ACQUIRING MINDS

There's been a significant increase in merger and acquisition activity in Canada over the past few years. What is the impact on pension and benefits plans? BY COLIN RIPSMAN

MERGER and acquisition (M&A) activity in Canada was the strongest ever in 2006. Data compiled by *Financial Post Crosbie: Mergers & Acquisitions in Canada* shows that there were 1,968 announced transactions in 2006—a 22% increase from the 1,613 deals announced in 2005—with a total transaction value of approximately $257 billion.

This huge increase in M&A volume was led by the metals and minerals sector, which witnessed two of the largest transactions in history: the $19.2 billion purchase of Falconbridge Limited by Swiss-based Xstrata plc and the $19.8 billion purchase of Inco Limited by Brazilian-based Companhia Vale do Rio Doce. The increase in megadeals (transactions over $1 billion) in 2006—51 megadeals, compared to only 33 megadeals in 2005—was also a factor.

However, the biggest contributor to the increase in M&A volume was cross-border activity, representing 76% of the total M&A deal value and a total of $196 billion in assets—an increase of almost 100% from the 2005 level of $99 billion. This increase in foreign acquisitions occurred despite a steady appreciation of the Canadian dollar from 2002 to 2006.

And there are indications that this trend will continue. Despite the North American credit crunch, Canadian M&A activities in the first three quarters of 2007 have already surpassed the record levels set in 2006. The strong Canadian capital markets, as reflected in the performance of the S&P/TSX index, have also contributed to the steady growth in Canadian M&A activities—which, in turn, have been buoyed by the rising global demand for natural resources.

Ripple Effects

What implications does this M&A activity have for pension and benefits plans? The type of purchaser has a significant impact on the outcome. There are three main types of acquiring companies: corporate purchasers with no existing Canadian operations, corporate purchasers with other existing Canadian operations and private equity purchasers.

Corporate purchasers with no existing Canadian operations - If the purchaser has no other existing Canadian operations, it is unlikely to make significant changes to existing benefits programs. There may be a desire to benchmark benefits to ensure that they are competitive and, if they are rich, to bring them in line with the market. In some cases, the purchaser may wish to harmonize the benefits with its worldwide benefits policies; however, the purchase agreement may preclude significant changes to the existing benefits structure.

Corporate purchasers with other existing Canadian operations - If the purchaser has other existing Canadian operations, it will often attempt to harmonize the acquired company's benefits and retirement arrangements with its existing programs and philosophy (subject to any limitations in the collective bargaining agreements and the agreement of purchase and sale) and consolidate the programs with the existing providers. Greg Durant, central Canada group and health care practice leader, with Watson Wyatt Worldwide, points out that benefits harmonization is crucial when people from the different companies will be working side by side, or if there are frequent transfers between companies.

Private equity purchasers - Private equity

purchasers—collective investment funds that raise venture capital to invest in companies with the intention of obtaining a controlling interest—aim to improve the target company's capital structure, management and organizational infrastructure. The companies are often delisted from public stock exchanges during the restructuring and re-listed for sale through an IPO at a significantly enhanced price once the restructuring is finished.

The growth in Canadian M&A activity has been accompanied by a similar growth in Canadian private equity deals. According to Thomson Financial, based on the value of disclosed dollars, private equity acquisitions of Canadian companies hit an all-time high of $10.9 billion in 2006, more than doubling the 2005 level of $4.5 billion. And, more than two-thirds of this activity was attributed to foreign purchasers.

In the case of a private equity purchaser, new management is typically focused on reducing costs—either by reducing existing benefits levels (often in conjunction with an industry competitiveness benchmarking exercise to reduce the likelihood of unwanted turnover) or through renegotiating with existing retirement and benefits plan providers. According to Doug Johnson, principal, with Mercer's merger and acquisition practice, in situations where new pension or benefits programs need to be put in place following an acquisition, some private equity firms managing a portfolio of Canadian business will use Canadian providers that have existing relationships within the current portfolio of companies to help manage these new programs.

In contrast, when the acquisition is a stand-alone transaction, there is less incentive to replace the existing providers. The focus then shifts to ensuring that the arrangement is competitive and that provider fees are reasonable. This could mean simplifying administration arrangements and relying more on the existing third-party providers or even outsourcing all aspects of the plan administration to a benefits provider or a third-party consultant.

Regardless of the type of purchaser, purchasers are concerned with limiting the financial risk associated with any defined benefit (DB) promise. Therefore, defined contribution (DC) plans are often preferred and, barring any restrictions under existing collective bargaining agreements or the purchase and sale agreement, a purchaser will consider switching employees to a DC program. However, Johnson suggests that "if the DB costs are reasonable and the plan is financially sound, then a purchaser will be less concerned with making changes. The best way to ensure that the DB plan survives the transaction is to ensure that the plan is well run and costs are being properly managed."

Restructuring Arrangements

M&A transactions are often driven by a desire to achieve greater efficiencies in the new merged entity. But can companies actually achieve efficiencies through restructuring retirement and benefits arrangements? Key factors include the consolidation of providers, governance and oversight efforts and reorganization costs.

BENEFITS HARMONIZATION IS CRUCIAL WHEN PEOPLE FROM THE DIFFERENT COMPANIES WILL BE WORKING SIDE BY SIDE.

Provider Consolidation

The efficiencies achievable by consolidating providers will depend on the specific plan demographics and on the type of plan in question. When there are two Canadian group benefits programs and two sets of providers, there may be some advantages to combining them. In general, a larger plan with more members will be more attractive in a plan marketing situation, creating more leverage to renegotiate lower expenses and fees for the combined program.

As Durant indicates, providers on both sides of a merger will expect some form of provider consolidation. They will often price the merged business more aggressively as a result, due to familiarity with the group and the low cost of acquiring the business. Johnson has found that consolidating providers for larger plans would not realize significant administrative savings based on efficiencies if current costs are already competitively priced. However, there are many instances in which large plans are not paying market-competitive administrative costs and a provider consolidation would realize significant savings.

The demographics of the two plans will also affect the cost structure of the merged program. Where the claims experience of the two organizations is significantly different, the pricing of the plan with better experience may erode, while the pricing for the plan with poorer claims experience may improve.

With DC plans, pricing is largely dependent on the average asset balance. Similar to merging benefits plans, when two DC plans with significantly different average asset balances per member merge, the cost structure of the less attractive plan will often improve at the expense of the pricing for the more attractive plan. The greatest opportunity for leverage exists when a smaller plan is merged with a larger plan,

as the larger plan can often use its influence with providers to add the new company to existing arrangements under the same terms.

With DB plans, there is the potential to use the larger size of the aggregate assets of the two plans as leverage, even where the plans are not merged. However, this would require the two plans to agree on a common investment manager structure.

There is also the potential to leverage global investment management relationships to achieve better investment pricing in Canada. However, this strategy often requires the Canadian plan to harmonize its investment management structure with the U.S. program. Historically, this has been difficult to do because of the strong Canadian bias under Canadian investment structures. Even with the removal of the Foreign Property Rule, most plans use domestic bonds and have a domestic bias to their equity allocation. However, Janet Rabovsky, Canadian investment consulting practice leader, with Watson Wyatt Worldwide, points out that where it is possible to leverage investment providers on a global basis, there can be significant long-term savings for the Canadian company.

THE BEST WAY TO ENSURE THAT THE DB PLAN SURVIVES THE TRANSACTION IS TO ENSURE THAT THE PLAN IS WELL RUN.

In the case of a U.S. purchaser with DC plans only in the U.S., the opportunity is less about economies of scale, in terms of price, and more about gaining synergies in other areas. As Dave McLellan, vice-president of Fidelity retirement services, points out, "the regulatory regimes in the U.S. and Canada, as well as the scale and cost structures of the two markets, are quite different, which makes it difficult to provide significant pricing leverage to the Canadian entity. However, the company may still benefit through shared governance, investment and recordkeeping oversight and vendor management practices." Providers may also extend enhanced services and support to the Canadian company as they work to ensure the continued satisfaction of the U.S. parent.

Governance and Oversight

The biggest advantage to consolidating Canadian providers is the reduced oversight requirements. Harmonizing providers may reduce the number of contacts, thereby reducing internal costs and potentially allowing the merged entity to reduce HR staffing levels. Once the new structure is in place, ongoing third-party consulting costs can be reduced, since there will be fewer renewals and fewer providers to monitor. It will also be easier to oversee existing providers, lessening the burden placed on pension committees, and to maintain a higher level of scrutiny for the remaining providers, facilitating quicker action should any issues arise.

Reorganization Costs

While there may be some cost savings achieved through the harmonization of providers, they will be partially—or in some cases, completely—offset by the initial costs of harmonization. These costs can sometimes be accounted for in a separate merger budget; however, they remain a significant expense.

Implementation costs upon the acquisition of a business could include the following.

Initial due diligence - This step is normally undertaken prior to purchase, and it is necessary to ensure that the plans are financially stable and that there is no unexpected potential liability accrued.

Benchmarking of plans and providers' capabilities and fees - This step involves benchmarking the competitiveness of the benefits and retirement plan levels against Canadian market norms and, in some cases, the existing programs of the purchaser.

Provider searches - If a common provider will be chosen from the existing providers, the company will need to initiate a formal marketing or search process. If the acquirer has decided to use its existing provider structure, pricing and renewal information must be obtained and analyzed. And if investment structures will be harmonized, the impact of the changes on the investment structure must be formally evaluated.

Implementation - The initial costs of plan harmonization may include internal costs to coordinate and oversee the process, as well as costs for third-party support from benefits, pension and investment consultants. Related activities include negotiating contracts, amending plan documentation, coordinating asset transfers, reviewing reconciliations, communicating with members, investment transition and project management.

The rash of Canadian acquisitions is driven by the desire to improve the efficiency and profitability of the target company. From a pension and benefits perspective, the efficiencies are limited and may be offset by the reorganization costs. However, from an operational efficiency and governance perspective, consolidating providers may be necessary to ensure the effective and prudent operation of the program. **BC**

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