Reproduction prohibited (Strictly for internal use)
Journal: Capital Finance
Article Date: 04.07.2005

Financing

Pension liabilities: what is their effect on acquisition price?

During an acquisition, the analysis of pension liabilities and costs can turn out to be crucial from a financial point of view. The methods for handling these aspects highlight the economic issues related to these financial components.

The consideration of pension liabilities is a widely discussed subject during an acquisition, given the amounts involved which can be very significant. The complexity of the subject can lead to disputes among experts, which would keep investors from being informed of the real economic issues. It is important for buyers wishing to "regain control" to have a few simple keys of analysis and particularly know how to use an often overlooked concept: actuarial present value of future payments (APVFP). The analyses to be performed are the same for companies and funds, but the results will be used differently depending on the buyer's profile: while a fund will primarily look at cash at five years, a company must be concerned about the consequences of consolidation in its accounts as well as the effect of a possible harmonisation of plans within the new group.

Analysing liabilities

The first issue that arises involves knowing how lines on the balance sheet and the income statement involving these liabilities should be analysed. In summary, and considering here only the defined-benefit plans, which are the only ones that involve the establishment of a provision, the net amount recorded on the balance sheet is obtained by following four steps:

1. Determination of the actuarial present value of future payments (APVFP), i.e. the present value of the estimated amounts of benefits that will be paid to all beneficiaries until the last of them dies.
2. Determination of share of the APVFP attributable to services already rendered by employees: this is the actuarial liability. This debt is generally determined through the projected benefit obligation (PBO) method, which applies the pension plan’s calculation formula by taking seniority to date into account and projecting changes in wages.
3. Consideration of any financial asset established to meet the obligations of the pension plan.
4. Spreading over time of changes in assumptions (actuarial gains and losses) and certain plan modifications to absorb fluctuations in the earmarked amount.

On the income statement, the calculated charge does not correspond to a flow of money and is broken down into LAS between operational (cost of services rendered, amortisation of actuarial gains and losses, cost of past services, etc.) and financial (interest expense, expected return on plan assets) components.

... then restating them

The accounting aspects are therefore complex and also rely on actuarial calculations. Moreover, it is rare to encounter business plans modelled with sufficient detail to identify the financial and operational components described above. Lastly, this complicated process does not lead to the recognition of a provision and a charge that can be easily linked to real cash flows. The investor must therefore make special adjustments for a financial valuation of the liability and ensure consistency between financial debt and future flows:

- Balance sheet entries, such as actuarial gains and losses, which aim to absorb fluctuations in value, do not correspond to any flow of money and must therefore be adjusted.

• The actuarial liability on the balance sheet does not take into account all future flows but only their share acquired as at the valuation date. This approach does not allow all financial flows to be captured in the valuation. As such, APVFP is a good estimate of future liabilities to be considered in a financial valuation. Unfortunately, this amount cannot be read directly from the accounts or their appendices and must therefore be the subject of special work. In the initial analysis, the APVFP can be closely estimated by multiplying the PBO by the Total average seniority/Average seniority to date[1].

As the plan's assets are recorded at fair value, like other financial assets, the only issue is the availability of funds. It is therefore necessary to specifically examine the issue of the liquidity of these assets, particularly in the context of structuring the acquisition debt.

- Expenses on the income statement have no monetary substance; they must be restated as part of a valuation, with all future flows captured in the debt through determination of the APVFP.

Using restatements

All of these restatements allow the APVFP to be isolated on the restated balance sheet, by excluding the non-monetary flows of the income statement. However, this approach has some practical drawbacks in the context of an acquisition:

- Determination of the APVFP requires a complex actuarial calculation, and the result is highly sensitive to certain assumptions. The list of these assumptions should therefore be obtained in order to verify their reasonableness. It is important to note that the objective here can only be to obtain a valuation range and not a precise figure. As the actuarial liability is the result of essentially random predictions, its nature is very different from a tangible financial debt, and its value is highly volatile. This must be taken into account in discussions about price and in the contractual mechanisms; it is unreasonable to negotiate this amount down to the euro, at the risk of being trapped in an endless dispute among experts.
- The APVFP takes into account only the population as at the valuation date. If the company's forecasts incorporate significant staffing changes, it is important to perform a special actuarial calculation to determine the consequences of these changes on the total liability.
- The calculation of the APVFP provides a total debt but does not contribute any cash flow forecast information. This can be very significant for the investor who, as part of an LBO, needs to accurately determine the actual flows on a relatively short horizon for the financial engineering of the operation. Equal amounts of debt can correspond to very different economic situations, for example:

1. A company whose employees are mostly close to retirement: in this case, the calculation of the debt will be accurate, and significant disbursements are to be expected over the life of the investment.
2. A mature company with little change in its staff and a uniform age pyramid: in this case, the debt will vary little over time and will be renewed as a sort of revolving credit with constant payments.
3. A growing company with young staff: in this case, the calculated debt will be very volatile, and the first actual disbursements will only occur in the very long term.

In the first example, the subject should be dealt with closely, particularly in order to position the acquisition debt and avoid a liquidity crisis during the holding period. In the second case, the investor may wonder, given its quasi-permanent nature, whether this debt cannot be excluded from the acquisition price for the most part, retaining only the projected disbursements over the planned investment period; this position is certainly incorrect in theory, but it reflects the reality of medium-term cash flows and may offer a competitive advantage in a bidding process. Lastly, in the third case, given the volatility of the debt and the lack of medium-term disbursements, the buyer may also decide to ignore this amount, always in a context of competition for purchase.

Thus, it is clear that the determination of only the APVFP is not enough to perform a relevant financial analysis. The best solution is to determine the timing of the underlying cash flows in

calculating the APVFP in order to assess the schedule of disbursements. It is therefore important to plan for the necessary time during due diligence measures to obtain and process the required detailed information.
In conclusion, a relevant analysis of pension liabilities as part of an acquisition requires the mobilisation of skills:

- Accounting, in order to interpret the information provided in the accounts and come back to the economic flows;
- Actuarial, in order to analyse and criticise the calculation assumptions and provide precise timing of the expected flows;
- Financial, in order to draw the right conclusions from the accounting and actuarial analyses with regard to valuation and financing packages;
- The combination of these skills will systematically provide greater security in the acquisition process and give the investor a real competitive advantage.

Frederick Duponchel *Managing Director*
Nicolas Barsalou, *Associate Director, AON Accuracy*

Notes:
1 - Like retirement benefits in France.
2 - Total seniority: projected seniority at the time of retirement; seniority to date: actual seniority as at the valuation date.
3 - For the sake of simplicity, issues related to accounting consolidation and plan changes are not addressed here.