

Impact on a company's share price of its final salary pension scheme

It is often suggested that corporate investors do not fully understand the financial implications and risks associated with a defined benefit (DB) pension scheme. If investors do start to gain a greater understanding of a DB scheme then companies may come under pressure to alter their scheme's funding and investment strategy.

Introduction

In conjunction with the Centre for Global Finance at the University of the West of England we have undertaken some research to consider the historic impact of various pension-related events on a company's share price. This is the third of a series of notes considering various pension events that should theoretically impact on the value an investor would place on a company.

The first note investigated a series of pension-related announcements and news stories relating to the BT pension scheme and found that some of them have had a significant impact on BT's share price (see <http://bwllp.co.uk/nm>).

Our second note considered the impact announcements on the use of a Special Purpose Vehicle (SPV) and the closing of the final salary pension scheme to future accrual had on the share prices of a sample of well known companies (see <http://bwllp.co.uk/p5>).

Impact on companies' share prices of changes to pension indexation

The level of increases applied to pensions provided by DB schemes has a significant impact on their cost. Therefore, two key decisions in the last few years relating to inflationary pension increases could have had a significant impact on the financial position of companies' DB schemes:

- In 2010 the Government confirmed that it would be using the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI) as the measure for calculating future statutory increases to pensions. For some but not all companies this could have reduced their DB scheme liabilities by up to 20%.
- More recently, the Office for National Statistics (ONS) undertook a review of the formula for calculating RPI and the findings were announced earlier this month. This could have had a similar impact for many companies that had not already benefited from the change to statutory increases.

With DB schemes having an increasing impact on the finances of many listed companies, this note considers the impact these announcements had on their share price.

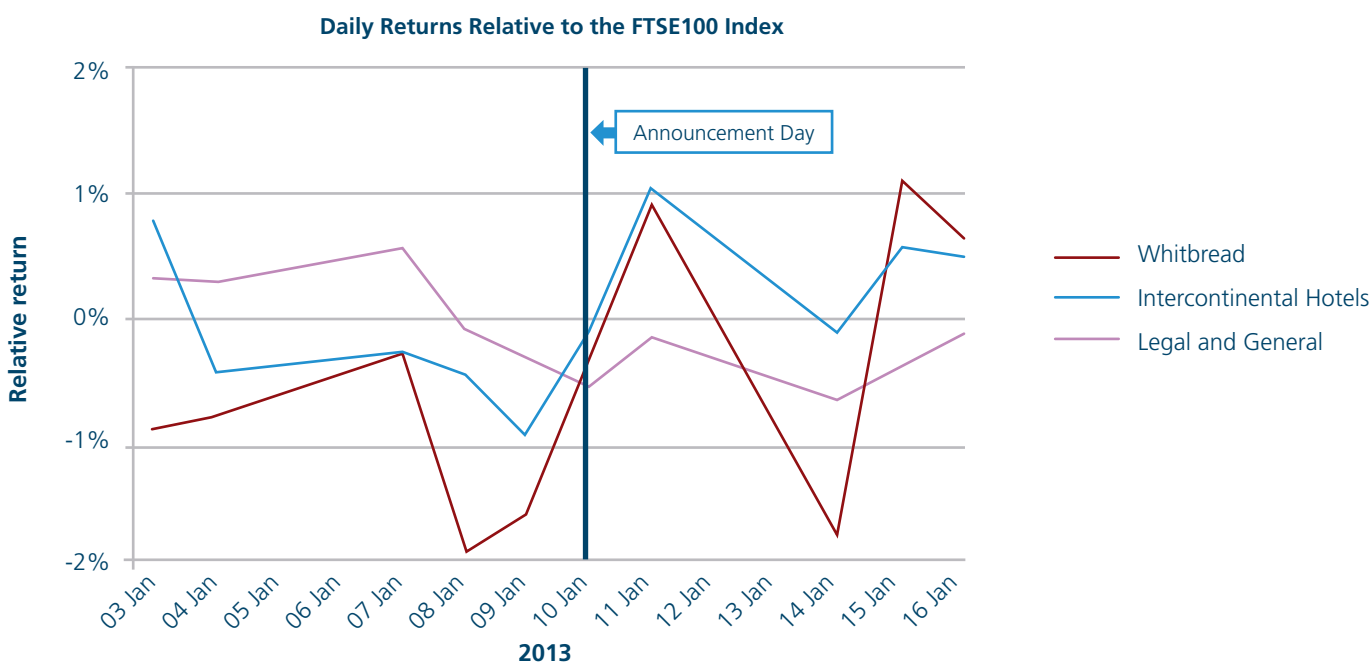


ONS announcement on the calculation of RPI

In January 2013, the ONS confirmed that it was not proposing to make any changes to the methodology used to calculate RPI. The market had been expecting the ONS to bring the index closer into line with CPI, or had at least believed a change was a serious possibility. This was reflected in the price of index linked gilts, which increased in value following the announcement that no change would be made. The increase in price was consistent with the market believing that RPI inflation was going to be 0.3% higher after the announcement. We estimate that this will have increased the aggregate pension liabilities of FTSE350 companies by around £15bn, relative to the anticipated position.

We have examined the impact that this announcement had on the share prices of three FTSE100 companies which use RPI to index their pension liabilities. We have selected those with the highest pension deficits as a proportion of market value.

The graph below shows the share price reaction relative to the FTSE100 on the day of the ONS announcement and in the window before and after that day.



Source: Centre for Global Finance at the University of the West of England & Barnett Waddingham LLP

There were negative share price movements in all three companies following the day of the announcement, but not of a statistically significant size in comparison to the general volatility of the share prices during the period around that time. There were no other company specific events on the day of the ONS announcement.

Investors were certainly alert to the ONS announcement, as index linked gilt yields fell by 0.3% pa immediately following the news. However, there is no evidence from our analysis that investors were taking into account the impact this announcement would have on the company's pension obligations.

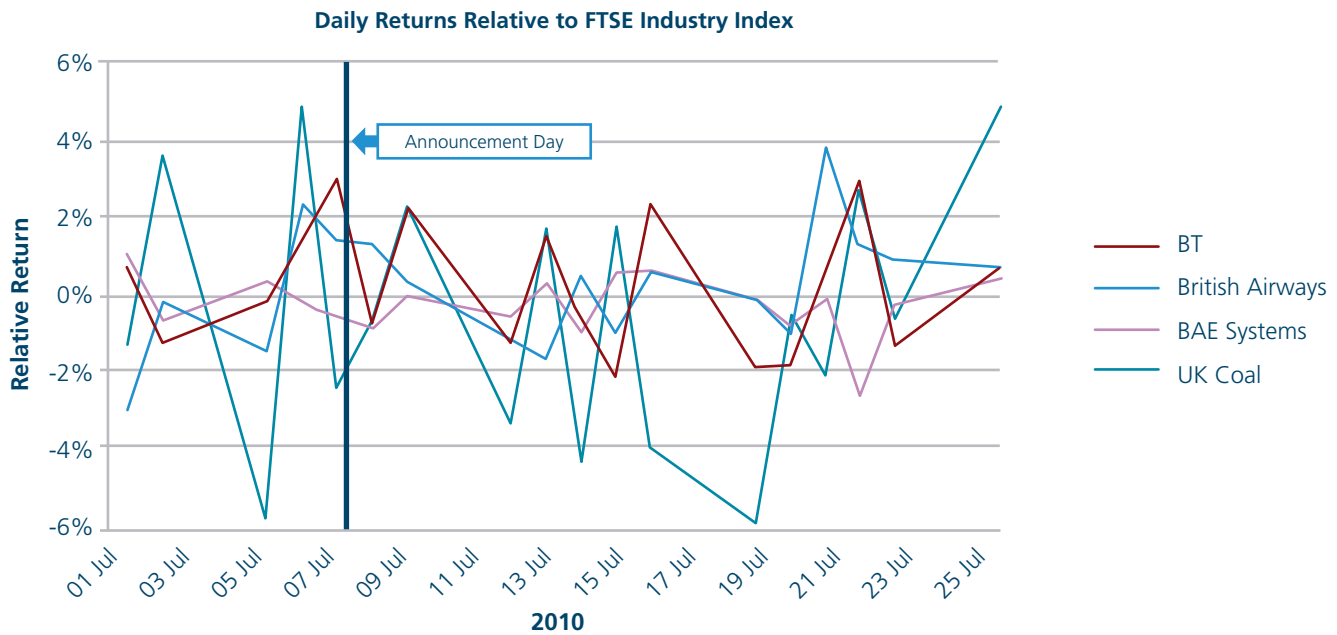
The Intercontinental scheme invests around half of its assets in a liability driven investment (LDI) fund, which seeks to hedge movements in interest rates and inflation. However, almost all of its pension liabilities are inflation linked, so this investment would at best halve the expected impact of the RPI announcement on the Intercontinental scheme deficit and, hence, traders' views on the appropriate change in share value. Many schemes will have some level of inflation matched investments, whether these are LDI funds, index linked gilts, or inflation swaps. These all help to reduce the impact of increases in future price inflation.

Government's announcement on the change from RPI to CPI

We have undertaken similar analysis relating to an earlier government announcement that it was changing the inflation index used to calculate the statutory minimum level of increase from RPI to CPI. This allowed private companies sponsoring DB schemes to use CPI as the inflation measure to index future benefit payments, unless the wording of individual schemes' rules specifically required RPI to be used. Due to the calculation methodologies and the basket of goods used to derive them, RPI is expected to be considerably higher than CPI.

DB pension deficits represent a significant burden for many companies so this change should have been perceived as a very positive announcement for these companies.

We have looked at four companies which should have significantly benefited from the change. The graph below shows the companies' share price movements on the day of the government announcement relative to a relevant market index.



Source: Centre for Global Finance at the University of the West of England & Barnett Waddingham LLP

Our analysis revealed no statistically significant share price movements on the day of the Government announcement outside the normal stock price volatility within the period considered.

This change would not have applied to all companies and in many cases there was some uncertainty over the inflation index that should be used. As a result we also analysed share price movements around the dates of formal company announcements about the inflation index that would be used for those companies' DB schemes. Again our analysis revealed no statistically significant share price movements on the day of these company announcements outside the normal stock price volatility within the period considered. As the table below shows, the benefits of switching from RPI to CPI are significant, although the scale varies between companies.

Company	Size of the deficit prior to change	Size of the deficit after change	Savings	Savings per share
BT	£7.9bn	£4.4bn	£3.5bn	27p or 28% of share value
BAE Systems	£3.75bn	£3.4bn	£348m	9.7p or 2.9% of the share value
British Airways	£3.7bn	£2.93bn	£770m	66p or 25% of the share value
UK Coal	£202.6m	£170m	£32.6m	11p or 28% of the share value

Source: Centre for Global Finance at the University of the West of England & Barnett Waddingham LLP

Since the regulatory change took place, 51 FTSE350 companies have made changes to pension indexation, reporting savings of nearly £7bn, which is an average of £135m per company. This is equivalent to 2% of market capitalisation or 29% of reported pension deficits prior to the change.

If the markets were fully informed and efficient, the value of companies' shares should have increased on average by 2% following the announcement. The fact that we have not observed statistically significant changes to the share price may be explained by a lack of understanding of DB schemes by investors, or the impact filtering through gradually over time.

Equity Analyst Survey

To further our research we surveyed a group of equity analysts to find out if they actively considered the impact they placed on the value of a company with an "average" pension scheme following the government's announcement on the change from RPI to CPI as the measure for statutory pension increases.

Of those surveyed 24% either disagreed or strongly disagreed while 35% remained undecided about considering the impact the government's announcement had when placing a value on a company with a significant DB scheme.

Summary

This analysis seems to back up the theory that financial markets do not fully understand DB pension schemes. The impact of these changes will not have had an immediate impact on dividends or cash flow and, as a result, may not have been considered important by investors. However, unlike many changes in the disclosed financial position of a pension scheme, these would have resulted in an actual change to the company's pensions costs as the DB benefits would have fundamentally changed.

The impact of these changes will inevitably filter through to companies' share prices over time, as the market evaluates the information (perhaps when it is disclosed in the next set of accounts) and as analysts are able to fully understand the value of the change.



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