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DIVESTING TO CREATE SHAREHOLDER VALUE

Pension Plans Through a Divestment Lens

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SUMMARY

History is replete with companies that have effectively utilized acquisitions to enter into new markets, grow their businesses and create shareholder value. In addition to acquisitions, divestitures also increase the value of a company by strategically shrinking non-core operations and unprofitable segments. Divesting also allows management to realign resources to other viable opportunities. Empirical evidence demonstrates capital markets reward companies that divest, particularly if the transaction improves the performance of the company's remaining operations.[1]

However, continuously examining a firm's business portfolio to identify non-core business segments takes time and discipline. Due to competing priorities, companies often hold on to the non-core segments to focus on more pressing matters. These companies may miss out on fleeting favorable economic circumstances and be forced to sell at a lower value.

The same is true of pension plans. For many companies that no longer rely on pension benefits to attract and retain talent, the pension plan is a non-core operation—it essentially functions like a runoff insurance company. The plan can be a drain on resources and funds that could be reallocated to other core business opportunities.

Unfortunately, it's easy for plan sponsors to mistime the market. They may look to de-risk only when the markets turn volatile, their plan funded status erodes and their core business sputters.

Transferring the risk to an insurer can have better results. Better yet, transacting during favorable market conditions allows companies to strengthen their defense and create financial flexibility to pursue growth opportunities at a time when their competitors may be unable to do so.

There's Growing Interest in Divesting

There has been a sharp increase in interest around corporate divestitures recently. Companies are exhibiting a desire to simplify their businesses and sell operations to tighten their core focus. A recent study by Ernst & Young[2] reported that 87% of executives interviewed plan to complete a divestiture within the next two years, up from 43% in 2017.

Much like an unprofitable business segment, pension plans divert resources from the core business, constrain cash flows and limit performance. In fact, divestment decisions and decisions to de-risk a pension obligation are driven by the same economic triggers and often produce similar outcomes.

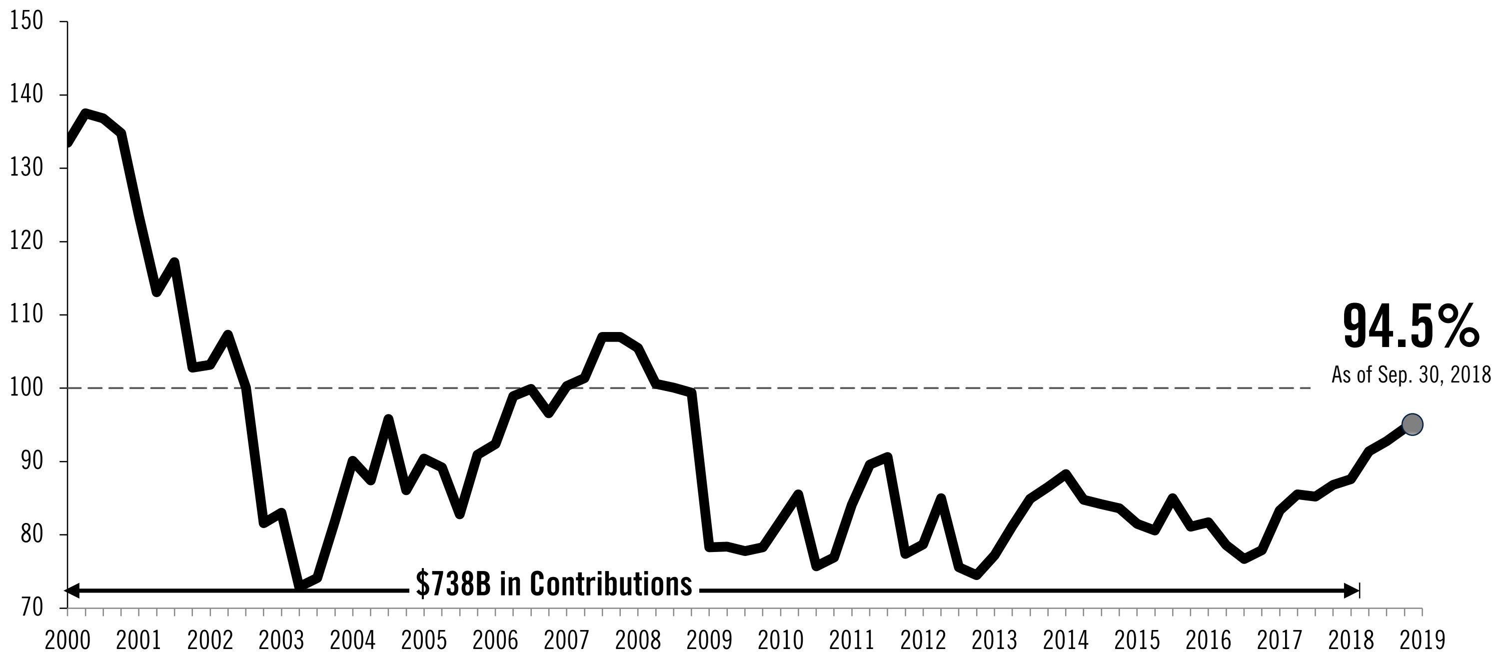
Though the motives and circumstances may change, there are three fundamental reasons most companies choose to divest: non-core business, prolonged underperformance and need for capital.

Non-core business: The most recent financial crisis accelerated pension plan freezes and closings. In fact, by 2015, 39% of plans were frozen and another 24% had stopped offering their primary defined benefit (DB) plan to new hires.[3] Many companies no longer view pension plans as a way to attract and retain top talent, and for many these obligations have become a "discontinued business operation."

These legacy plans can reduce competitiveness and are often a drain on management time and company resources. When senior management is busy managing assets and longevity risk, time and money are taken away from the core business. A de-risking solution with an insurer is a more effective way to manage risk, and it frees up resources to focus on the core business.

Underperformance and additional need for capital: Prolonged underperformance of a business segment is a common and financially sound reason for a company to divest. When it comes to pensions, plan contributions can significantly drain free cash flow. Funded status is also volatile and costly. Twice since 2000, pension funded status in the U.S. has plummeted more than 30%,[4] and funded status declines have undesirable long-term consequences. Large cash infusions may be required, corporate income can be reduced, and balance sheet liabilities may multiply at the exact moment the underlying business is experiencing hardship. Exhibit 1 illustrates the funded status fluctuations of the 100 largest U.S. corporate pension plans reporting under Generally Accepted Accounting Principles (GAAP).

Exhibit 1: U.S. Corporate Plan Funded Status Volatility



Source: Milliman 100 Pension Funding Index, the largest 100 U.S. corporate pension plans.

All told, these plan sponsors were compelled to contribute over $450 billion to their plans between 2009 and 2017. Without question, funded status volatility has been a significant pain point for U.S. pension funds over the past 15 years.

Meanwhile, the cost of running a pension plan continues to increase, which is a further drain on cash flows:

- PBGC (Pension Benefit Guaranty Corporation) premiums have risen every year since 2012.[5]
  - The annual flat-rate premium will increase to $80 per participant in 2019, up by more than 125% from 2012.
  - The annual variable premium will increase to 4.2% of unfunded plan liabilities—up more than 360% since 2012—with a cap of $523 per participant.

Be Proactive to Increase Shareholder Value

To improve financial flexibility and enhance shareholder value, sponsors should consider meaningfully shrinking the size of their pension liabilities and allow greater focus on the firm's core business. Many studies[6,7] show that pension risk weighs on the stock prices of pension-heavy companies; these companies underperform compared to others with either small or no DB pensions.

Transferring pension liabilities to an insurer is a positive net present value transaction, and companies that proactively address pensions are rewarded by the market.[8] Exhibit 2 highlights companies that meaningfully reduced pension liabilities and experienced stock price outperformance relative to the market as of the date the de-risking transaction was announced to the public.

Exhibit 2: Companies That Meaningfully Reduce Pension Liabilities Exhibit Strong Stock Price Outperformance Relative to the Market

Positive correlation between announcement day stock returns relative to the S&P 500, and the magnitude of risk reduced (measured by pension benefit obligation [PBO] reduction as a percentage of market capitalization)

Company Name	De-risking Transaction Announcement Date*	PBO Reduction as a Percentage of Market Capitalization	Stock Returns Relative to S&P 500	Transaction PBO Size ($ billion)	PBO to Market Cap Pre-Transaction	Funded Status
General Motors	6/1/2012	75%	1.61%	25.0	315%	90%
J.C. Penney	10/2/2015	58%	5.58%	0.8	172%	104%
Motorola	9/25/2014	26%	2.33%	3.1	47%	83%
WestRock	9/9/2016	22%	-1.08%	2.5	51%	106%
Timken	11/19/2015	18%	1.35%	0.5	46%	100%
The Hartford Financial Services Group	6/26/2017	8%	1.08%	1.6	30%	85%
Verizon	10/18/2012	6%	2.61%	7.5	24%	80%
Philips	10/1/2015	6%	0.65%	1.1	139%	85%
PPG Industries	6/28/2016	6%	0.12%	1.6	20%	87%
Kimberly-Clark	2/23/2015	6%	0.06%	2.5	17%	86%
Molson Coors Brewing Company	12/1/2017	5%	1.75%	0.9	35%	96%
International Paper	10/2/2017	5%	0.60%	1.3	59%	75%
CBS Corporation	11/2/2017	4%	1.42%	0.8	21%	70%
NCR	12/17/2014	4%	-1.21%	0.2	68%	92%
Bristol-Myers Squibb	10/1/2014	2%	0.75%	1.4	5%	102%
United Technologies	10/6/2016	2%	-1.14%	0.8	31%	88%

**Note: When the transaction was announced after market close, stock returns relative to the S&P 500 were evaluated as of the next trading date.*
Source: Bloomberg/company press releases.

More Than an Annuity Purchase

Plan sponsors who proactively transfer pension risk should effectively communicate their strategy and approach to educate their external stakeholders—equity and credit risk analysts and shareholders. Plan sponsors often describe a pension risk transfer transaction simply as "an annuity purchase," which may have a negative connotation. Instead, sponsors should position risk transfer to stakeholders as a divestiture of a non-core operation. This conveys that the management team took proactive steps to reduce future cash flow volatility and increase financial flexibility. And by doing so, the company can focus on its core business, position itself to better endure the next economic downturn, pursue growth initiatives and remain competitive.

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1) The Boston Consulting Group, "Don't Miss the Exit: Creating Shareholder Value Through Divestitures," September 2014.
2) Ernst & Young, "How Can Divesting Fuel Your Future Growth?" Global Corporate Divestment Study of 2018.
3) Willis Towers Watson, "A Continuing Shift in Retirement Offerings in the Fortune 500," Feb. 18, 2016.
4) Milliman 100 Pension Funding Index.
5) Source: Pension Benefit Guaranty Corporation. Available at pbgc.gov/prac/prem/premium-rates.
6) Long, C., E. Bronsnick, and H. Zwiebel, "Pensions in Practice, How Corporate Pension Plans Impact Stock Prices," Morgan Stanley, October 2010.
7) Mathur, R., S. Kaplan, and R. Ramirez, "Means and Markets Have Aligned, Why You Should Consider De-risking Now," Prudential Financial, 2017.
8) Positive market reaction is notwithstanding one-time charges and cash contributions required to restore funded status. Companies that currently do not follow mark-to-market accounting may have to recognize a one-time charge to reflect actuarial losses in proportion to pension liabilities that are settled.

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