Examples of inadequate and good analysis in covenant reports

Case study

- The sole participating employer is part of a strong group but is the only entity legally obliged to support the scheme.
- The wider group has stated it is willing to support the scheme but there are no plans for it to fund deficit repair contributions (DRCs).
- The level of DRCs agreed at the last valuation is £1m per annum.
- Using the same valuation basis as at the last triennial valuation, the scheme funding deficit has increased from £12m to £20m. The deficit on a section 75 basis is £45m.
- The scheme's investment strategy has a three-year, 1-in-20 value at risk (VaR) of £8m based on the current level of DRCs.
- Based on the latest publicly available financial statements, the employer's pre-tax profit increased to £3.2m in the last financial year.
- Under UK accounting rules it is not required to prepare a cash flow statement.
- The company is forecasting an increase in annual cash flow from £2m to £3m. Net assets of the employer of £75m include £50m of tangible assets, cash of £1m, and debt of £1.5m.

Key analysis in an inadequate covenant report

- Since the last valuation, the employer has improved its profitability to £3.2m in the last financial year. It did not produce a cash flow statement and therefore we have not reviewed its cash flows.
- Profitability comfortably exceeds the existing level of DRCs.
- The employer has net assets of £75m, of which £50m are tangible assets including the factory and machinery used in its production process. This is significantly larger than the £20m scheme funding deficit.
- The wider group says it is willing to provide support to the scheme.

Conclusion:

We consider the covenant to be strong as the group is strong and the employer is profitable and has a large tangible asset base.

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Key analysis in a good covenant report

- The employer is the sole participating employer of the scheme and source of committed financial support. The scheme has no legal recourse to the assets and cash flows generated by the wider group. In addition, there are no plans for it to provide financial support and therefore the wider group has not been considered in this assessment.
- Preliminary valuation results suggest the scheme deficit has increased by £8m to £20m since the last valuation. The preliminary results have been prepared using the same assumptions at the last valuation, updated only for changes in market conditions, and so are subject to revision. The scheme has assets of £60m.
- The employer has limited financial resources with cash of £1m and debt repayment obligations of £0.5m per annum for the next three years.
- The employer is forecasting improved cash generation from operations to £3m per annum due to reductions to its cost base and its forecasts are deemed to be robust. The employer's position within its sector remains strong.
- No cash flows generated by the employer are being extracted by the wider group and therefore they remain available to support the scheme.
- Based on the forecast increase in cash generation, the employer could potentially increase contributions to £2m per annum.
- The scheme's investment strategy carries significant investment risk and the three-year 1-in-20 VaR has increased to £8m. This means there is a 5% chance the deficit could be more than £28m in three years' time in the absence of any change in DRCs.
- The existing deficit and VaR combined could place a strain on the employer's available cash flows in a downside investment scenario.
- The trustees and employer could reassess their shared risk tolerance and consider how to reduce reliance on the covenant in the longer term, for example by reducing investment risk and seeking higher contributions in the short term.
- In addition, the trustees could ask the wider group to formalise the support it has said it is willing to provide. We expect this would improve the covenant and should increase the affordable level of DRCs. The improved covenant could be reflected in the scheme's investment and funding strategy.
- Finally, the employer's forecast performance is vulnerable to changes in energy prices.The trustees should consider stress-testing the covenant and the investment strategy in scenarios of adverse changes in energy prices, and possibly adjusting their investment strategy to reduce the scheme's overall risk exposure to energy prices.

Conclusions and recommendations:

As the scheme deficit remains large relative to the cash flows of the employer, we would characterise the strength of the covenant as 'tending to weak'.

Although the affordability of contributions to the scheme has increased, the scheme's funding requirements have also increased. Therefore, the covenant is materially unchanged since the last valuation.

Note: the nature and scope of the covenant assessment will depend on the circumstances of the scheme and employer.