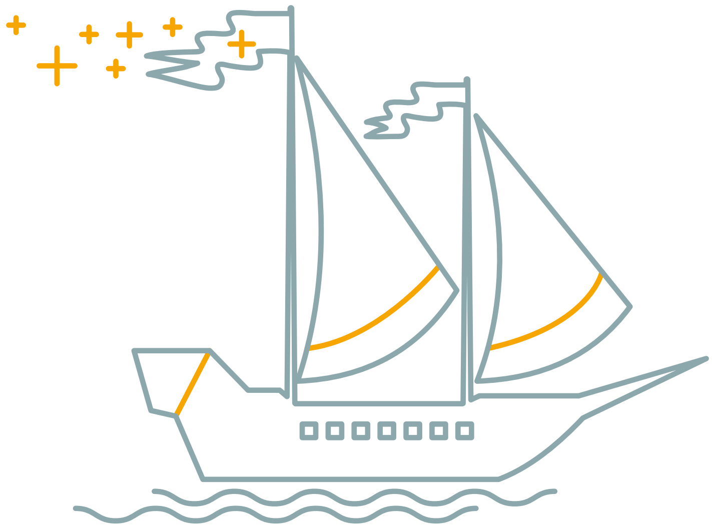
LCP INSIGHT CLARITY ADVICE

Built to last

A practical guide on how covenant strength interacts with investment strategy for DB pensions

December 2019



Introduction

Your scheme, your journey

A scheme's long-term funding target is key, however the journey can be equally important and should be planned and managed well to maximise the chance of success. Wherever your scheme stands on its journey, it will be in a unique position. Now more than ever, informed decisions and clear advice which brings together investment, funding and covenant elements, is essential in ensuring you can weather a pension storm.

This report is part of our 'Chart your own course'[1] series which is aimed at helping trustees through the pension scheme journey in order to deliver better outcomes for members. It kicked off with our headline report which laid out a blueprint for developing an integrated journey plan spanning investment, funding and covenant. This piece digs further into the interaction between two of these areas: investment and covenant.

Integrating advice has been difficult

Historically many trustees have found covenant and investment advice difficult to integrate as the two sets of advisers often talk slightly different languages, the risks presented are hard to reconcile and moving forward confidently can be challenging.

In this piece we first lay out a short framework which could underpin communication between the investment advisor and covenant advisor, and follow this with three example case studies which draw from our experience advising real-life clients (although each situation itself is stylised and not representative of any one case).

LCP is an independent advisor with investment, funding and covenant skill-sets working together for hundreds of clients under one roof. This gives us a unique perspective on the challenges and benefits to developing a truly integrated approach to DB journey planning.

What's needed more than ever is clear advice joined up across covenant, investment and funding. We support trustees to confidently make the decisions that are right for their members.

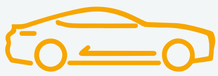
[1] To find out more about the 'Chart your own course' campaign please click here

Summary

Trustees need an integrated picture of the risks their scheme is running, which takes into account both investment and covenant perspectives, but this is not straightforward with the traditional models used.

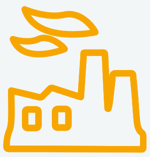
You may have already seen our simple six step TESTED framework (see page 4) to begin integrating investment and covenant considerations covering: timelines, enterprise risk capacity, security, tipping points, events and dividends as a starting point for discussions between advisors.

To help bring this framework to life, we've created three case studies where integrating covenant and investment advice provided real win-wins for trustees, members and sponsors. These case studies are broadly based on experiences we have had, but none represent specific real-life situations.



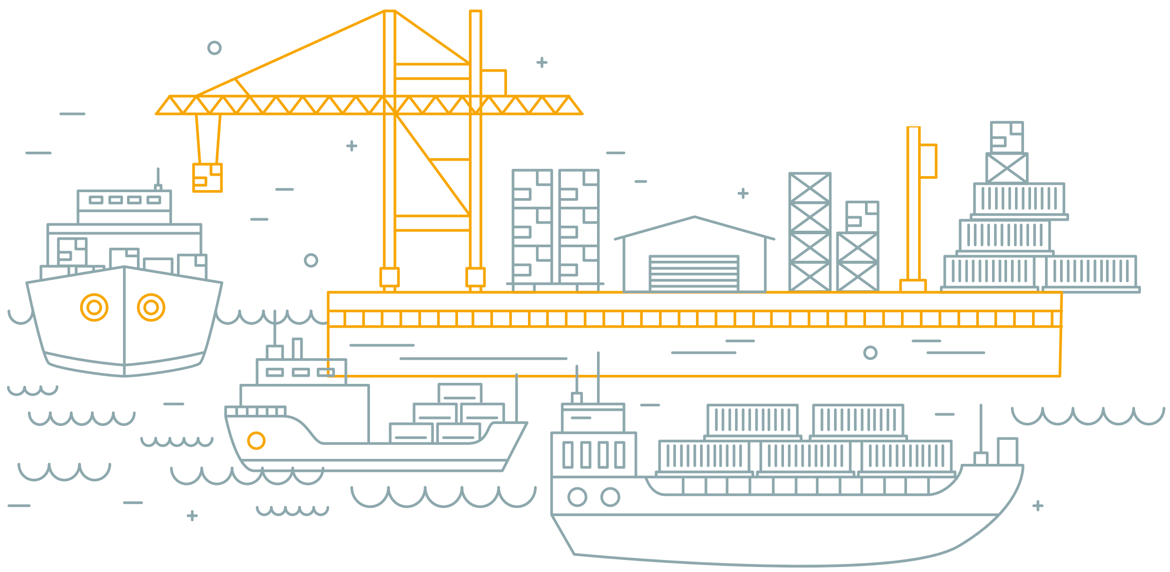
Our first case features an auto-parts supplier with a strong group, but a weak and potentially worsening direct covenant situation, which is able to get on an investment journey leading to buyout over the next decade or so thanks to a group guarantee.

We then illustrate a pharmaceutical company with significant research and development needs which creates significant competition for cash over the medium term and a potential covenant cliff-edge. Here a letter of credit solution provided the security needed to pursue a higher return investment strategy, take immediate pressure off contributions, while the sponsor re-invests in the business, improving covenant.



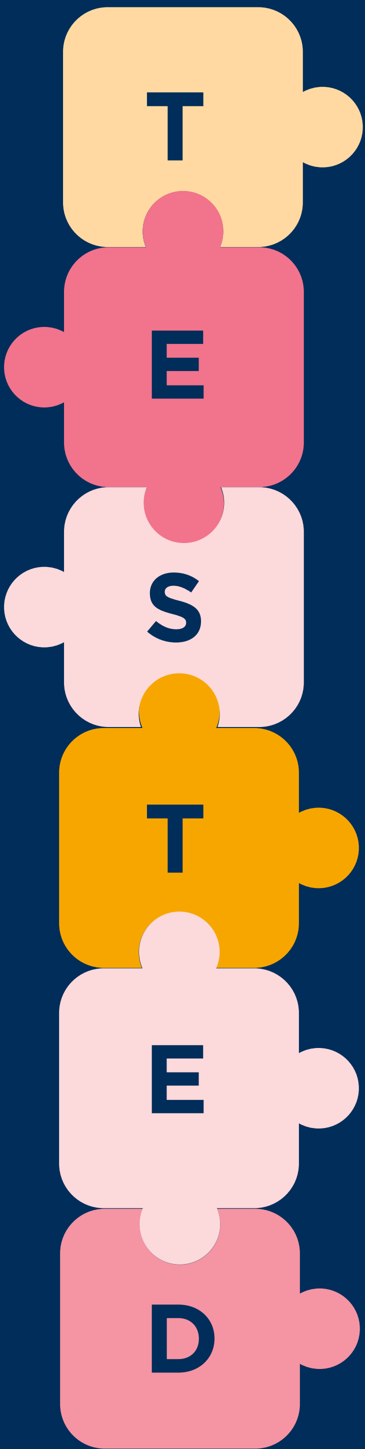
In our final example, a UK regional utility opts for a long-term, stable 'self-sufficient' investment approach. The solution combines elements of a DIY insurer-style investment strategy with a stable 20-year cashflow stream supported by both the long-term regulated license and an Asset-backed funding vehicle.

In each case study, there is hidden depth to the risks being run, but looking into this detail uncovers covenant-related steps that can be taken to allow extra flexibility in the investment approach.



A Framework for integrating Investment and Covenant Considerations

We think there are six basic questions that an investment adviser needs to ask a covenant adviser, and they form the acronym TESTED.



TIMELINE: are there specific milestone timepoints in the sponsor's business (eg rolling over of key customer or supplier contracts, patent expiry, debt profile, customer lifecycle)? - these can affect the decision around when to aim for full funding.

ENTERPRISE RISK CAPACITY: key affordability ratios can shed light on what the covenant can reasonably support (eg free cashflow divided by pension deficit plus Value-at-Risk). Is the coverage high or low compared to your peers and what you would expect given the covenant grading?

SECURITY: are there viable options for contingent security that might be negotiable with the sponsor (eg properties or asset-based funding arrangements)? If these are available, it could allow the trustees to get comfortable underwriting more risk in the investment strategy.

TIPPING POINT: is there a tipping point that could come into play with respect to the strength of the sponsor covenant and what are the key variables influencing that (eg expiry of debt facilities, end of key contracts)? The trustees will want to form a contingency plan with respect to investment strategy, perhaps reducing risk or changing the endgame target.

EVENTS: A number of key events might happen that require trustees to put contingency plans in place. A takeover, a debt-funded M&A, or the loss of a key customer contract. The trustees have levers they can pull on the investment strategy in response to these events, but a plan is key. A good covenant advisor will also be able to help in setting up information sharing protocols, to allow the trustees to be kept informed.

DIVIDENDS / LEAKAGE: what is the level of dividends vs deficit contributions, and what other forms of covenant leakage could be possible over the period of the journey plan to full funding? Forewarned is forearmed and the trustees can form a fall-back plan on the investment side which might involve a change of endgame target, risk budget and strategy.

But, don't forget that the answers to these questions can change over time.

Case study 1: On the brink

Overseas parented global group

Sector: Supplier to automotive manufacturers

Global turnover: +£5bn

UK business turnover: +£200m

Medium sized scheme, poorly funded.

First engaged on covenant matters in relation to a triennial valuation.

Global turnover:
+£5bn

Scheme assets:
c£250m
65% funding level[2]

A full covenant analysis revealed a potential 'perfect storm' for the trustees from a covenant risk perspective.

Having historically invested the pension fund with the mindset of the strong backing of a much larger global business, following a deeper covenant review the trustees were faced with the reality of relying solely on the covenant of the UK business (a second-tier supplier to global car manufacturers), a very different proposition.

This analysis brought two further issues to the fore:

On the one hand the trustees are faced with the issue of Brexit bringing the consequence of making it less appealing for automotive manufacturers to locate themselves in the UK, which led to the potential loss of customers for the employer – this brings significant short to medium term uncertainty over future covenant longevity.

Secondly, there is the significant market uncertainty over long term viability of petrol and diesel engine cars in an era of disruption by electric cars – and if the group does invest in this area, will it invest in the UK company? This brings more uncertainty over future direct covenant longevity over the medium to long term. These questions were weighing heavily on the minds of the trustees as they approached their actuarial valuation and investment strategy review.

At present, the scheme is quite materially underfunded and reliant on investments to do a lot of the heavy lifting to improve the position. The global group is healthy and cash-generative relative to the size of the scheme and this had historically underpinned the trustees' growth-focused investment approach. However, it was clear that when allowing only for the direct covenant of the UK business, this would have to change.

This led to the trustees feeling very exposed in terms of risk in the absence of some contingent covenant support or some serious thinking on the investment strategy.

[2] Funding level measured on a long-term funding basis

The initial investment taken here presents a very challenging picture for the trustees. Ultimately the investment recommendation could well be to reduce risk in order to protect the scheme's current funding position and to avoid impinging on the viability of the UK sponsor. This would lead to a long pathway to full funding, which is not ideal given the concerns over the sponsor but may be the best option in a tough situation. Additionally, the sponsoring employer and global parent were not happy with the potential implication for cash contributions and initially resisted the proposals.

We helped the trustees understand their options here and the idea of a group guarantee was discussed and became a realistic option. Without the guarantee the trustees felt their only option was to take a conservative stance on investment risk to avoid potentially harming the UK company. With the parent company guarantee secured this enabled the trustees to take a little more investment risk in order to pursue a strategy that could get the pension scheme to its long-term funding target over the course of a decade and with a reduced level of contributions than if only the UK covenant could be relied upon.

By pursuing a well-diversified strategy the Trustees were able to make the most of the risk budget afforded by the Company guarantee and target buyout over 10-15 years (and take away the strain of a DB scheme on the smaller UK business) with a manageable amount of sponsor contributions.

Expected return	Gilts + 1.3% (pa)
Risk[3]	4%
Timeframe to LTFT[4]	15+ yrs
Total contributions	c£75m

[3] Risk defined as 1-year 95% Value-at-risk as a percentage of liabilities.
[4] Long term funding target.

Expected return	Gilts + 2.7% (pa)
Risk	8%
Timeframe to LTFT	10-15 yrs
Total contributions	c£40m
Target	Buyout

Once the new investment strategy was in place, ongoing monitoring was also an important part of the trustees ongoing risk management strategy. Given the nature of the covenant situation, this covered both the UK and the global group's projected free cashflow, as well as an information-sharing protocol around key strategic plans for the UK business.

Key takeaways

1. Make sure you know where legal covenant lies (UK entity or global group)

2. Group guarantees can:
   - Support higher investment risk (and return)
   - Make more efficient use of company resources
   - And provide better protection for members.

Case study 2: A cash cliff

Overseas parented global group

Sector: Pharmaceuticals

Global turnover: +£10bn

Large mature scheme, quite well funded

UK employer weak BUT – already have a guarantee from a credit-worthy global parent

Historically the covenant was very strong, based on the licensing of a handful of key drugs which had been developed a number of decades ago, however these patents are expiring in the medium term (before the scheme is projected to become fully funded).

Future covenant strength rests on drug pipeline, which requires large ongoing investment into research and development (R&D) over the next decade, leaving little scope to pay deficit recovery contributions in the short to medium term.

Global turnover:
+£10 billion

Scheme assets:
c£2bn
80% funding level

The covenant advice:

In this case the covenant analysis leading in to the actuarial valuation revealed that a number of the company's patents were due to expire within the timeframe of the pension scheme's journey, on a number of the blockbuster cash generating drugs in the company's portfolios.

On closer analysis, it became clear that the drug pipeline had not adequately been replaced with new drugs – this brings the risk of significantly reduced free cash flows from ongoing trading once existing patents expire.

The consequence is that the group needs to utilise a significant amount of current cash reserves, and future cash flows, to invest in either acquiring businesses with strong pipelines or in R&D to develop new drugs.

The available funding for the scheme is thus significantly constrained in the short to medium term, while also presenting a possible 'cliff-edge' in terms of the timeline – what implications does this have for the investment strategy?

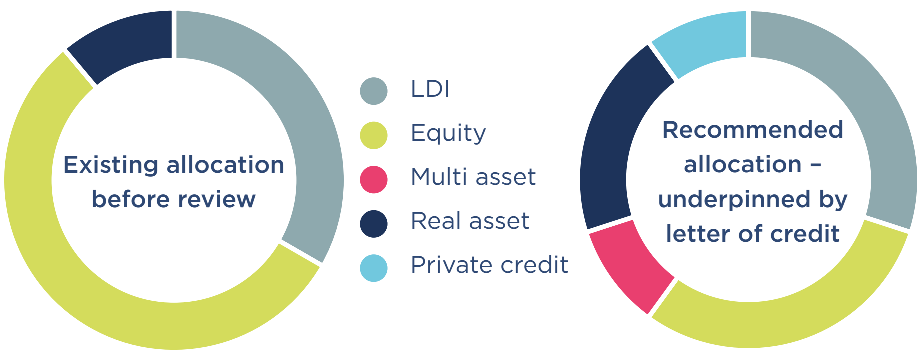
Case study 2: Investment consequences

There is a strong covenant here with significant competing demands for money as the business needs to invest in R&D to remain competitive and strong over the longer term.

The existing investment strategy in the pension scheme had performed very well and improved the funding position but contained a substantial allocation to equities and some unhedged liabilities, leading to a significant risk exposure. So overall the trustees face the prospect of substantial risk in the short to medium term from both an investment and covenant perspective.

In the first assessment of investment strategy, the trustees considered significantly reducing their investment risk, in order to manage the deficit and contribution variability. However, they found that would either entail a longer journey to full funding which extended beyond the timeline over which there was good covenant visibility; or cause materially higher contributions reducing the ability of the covenant to withstand downturns – both of which weren't ideal from a member security or corporate perspective.

A possible solution in this instance could be a letter of credit from a third-party bank (or alternatively a surety bond from an insurer). This solution provides mitigation to the longer-term covenant uncertainty and provides flexibility to allow for longer investment time horizons and/or maintain a high level of investment return. This provides the flexibility to target a journey plan, which is expected to get the scheme fully funded before the end of the patents of the existing drugs, while providing the back-up security should investment returns end up being lower than expected. Further investment analysis also made the strategy more efficient and better hedged liability risks, to make the most of the risk budget permitted. So the investment consultant was able to present a balanced growth-oriented strategy that stays on track for full funding over the next decade at a manageable level of risk that is supportable.



Expected return	Gilts + 3.4% (pa)
Risk	16%
Timeframe to LTFT	10 yrs

Expected return	Gilts + 3% (pa)
Risk	10%
Timeframe to LTFT	10-12 yrs
Target	Low dependency

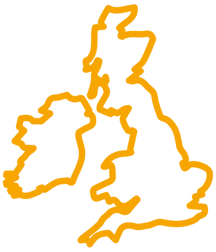
Key takeaways

1. Understanding the underlying products of the business and how these can affect the covenant strength is vital.
2. Timelines a key driver here given nature of business.
3. Finding a balance between contributions and re-investing to improve a covenant is a difficult balance.
4. Different forms of contingent assets suitable in different circumstances. In this case, given strong credit rating of business letter of credit was relatively the cheaper option.

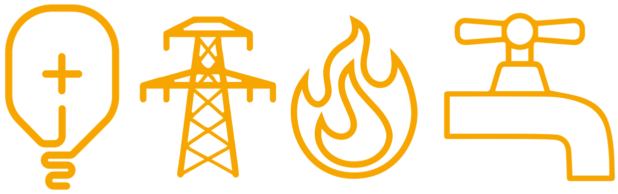
Working hard on investment risk reduction/efficiency can make the most of the risk budget available to the trustees, and contribute to cash certainty for the company by running less risk for the same level of return.

Case study 3: Competing cash demands

Our third case study is a DB scheme where the sponsoring employer is a UK regional utility company.



Turnover:
+£1bn



Scheme assets:
c£2bn, 80% funding level

Here the sponsoring employer is heavily regulated, with strong, stable cash generation that is likely to continue well into the future due to its long-term license. This gives comfort for the trustees in terms of the strength of the covenant that can support the investment strategy, leading to a high risk/return strategy historically. There is an allowance for scheme deficit to be recovered as per the utility regulator over a period of years.

The scheme is large, quite well funded and approaching an actuarial valuation.

Potential issues on a closer analysis of the covenant:

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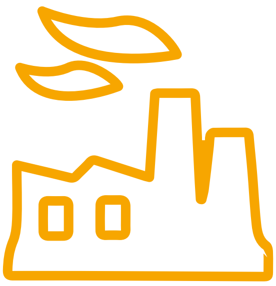
- **Highly leveraged business, lower tier of investment grade rating**
- **Significant proportion of free cash flows are committed to debt servicing**
- **Heavy capex requirement within the business**
- **Significant competing demands for cash including debt servicing and dividends**
- **High level of 'covenant leakage' – dividends significantly higher than the level of contributions being paid to the scheme.**



While in this case there is a regulatory mechanism to recover pension deficits through higher prices over time (within the utility's industry), this conflicts with the pension regulator's guidance for stronger sponsors to repair deficits over shorter periods of time.

Case study 3: Investment consequences

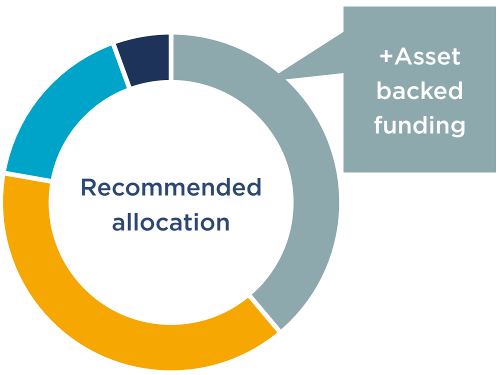
On the initial investment take the trustees are minded to maintain a high level of investment risk, supported by the long-term covenant visibility and comfort provided by the company's regulated status.

However, in this case there is an argument that position isn't required and the investment strategy of the pension scheme could be better aligned to the long-term stable nature of the business. Furthermore, the capital intensive nature of the business means there is a plentiful supply of fixed assets which could be used to provide security to the trustees and further under-pin a long-term 'self-sufficiency' strategy.

In this case, an asset-backed funding (ABF) arrangement could be used to provide a long-term stable recovery plan to the company, whilst providing a long-term, secure, inflation-linked income stream to the pension scheme.

This asset could then be combined with other secure, contractual investment assets (such as those commonly used by insurers when backing annuity contracts) to provide a low-risk investment strategy. Given the long-term nature and the ABF structure, the trustees were comfortable not to target insurance solutions. Instead they could consider investments that offer similar characteristics, but that insurers avoid due to less favourable treatment under regulation, which further improve risk-adjusted returns.

The net result is a low-risk position for both the company and members, as opposed to the volatile equity-heavy strategy that has historically been in place. Aligning the investment and funding strategy to the timeline and nature of the sponsor's business gives a potential win-win here.



- LDI
- Credit
- Asset-backed securities
- Real asset

Expected return	Gilts + 1.5% (pa)
Risk	5%
Timeframe to LTFT	20 yrs
Target	Long-term self-sufficiency

Key takeaways

1. Two different faces to the business to consider:
   - Strong stable cashflows
   - High dividends and leverage.
2. Timeframe and enterprise risk capacity are key drivers.
3. Aligning the investment strategy with sponsor's business offered most effective solution.
4. Asset backed funding gives trustees comfort in the face of dividends and covenant leakage.

Conclusion

Covenant advice – Take control and review your covenant so you can drive your investment decision making forward. Speak to your covenant adviser as they can help you unlock more bespoke solutions which can allow flexibility in your investment approach.

Work together – Meet with your sponsor and advisers in the same room to bring different perspectives together and to help make better decisions.

Monitor – Don't wait until your valuation to open discussions. As new regulations and buyer behaviours change it's important to keep abreast these changes so that risks and opportunities are recognised.

Your Checklist

- Are you getting good quality independent covenant advice?
- Does your investment advice refer to covenant? If not ask why not
- Use the six step TESTED framework to get conversations going
- Keep a look out for regulator's consultation and guidance next year
- Consider engaging covenant review well in advance of next valuation
- Consider whether contingent funding could make a difference
- Do you have regular covenant monitoring of key metrics in place for things that could affect the Enterprise Risk Capacity
- Do you have information sharing protocols in place to ensure trustees kept abreast of key events at company.

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