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Manufacturing

Pensions restructuring

Avoiding the inevitable

UK manufacturing faces an uncertain future, facing challenges to compete in the global economy. Many companies traditionally employed large workforces entitled to valuable salary-related pension benefits. As these companies have slimmed down to achieve operating efficiency, their pension deficits have continued to increase. As a result, some of these companies have no realistic prospect of clearing their pensions deficit, which can often represent the largest single balance sheet liability.

Insolvency for the company, with the pension scheme being taken over by the Pension Protection Fund (PPF) seems inevitable; or does it?

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Background

Traditionally, companies in the manufacturing sector have offered generous salary-related pension benefits to their employees, many of whom would have expected to work with the same employer from joining as an apprentice to leaving at normal retirement age.

Each of the main manufacturing sectors, including aerospace and defence, automotive, chemical, metal, paper and packaging and industrial product manufacturing have been part of a changing economic landscape. Most of the companies that continue to operate are now struggling to deal with pensions deficits which, even allowing for optimistic profit forecasts, may never be cleared. Issues such as improving mortality and lower than expected investment returns mean that this situation, if anything, is likely to deteriorate further.

Unless this issue is addressed, the most likely outcome is that many manufacturing companies may fold and their pension schemes will be taken over by the Pension Protection Fund (PPF). This means that shareholders may receive little or no return on their investment and many employees and former employees could receive greatly reduced pension entitlements.

From the PPF's perspective, there is a serious risk that it could become overwhelmed by the net pensions liabilities of former manufacturing companies. This could result in sharp increases to the annual levy with the further risk of driving more companies to insolvency.

An alternative approach

Most of the manufacturing companies facing this uncertain future have already attempted to tackle the issue by closing their defined benefit pension scheme to new entrants and/or future benefit accrual. While this will have some effect on slowing down the increase in the size of their pensions deficit, it is unlikely to fundamentally alter the position.

Insolvency for the company with the PPF taking over the pension scheme represents a 'no win' situation for all the stakeholders concerned, including unsecured creditors, shareholders, pension scheme members and the PPF. Even where a manufacturing company is trading profitably, a sale of the business would be unlikely as no purchaser would be prepared to take this on with a disproportionately large pensions deficit.

The alternative lies in a Company Voluntary Arrangement (CVA) backed by the various stakeholders, including the Pensions Regulator and the PPF. Both the Regulator and the PPF recognise they need to be flexible when considering alternative options for manufacturing companies in this position. They have both indicated that they will consider alternative options provided that these are likely to result in a greater return than would be available through a formal insolvency procedure.

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Structuring a solution

In order to structure a solution for manufacturing companies who are facing challenges in dealing with their pensions deficit, which gives a more favourable outcome to all of the stakeholders, a co-ordinated approach is essential. This will likely include financial restructuring for the company and effective negotiations with:

- Shareholders;
- Bankers;
- Trade creditors;
- Pension scheme trustees;
- Employee representatives;
- The Pensions Regulator; and
- The Pensions Protection Fund.

The first step is for the company to arrange for the preparation of an estimate of the likely outcome for each of the parties above, should the business fall into insolvency. This provides a benchmark by which any alternative proposition can be assessed.

As the pension scheme is one of the major obstacles to business restructuring, it is vital to ascertain whether, in principle, the PPF is willing to consider an alternative proposition. In previous cases for example, the PPF has been prepared to take an equity stake in the restructured business in return for its support and this is something that can be considered in conjunction with other solutions.

Armed with an 'in principle' agreement from the PPF, potential new investors can be approached with a proposal. Once a new investor has been identified and details of the financial restructuring of the business going forward have been agreed, the CVA can be presented to creditors and shareholders for their approval.

Correctly structured and carefully negotiated, the use of a CVA for manufacturing companies facing an inevitable slide towards insolvency can result in a solvent company and job security, albeit at the partial expense of the pension scheme. The alternative, however, would likely result in the loss of all jobs and an even smaller entitlement for pension scheme members under the PPF.

Under the CVA, shareholders are likely to receive a smaller stake than they previously had, however this will now be in a restructured manufacturing company which is free of its crippling pension liabilities and therefore with the potential for growth.

In relation to future pension provision for the employees in the re-structured company, while this could be set up again on a defined benefit basis, it is more likely that the company would want to restrict its risk exposure by offering a defined contribution arrangement. This is more in line with the pensions offered by global competitors as well as with new businesses in the UK.

Deloitte service areas with experience of working together on these transactions for manufacturing companies include:

- Corporate Finance – re-financing of the company.
- Reorganisation Services – negotiations with the Pensions Regulator and the PPF.
- Corporate Tax – tax structuring.
- Pensions Actuarial – pensions liability assessment.

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Summary

What initially looks like a hopeless situation can be turned around, resulting in a revitalised manufacturing company with a solvent balance sheet free of historical pension liabilities, as well as jobs for employees who were previously facing redundancy. This is brought about, in part, by the Pensions Regulator and the PPF taking a pragmatic stance when considering alternative proposals.

Deloitte is able to assist manufacturing companies in all areas of such a transaction which can often be complex and must be closely and effectively integrated to ensure success. These complexities are overcome by having a clear picture of what the outcome might look like as well as an appropriate approach to not only the Regulator and the PPF but to all the other stakeholders who are required to formally agree to the arrangement.

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Designed and produced by The Creative Studio at Deloitte, London.

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