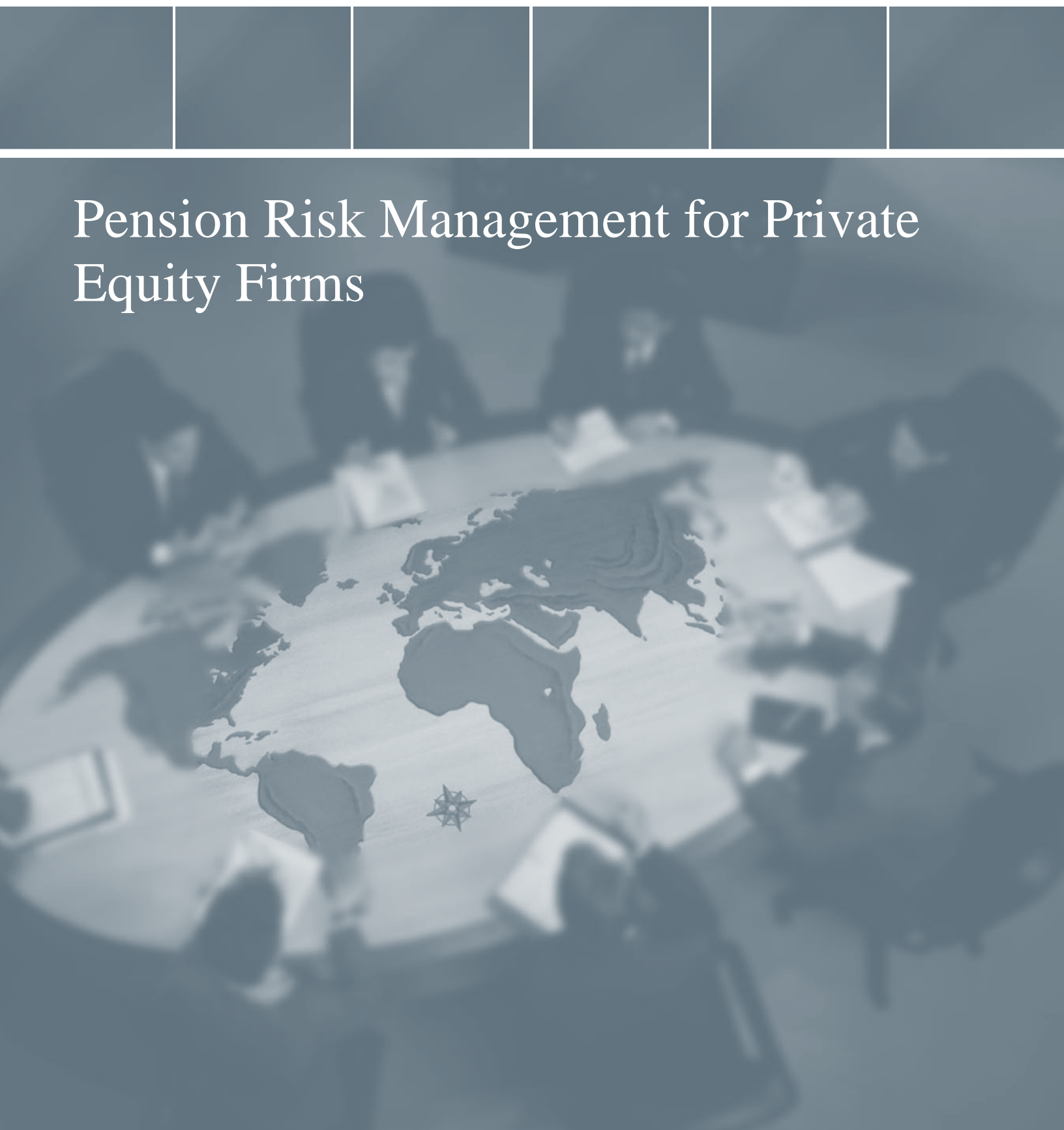


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# Pension Risk Management for Private Equity Firms



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*“Private equity firms devote significant resources to measure the financial risk of defined benefit plans during pre-acquisition due diligence. Most, however, fail to recognize the operational risk to the financial performance of their portfolios during the holding period.”* Scott Allen, FCA, EA, Principal, Mercer

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## The Pension Risk Setting for Private Equity Firms

There is no doubt that financial risk considerations are increasingly important in successfully managing pension plans – in particular for Private Equity firms with US portfolio companies or potential US targets that sponsor these types of plans. The recent market meltdown has aggravated the volatility inherent in most pension plans especially when combined with the more stringent funding requirements of the Pension Protection Act. This is causing many plan pension sponsors to reevaluate their financial management policies.

In general, sponsors are taking one of three approaches:

- Immediately de-risk the plan because they cannot tolerate any further downside risk
- Stay the course as they are reluctant to sell equities now
- Formulate a phased funding and de-risking strategy to gradually recover the deficit of the plan over time.

Compared to corporate pension sponsors, Private Equity firms have some unique considerations when it comes to the risk management of their DB plans. We examine some of the key considerations below:

### 1. Short-term Risk and the Investment Horizon

Significant near-term volatility exists under traditional investment strategies for pension plans. General opinion and the practice of most pension sponsors in the past have supported that equity returns will outperform fixed-income vehicles over a long-term horizon, although the question of how long is long-term has been very much tested over the past 12 months.

Over a shorter term period, more typical of a portfolio company holding period, the expectations are not as compelling. Private Equity portfolio managers need to decide whether the potential for higher returns is worth the short term risk exposure produced by a traditional pension investment strategy.

### 2. Pension Pricing and Potential Disconnects

The equity risk premium inherent in most pension investment allocations is credited before it is earned under US GAAP. The accounting rules that cause this equity bias are not as important to private equity firms that are instead usually more focused on the cash and balance sheet realities.

Pro-forma earnings estimates include this equity risk premium, based on the current pension investment allocation. However, Private Equity firms are more inclined to value portfolio companies on a balance sheet basis or based on the present value of risk-adjusted future cash flows. The pension balance sheet should be the core metric for risk management and the benchmarking of success or failure. For this purpose the equity risk premium is not capitalized or anticipated.

Thus, from day one, the investment allocation assumed by Private Equity buyers and the valuation assumptions underlying the purchase price are misaligned.

### 3. The Corporate Finance Perspective

Some argue that pension plan equity exposure is equivalent to the sponsor taking on financial leverage in an area outside the core business to earn returns similar to those easily available in the stock market – something investors would prefer to obtain directly on their own. In this view, investors would pay a premium for a business that wisely deploys risks to pursue greater returns in areas where it holds a natural competitive advantage.

Specific to Private Equity buyers, continuing equity exposure in the pension plan usually gains exposure to a generic market beta. This has the effect of diluting the additional returns anticipated by the purchase of the portfolio firm, and compromising the financial objectives of the deal.

### Where does “LDI” come in?

Much has been written and said about Liability-Driven Investing (LDI). LDI is an investment strategy that is set with explicit reference to liabilities. Any return objectives must be carefully weighed against the plan funded status (surplus/deficit) risk implications.

LDI comes in a variety of flavors. At one extreme, sponsors use LDI to eliminate as much risk as possible. At the opposite extreme, sponsors use LDI to redeploy risks in search of higher returns. The common theme among sponsors using LDI is that they don’t look at the asset performance in isolation. Rather they incorporate the characteristics of the liabilities and the objectives of the enterprise into the analysis to deploy risk more wisely.

LDI has come more into vogue in the past year or two due to:

- The heightened transparency and focus on pension deficits by recent funding and accounting regulations in the US and globally
- Pension deficits result in burdensome contributions that are in turn based on liability based amounts

- Pension surpluses that have quickly turned into significant pension deficits
- The compressed time frame that is afforded plan sponsors to make up these deficits which shortens the horizon for equities to outperform in the “long term”.

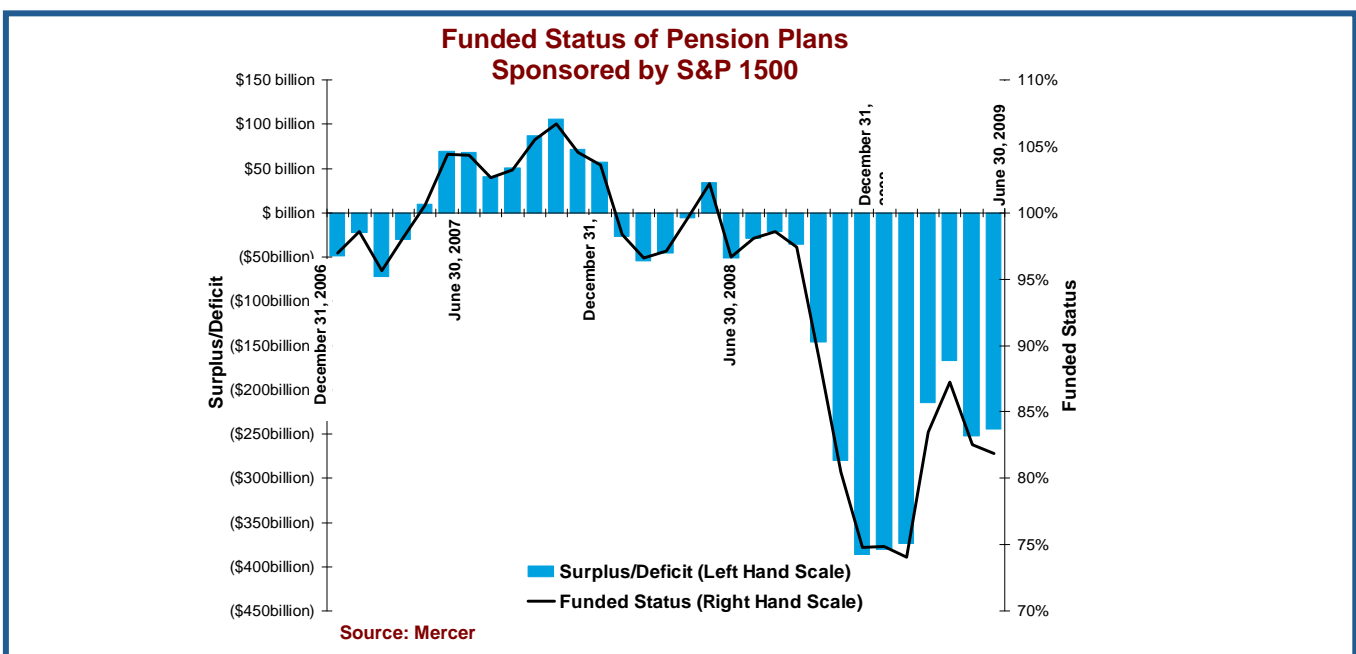
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*“At a minimum PE buyers should use liability aware techniques to value the pension risks to which they are exposed.”*

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LDI results in measures of risk that are different from “asset-only” strategies and can result in different optimal asset allocations. For example, while cash may be the least risk asset in an asset only world, volatility of pension liabilities resulting from interest rate movements results in liability risk that is increased by holding cash.

Particularly given the shorter time horizon for the exit strategy of many Private Equity buyers, and the significance of pension deficits, the liability driven perspective is critical to the ongoing management of the pension plans they acquire. At a minimum Private Equity buyers should use liability aware techniques to value the pension risks to which they are exposed, and many may be highly motivated to reduce or minimize this risk in light of the unique circumstances described earlier.



## Some Practical Considerations in Today's Environment

### When to De-risk: Finding the Bottom?

While US equity type investments have not earned much since the beginning of the year, pension plans have staged a partial recovery that has gone unnoticed by many<sup>1</sup>. Since the start of 2009, the average plan's funded status has recovered significantly mostly due to the impact of increases over that period in long term corporate bond rates that drive pension liability values (though some of these gains have been given back recently). Plan sponsors reluctant to "sell at the bottom" may wish to reconsider when taking a holistic view of plan management and accounting for the impact of interest rates on plan liabilities. While "selling at the bottom" may present some attractive buying opportunities for asset classes such as long credit, there is also the additional advantage of reducing pension liability risk exposure (as described further below).

### Minding the Gap

As noted above, the gains in funded status experienced during 2009 bring with them some short term opportunities for plan sponsors. Pension plan liabilities have sustained a significant recovery due in part to the size of credit spreads in corporate bond rates that drive pension liabilities. As the financial crisis has evolved there has been a massive widening of credit spreads between the highest quality fixed income instruments (e.g. Treasury bonds, strips and swaps) and investment grade corporate bonds. As a result, Treasury bonds, strips and swaps significantly increased in value relative to pension liabilities. A reversion of credit spreads toward historical norms would cause Treasury bonds, strips and swaps to lose value relative to pension liabilities, causing further reduction in pension plans' funded status, unless accompanied by strong equity returns. We cover this topic in more detail in Mercer's iRFM perspective "*Minding the gap: Delivering retirement benefits to globally mobile employees*"<sup>2</sup>.

For private equity firms considering risk mitigation strategies, these current conditions and opportunities are critical to consider. For example, any long duration Treasury bonds, strips or swaps would be expected to drag on pension-funded status until spreads have "normalized", and long-duration corporate bonds are relatively attractively priced and may improve the matching between assets and

liabilities. However, as credit spreads have already started to contract, this is an area with some nuance now that the opportunity is less dramatic than it was a few months ago.

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*There are profound disconnects between heritage pension financial objectives of portfolio companies and the goals of Private Equity firms.*

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### Governance Considerations

Given the factors outlined above, there may be a strong motivation for private equity funds to begin to take pension risk off the table for their portfolio companies. Any actions taken will depend on how involved and proactive they are in the governance of these companies and their pension plans. In many cases, companies will employ a hands-off approach. Nevertheless, private equity firms should be highly motivated to take a fresh look at the pension risks they have inherited, and get more involved in these decisions than they have in the past. The market turbulence also brings specific de-risking opportunities to manage downside interest rate risk in the current interest rate environment as noted above.

### In Summary

Private equity firms with material pension obligations within their portfolios should be conscious of this exposure and the potential implications on fund performance and be proactive in tailoring their risk management strategies to their unique needs. In addition, a heightened emphasis should be placed on this analysis during due diligence.

The shorter horizon to exit is often at odds with the longer term perspective adopted by portfolio companies resulting in an even stronger imperative to de-risk these plans.

The pension strategy of portfolio companies rarely aligns with the objectives of Private Equity buyers. In the current environment, Private Equity firms have a stronger incentive than ever to adopt a liability aware perspective.

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<sup>1</sup> S&P 500 Index YTD, July 29, 2009, CNNMoney.com

<sup>2</sup> To read Mercer's Perspective "*Minding the gap: Delivering retirement benefits to globally mobile employees*", visit: <http://www.mercer.com/mindingthegap>

**Additional resources:** To read “Top 10 Myths about Liability-Driven Investing” visit <http://www.mercer.com/LDI>

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### **About the Authors**



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