THE ROLE OF PENSION BUYOUTS IN M&A TRANSACTIONS

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M&A transactions often lack a holistic approach with regard to long-term pension obligations. A solution can be a pension buyout where a full and final release can be achieved through the transfer of pension obligations to a separate external legal entity by means of a demerger. The following article describes exemplified by a pension buyout for German defined benefit obligations towards former (inactive) employees how a buyout can be integrated into a M&A transaction.

► *Pensions in M&A transactions*

Pensions are only one of many issues in M&A transactions and often do not receive the attention they deserve. Pension obligations can be a key challenge to the successful completion of an M&A transaction.

In most M&A transactions, pension liabilities only affect the valuation of the target company as they are treated as financial liabilities and therefore deducted from the enterprise value of the target company in determining the equity value or purchase price. In most cases, the unfunded portion of the defined benefit obligation (DBO) under IFRS accounting standards is used as a deduction. Company-specific longevity, impending but not yet realised pension increases or the subsidiary risks of obligations to make additional contributions to external funding vehicles are often not explicitly taken into account. Only findings from (red flag) due diligence can lead to further lump sum deductions or indemnifications. In economic terms, the actual obligations and associated risks may be significantly higher than what is reflected in the balance sheet and for valuation purposes.

In some M&A transactions pension obligations may present an explicit deal issue or even a deal breaker because of

- their large relative size compared to the target's enterprise value,
- perception by potential buyers of pension obligations as non-core legacy liabilities unrelated to the target's business, or
- the general perception of German pensions as complex to manage and inflexible to restructure or settle.

In such cases, the ability to successfully complete a transaction or achieve the desired purchase price will largely depend on the attractiveness of the target and the competition

in the process. With respect to pensions, outcomes can range from higher than expected purchase price adjustments, requirements to fund existing pension obligations prior to closing, retention of pension obligations by the seller, or even failure to complete the transaction.

In the following, we introduce the pension buyout as a tool to effectively address transactional issues relating to German pension obligations.

► ***Pension buyout for German pension obligations***

A pension buyout generally refers to the complete transfer of pension obligations to an external risk carrier (often an insurance company) in order to achieve full and final relief:

► Economically - by eliminating future risks such as longevity and inflation. It also limits investment and labour law risks,

► Legally - by obtaining a release from the pension obligations to beneficiaries,

► Financially - by achieving settlement of pension liabilities in accordance with local and international accounting standards, and

► Operationally - by fully outsourcing pension administration.

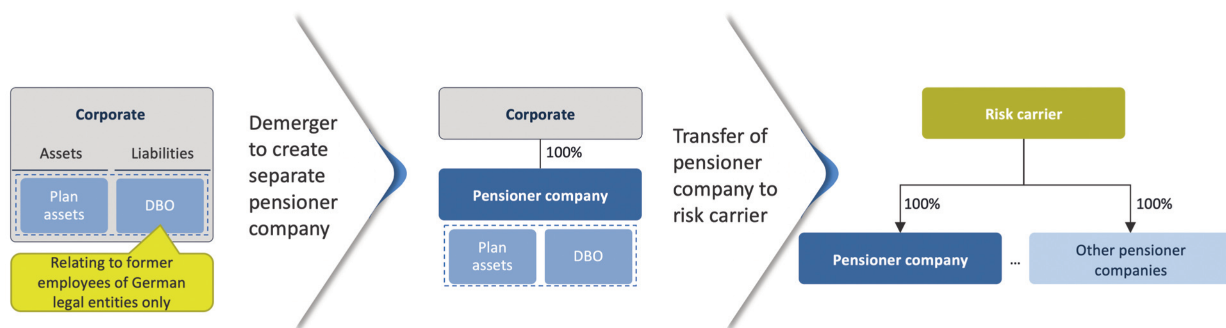
While the pension buyout market in Anglo-Saxon countries is quite mature, the German market is right at the beginning and considered to have huge growth potential.

In the Anglo-Saxon world, where the pension buyout is well established as a common pension de-risking tool, pension liabilities are typically transferred to an insurance company.

In Germany, a pension buyout can be facilitated through a corporate transaction governed by German corporate law, which allows for a much more cost-effective release and greater flexibility to meet individual objectives and requirements.

Pension obligations relating to former employees, i.e. deferred scheme members and pensioners, are transferred to a separate company by means of a demerger in accordance with the German Transformation Act (*Umwandlungsgesetz*). This separate company is known as the "pensioner company" (*Rentnergesellschaft*) because its sole purpose is to manage and service the pension entitlements assumed in perpetuity. In a second step, this pensioner company is transferred to an external risk carrier.

ILLUSTRATIVE TRANSACTION STRUCTURE OF A PENSION BUYOUT THROUGH A PENSIONER COMPANY



Source: Deutsche Betriebsrenten Holding.

The pension buyout also involves the transfer of assets to the extent necessary to fund all future pension payments and related costs of servicing the pension obligations – also referred to as the funding requirement. This is essentially the "price" or "cost" of the pension buyout, except that all the assets are ring-fenced and protected against insolvency through a trust structure - a contractual trust arrangement or CTA - and therefore remain available solely to meet the pension claims of the beneficiaries in the long term. These assets can be existing plan assets, cash or even a claim on the transferring company to be paid out over time according to an agreed payment schedule.

In 2008, the German Federal Labour Court (*Bundesarbeitsgericht*) issued a ruling that provided a clear legal basis and thus certainty with regard to the structure of the transaction and the funding requirements. It confirmed that such a pension buyout is solely at the discretion of the management and shareholders of the transferring company. No approval is required from pension beneficiaries, the works council, supervisory authorities or the German pension protection association PSVaG. At the same time, the court provided guidance on the adequacy of the financial resources of a pensioner company to ensure that it is sufficiently funded based on a realistic commercial assessment and an enhanced principle of prudence.

The funding requirement for a pensioner company is determined by the risk carrier and is based on the individual pension entitlements, the specific life expectancy of the

beneficiaries, inflation scenarios, administrative costs and appropriate risk premiums. These factors alone would result in a premium on the carrying value of the transferred pension liabilities. However, this is largely offset by the fact that the future investment returns on the assets contributed to the pensioner company are expected to exceed the discount rates used in the financial statements. Therefore, in many cases, the "price" of a pension buyout remains close to the carrying value of the pension liability.

The pension buyout is designed to shield the transferring company from any obligation to make additional payments after the completion of the buyout. The German Transformation Act generally foresees a continued liability (*Nachhaftung)* for pension payments in the 10 years following the demerger. However, the risks from this continued liability can be eliminated for the transferring company through an indemnification by the risk carrier backed by guarantees from leading financial institutions. A number of further safety and governance measures apply to ensure the long-term sustainability of the pensioner company even in adverse scenarios.

► *Advantages of a pension buyout in an M&A transaction*

First and foremost, the price of a pension buyout represents an objective assessment of the economic value of the pension obligations in question and could be used to determine the purchase price instead of the most recent balance sheet pension provisions. The buyout price is objective in the sense that an independent third party would be willing to transact on this basis.

In addition, a pension buyout can help to eliminate pension-related transaction issues, making it easier for both sellers and potential buyers to complete a deal. Pension obligations are no longer an inseparable part of the transaction, but can be dealt with separately - at least as far as pension obligations to former employees of German legal entities are concerned.

Finally, a pension buyout could even be a source of financing for the seller. This can be achieved by carving out pension liabilities from the M&A transaction and simultaneously entering into a pension buyout that is fully funded only over time, based on an agreed payment schedule. Carving out pension liabilities from the transaction results in an immediate increase in the purchase price. The additional liquidity or financing available to the seller is the difference between the increase in the purchase price and the amount outstanding to fund the pension buyout. Of course, a seller could achieve the same effect by excluding pension liabilities from the transaction without entering into a pension buyout. However, this would also mean retaining pension obligations unrelated to the seller's remaining business and retaining all pension-related risks.

► *How to integrate a pension buy-out into an M&A process*

A buyout of German pension obligations can be completed within 3 to 6 months.

The different phases of a pension buyout process can be fully aligned to a customary sellside process:

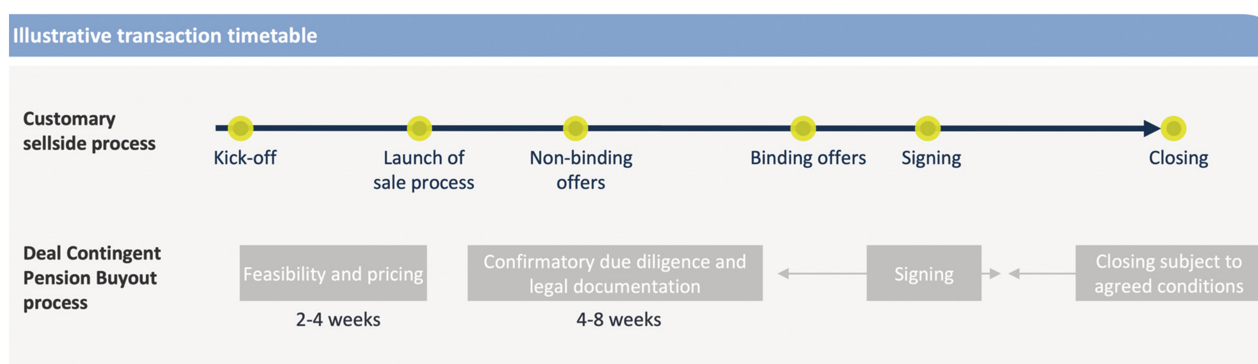
1. Feasibility and pricing of a pension buyout can be reliably determined within a matter of 2 to 4 weeks before or during early phases of an M&A process and on the basis of typically readily available information.

2. Confirmatory due diligence by the risk carrier can be completed and the required legal documentation can be drawn up in parallel to the M&A process within 4 to 8 weeks thereafter.

3. Signing and closing could take place between signing and closing of the M&A transaction itself.

The pension buyout can be tailored to the specific objectives and requirements of the transferring company and the M&A process. In particular, the fact that the pension buyout can be completed solely at the discretion of the management of the transferring company and its shareholders ensures full control over the buyout process and its interdependencies with the M&A transaction process.

ILLUSTRATION OF M&A AND PENSION BUYOUT TRANSACTION PROCESSES



Source: Deutsche Betriebsrenten Holding.

The completion of the pension buyout will typically be conditional on the outcome of the M&A transaction to ensure full alignment of both transactions. This is particularly important with regard to the availability of funding for the pension buyout - either through the (higher) proceeds of the M&A transaction for the seller or the availability of M&A funding for the buyer. In addition, the seller may wish to prepare for a pension buyout and obtain certainty as to its viability and pricing in case pension liabilities become a deal issue, but at the same time may not wish to disclose such an option to potential buyers or even commit to such a buyout transaction. For this reason, we refer to the optionality described above as a "Deal Contingent Pension Buyout".

- *Summary*

Not only is there a pension buyout option for German pension liabilities, but its structural flexibility and speed of execution also allow it to be integrated into M&A transaction processes. A seller and its advisers should consider early in the process whether pensions could be a potential deal issue. Indeed, preparatory steps should be considered in any demerger or carve-out activity. As with any aspect of M&A transactions, preparation is key and therefore the Deal Contingent Pension Buyout provides the greatest degree of flexibility in dealing with pension-related deal issues if and when they arise during a transaction process.

It will be exciting to watch the evolution of the described pension buyout for German defined benefit obligations and its impact on M&A transactions: Will pension buyout pricing replace the current purchase price adjustments based on accounting values? Will pension buyouts become a standard as reps and warranty insurance is today?

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