandably gaining more attention. Investment bankers, bondholders, and equity owners need to know whether a company has sufficient resources to grow or will instead have to use cash to satisfy statutory contribution minimums.[7] A pension-poor company may be unable to attract new capital, go public, merge or be acquired by a friendly competitor, avoid distress, and/or add to its portfolio of positive net present value projects. With no immediate relief in sight, chief financial officers (CFOs) are bracing themselves for the worst."[8] Deals are getting structured to explicitly take pension issues into account. In late April 2013, the Eastman Kodak Co. announced the sale of two businesses to U.K. retirees as part of its $2.8

5 Marielle Segarra, "Does Danger Loom for Multiemployer Pension Plans?" CFO.com, March 30, 2012.

6 Jerry Geisel, "PBGC Deficit Hits Record $34 Billion in 2012 Fiscal Year," BusinessInsurance.com, Nov. 16, 2012.

7 The Pension Protection Act of 2006 (PPA) increased funding requirements for "at risk" plans. As a result, some companies found themselves having to come up with large amounts of cash to meet contribution mandates. In 2012, the passage of the Moving Ahead for Progress in the 21st Century Act (MAP 21) offered some assistance to plan sponsors by changing the way liabilities are discounted.

8 Susan Mangiero, "Pension Risk, Governance and CFO Liability," *Journal of Corporate Treasury Management*, Dec. 6, 2011.

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billion obligation, a large sum that was threatening to complicate the company's efforts to reorganize."[9]

Some companies want out of the "pension business." Fiduciary fatigue and an awareness that a mobile work force may be interested in other kinds of employee benefit plans are two motivations for change. Firms such as Equifax and NCR have given employees the option to take a lump-sum payment in lieu of monthly checks later on.[10] Other firms such as Macy's, Genuine Parts Co., Aurora Health Care, American Airlines. and the McGraw-Hill Companies Inc. show up on a long list of sponsors that will freeze or have partially or fully frozen benefit accruals.[11] Late last year, IBM announced that it was cutting back its 401(k) plan match for any individual who leaves the company before December 15 of each year, other than for retirement.

Some companies have decided to forgo the company match altogether as a way to preserve cash. Yet other firms are entering into transactions that have the effect of restructuring pension assets and liabilities. Described as "derisking," this trend is large and growing in the U.K. and starting to take off in the U.S. Derisking transactions take different forms but often involve a large insurance company that has been asked to buy in or buy out a company's pension plan IOUs or reinsure longevity swap risk.

Other employers are turning to the derivatives market to create hedging programs or attempt to boost investment yields. Yet other firms are changing their asset allocation mix to favor bonds as part of a cash flow matching or duration immunization program.

The solutions are varied and depend on a number of factors. Cash-poor firms or those facing a seasonal sales cycle may struggle to afford a lump-sum payout or withdrawal from a multiemployer collective bargaining pact. Small firms with limited staff size and budget are unlikely to embrace a sophisticated, time-intensive investment strategy that is designed to either reduce risks or enhance returns. A firm that is positioning itself for an initial public offering or pressured by private equity fund investors to clean up its balance sheet may be more flexible about how to restructure its employee benefit plans. A company with global competitors may find itself unable to win business unless it is willing to renegotiate contracts with labor unions.

Recognizing that bad pension economics can adversely impact corporate strategy, increase a company's cost of capital, and reduce enterprise value is an important first step. Whether an organization is a buyer, seller, or lender to another firm, due diligence that ignores pension economics can be expensive and fraught with exposure to being sued. Small to midsize and private businesses are not exempt. To the contrary, an owner's wealth for a certain size company is more concentrated than larger peers, access to capital is limited, and growth via some type of exit strategy may be doomed if employee benefit plan problems exist.

Traditional defined benefit plans are not the only source of concern to regulators, lenders, and investors. With fiduciary breach enforcement on the rise and an active plaintiff's bar that has its eye on defined benefit, defined contribution, cash balance, healthcare, ESOPs and executive compensation arrangements, legal risk and the possible costs of defense or deals gone astray are real.

Deciphering pension information. Someone once said that a pension expert has a job for life. How true. Actuarial, accounting, and regulatory reports are complex. They are influenced by plan design, change over time, vary by country because of different rules, and are sensitive to assumptions. An assessment of pension economics must begin with a proper parsing of data. This means that an appraiser must become

9 Emily Glazer and Mike Spector, "Kodak Gives Assets to U.K. Retirees," *Wall Street Journal*, April 29, 2013.

10 J. Scott Trubey, "Companies Pitch Lump Sums to Dig Out of Pension Holes," *The Atlanta Journal Constitution,* Oct. 13, 2012.

11 See "Get the Facts," Pension Rights Center website.

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familiar with how the numbers are assembled, what they represent, and how they differ.

In addition, an appraiser should be able to unbundle accounting and actuarial numbers to determine how much cash will be needed to meet contribution levels. Estimating future expected cash requirements to service a plan(s) is imperative if an appraiser wants to verify whether a firm can realize its growth targets, avoid breach of loan or bond indenture agreements, and/or be sufficiently liquid to survive a recession or mount an offense against new competitors. Identifying how benefit plan economics are expected to change when derivatives are used or a plan has been redesigned for part of its work force are other important considerations.

It is beyond the scope of this article to fully describe how to properly vet information for the myriad types of employee benefit plans that an appraiser might encounter. Instead, common attributes of employee benefit plans, regardless of category and/or features, are presented in Exhibit 1. This is not an exhaustive list.

Pensions take on more risk. In anticipation of higher returns, pension plans as a group are investing in "hard-to-value" assets as one way to try to close any funding gaps. Hard-to-value assets include real estate, commodities, hedge funds, distressed debt, venture capital, leveraged buyouts, private equity funds, and intellectual property such as patents.[12] Some posit that a plan can set itself up to take less risk in the future by taking more risks now.[13] The downside is that a pension plan realizes a large loss, its funding gap widens as a result, and the original deficit becomes larger. Obviously this chain of events would not be good. This is why an appraiser must consider the asset side of the equation as well as the nature of liabilities. This necessitates that the appraiser examine, understand, and assess how well a particular pension plan manages its various risks.

On the asset side, not every dollar of return is equal in terms of risk. It is necessary to evaluate the long list of items that contribute to the riskiness of any one investment as well as understanding the portfolio impact when instruments and funds are combined. Besides an evaluation of the time-variable correlation impact of adding or removing items from a pension portfolio, lockups, redemption allowances, voting rights, legal status, regulatory compliance, transparency, side pockets, fund governance, and diversification are only a few of the items to be reviewed. A cursory inspection is ill-advised, certainly for top holdings. A defined benefit plan may have significant dollars allocated to a private fund that honors redemption requests several times per year but only with additional assets (some of which could be hard to value) instead of cash. Real estate holdings may be geographically located in a hard-hit part of the country and unlikely to appreciate any time soon. A venture capital fund may have a valuation committee that rarely or never meets, thereby casting doubt on reported numbers. Exposure to asset-backed securities could prove troublesome if the underlying collateral is insufficient or of questionable worth.

When derivative instruments are being used on a large-scale basis, the appraiser wants to become familiar with how they are deployed. Hedging changes the risk-return profile of a pension plan in an altogether different way than speculation does. The rules are changing with respect to how over-the-counter derivatives are cleared. It is not clear yet whether costs will be reduced and whether pension plans will be more active participants in a global market that now exceeds $600 trillion.[14,15] What is known

12 In testimony before the ERISA Advisory Council about hard-to-value investing on Sept. 11, 2008, Dr. Susan Mangiero emphasized that not all hedge funds should be categorized as "hard to value." She added that some traditional offerings such as mutual funds could be classified as "hard to value" by virtue of their use of complex derivative instruments.

13 Mariah Summers, "Corporate Pensions to Up Risk in Funding Drive," *Fund Fire*, March 20, 2013.

14 Refer to www.bis.org/statistics/otcder/dt1920a.pdf for a tally by type of derivative instrument.

15 See www.pensionriskmatters.com/2013/03/articles/derivatives/dol-issues-advisory-opinion-about-use-of-swaps-by-erisa-plans/ for a discussion about regulations and swaps.

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Exhibit 1. Attributes of Pension Plans That Impact Appraisal Analysis

Pension plans are complex mechanisms, but they all share certain characteristics that an appraiser should understand to do a proper evaluation.

1. For any type of fixed formula scheme such as a traditional pension plan, sponsors are legally obliged to make payments on time. This requires having enough cash on hand at relevant points in time to write checks to retirees. Even if a plan is reported as overfunded, it may lack sufficient liquidity.

2. An illiquid plan may pose a risk to participants if the sponsor is generating ample operating cash flow and/or has adequate access to capital at cost-effective rates. Low interest rates are a boon to any company (or government) with borrowing capacity. It can issue debt and use the proceeds to replenish an underfunded pension plan.

3. Pension accounting in the United States currently allows for the amortization of gains and losses. Smoothing can mask wide swings in the value of assets and liabilities. Since some countries have already changed the accounting treatment of pension plans, an appraiser needs to unbundle reported numbers if he or she is evaluating pension economics for different geographic divisions of a parent firm.

4. Statutory funding ratios that are computed as part of compliance with the Employee Retirement Income Security Act of 1974 (ERISA) can vary, sometimes materially so, from numbers assembled for 10-K inclusion.

5. A metric that assumes a "worst case" situation such as company bankruptcy and/or subsequent ownership by the Pension Benefit Guaranty Corp. (PBGC) as sponsor of last resort will typically differ from an ongoing concern evaluation.

6. Cash needs and financial disclosures are likely to spike or decline for any company that anticipates a major labor event such as a large-scale reduction in force or acquisition of a business and related hiring of its team. Stale actuarial reports and time-lagged government filings will have to be updated to reflect expected liquidity needs as the size, salary levels, age, and health of human capital shifts.

7. Any type of financial engineering overlay strategy that has an economic impact on pension plan liabilities or assets must be unpacked from pension disclosures as a first step in assessing the relationship between benefit plan costs and enterprise value.

is that transacting with derivative instruments allows a pension plan to manufacture leverage by gaining exposure to an asset class for a fraction of what it would cost via direct investing. Leverage is not necessarily bad but must be understood. An outflow of cash to meet margin calls diminishes the ability to write checks to retirees and could result in increased borrowing by the sponsor to make good on its legal obligations.

Regarding plan redesign or termination, an appraiser needs to query whether an anticipated partial or full transfer of assets and liabilities to a third party is planned. Many of these transactions require cash for either an up-front settlement to be paid to an insurance company or employees. For sponsors that are switching employees to what they describe as a more generous defined contribution plan, cash may be required to facilitate larger employer matches. As alluded to already, the derisking market is far from trivial and growing. It is simply not enough to conduct a point-in-time assessment of the health of a plan(s). Valuation professionals must ask whether management projections are taking employee benefit plan costs into account in a meaningful way.

It is an unhappy reality that certain companies are racing for bankruptcy court because their benefit promises exceed net worth. An appraiser can be thorough with his or her evaluation of employee benefit plan obligations, count on Lady Luck, or test the E&O underwriter's willingness to pay.

Pensions and due diligence. Facts and circumstances are integral to a comprehensive appraisal of a company (or fraction thereof) that

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takes employee benefit plan economics into account. It is therefore not possible to provide an exhaustive list of what should be inspected and analyzed. Exhibit 2 sets forth a starter list of documents to gather and examine.

Conclusion. Those with an ear to the ground in Washington, D.C., talk about "when" and not "if" regulators mandate the classification of appraisers as ERISA fiduciaries.[16] If they are right, appraisers will face heightened liability. Some appraisers may exit the business of serving ERISA plan sponsors. Those who continue to serve this market segment need to acknowledge the new paradigm. The financial statement impact, cash needs, and possible drain on future growth due to the creation and maintenance of employee retirement plans for some businesses are huge. Ignorance is not bliss.

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16 See www.aicpa.org/advocacy/issues/pages/dolproposedfiduciarydefinition.aspx and www.lifehealthpro.com/2013/01/29/industry-girds-for-dol-fiduciary-rule.

Exhibit 2. 10 Key Documents Related to Retirement Plans

While this list is not exhaustive, it contains important documents appraisers should examine at the very least.

1. Summary plan description (SPD)
2. Recent actuarial reports
3. Recent financial statements
4. Investment policy statement(s)
5. Form 5500 filings
6. Collective bargaining agreements (if applicable)
7. Third-party administrator (TPA) reports
8. Liquidity projection reports (if they exist)
9. Legal complaints against plan sponsor (if applicable)
10. Private placement memorandums for top holdings in "Level 2" and "Level 3" assets

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