Impact of Negative Investment Returns And Low Interest Rates On M&A Transactions

The negative investment returns on retirement plan assets and the low interest rates have had a large impact on merger/ acquisition transactions. For qualified pension plans, the negative returns of the last three years have reduced the asset value by 20% to 40%, and the low interest rates have increased the benefit liabilities by 20% to 30%. This combination of events has raised the unfunded liabilities (accrued benefit liabilities over plan assets) from zero to many millions (or billions for large corporations).

For unfunded pension plans (Supplemental Executive, Top Hat…etc arrangements), the drop in interest rates has increased the value of the benefit obligations by 15% to 30% depending on the demographics of the plan participants.

Similarly, retiree medical plans are affected by the low interest rates used in calculating liabilities. However, there is the added factor of rapidly rising medical and prescription drug utilization and cost trend, at 12 to 15% for the last three years. Consequently, retiree medical liabilities have increased by 25% to 45%. The increased liabilities do not reflect the potential changes in the basic Medicare benefits to deal with the looming solvency concerns. It is likely that the retiree medical plans will bear the brunt of the cost shifting, thus further increasing liabilities and costs.

Besides the analysis of unfunded liabilities, merger/ acquisition due diligence also involves the assessment of the ongoing costs. Pension plans have seen a 25% to 50% increase in annual contribution and accounting expense in 2003 due to the jump in unfunded liabilities. For non-qualified retirement plans, the 2003 accounting expense can increase by 40% to 50% if many of the participants are near retirement age. As for retiree medical, the 2003 annual cost can be 15% to 20% higher than 2002 due to the rapid rise in utilization and cost trend mentioned above.

One may ask how has the recent stock market rise changed the picture? For pension plans, the answer depends on the asset allocation and the original drop in asset value. If a pension plan has adjusted the asset allocation by increasing bond investments to reduce further losses from stocks, then the market run up from March to December 2003 would have a smaller impact on the overall portfolio value than otherwise.

A simple example on investment mathematics would illustrate that large market gains are needed to recoup the losses of the last three years. For example, a pension plan had $100 million in assets at 1/1/2000 and $70 million on 1/1/2003. This portfolio would need an overall 42.86% gain to get back to the $100 million value. If this portfolio allocated 70% of the assets into stocks, stock investments would have to rise over 76.67% to recoup the overall portfolio losses, assuming that the remaining 30% of bond and cash would earn the prevailing rate of returns.

Based on the above example, many pension plans still have large unfunded liabilities and a sizable increase in annual contributions. As for the unfunded benefit plans, the value of the benefit obligations will not decrease until there is a rise in the long-term interest rates. With the continual increase of healthcare and prescription drug costs, retiree medical liabilities and annual costs will continue to escalate.

With the increased liabilities and costs, it is important that the merger/ acquisition due diligence process includes a thorough analysis of the pension, retiree medical and other benefit obligations.

The above discussion of unfunded liabilities and ongoing costs are based on our experience in working with many companies on merger and acquisition transactions. If you have any questions on our M&A services, please contact us at (858) 538-3566 or jgeng@actbenefit.com.

12310 DORMOUSE ROAD • SAN DIEGO, CA 92129
PHONE: (858) 538-3566• EMAIL:jgeng@actbenefit.com