FTSE350 PENSIONS

Not all sectors are created equal

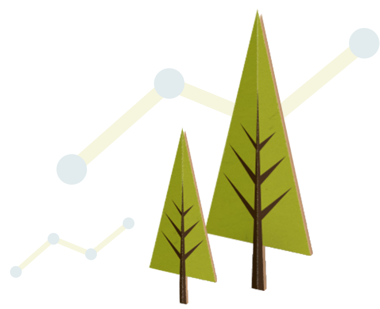
With strict lockdowns being imposed in most of the world's major economies, the coronavirus pandemic has wreaked havoc across global financial markets. Here in the UK, the Bank of England has forecast the country's deepest recession since 1706, with the economy expected to shrink by 14% this year. While equity markets have fallen sharply since the start of the year, the size of this fall varies significantly across the different industry sectors.

From a defined benefit (DB) pension scheme perspective, the plunge in equity markets and the continued downward march in gilt yields will have pushed funding levels further into the red (though the fall in inflation expectations will have provided some respite).

With The Pensions Regulator's (TPR) DB scheme funding consultation on the horizon, potentially pushing pension costs even higher, the nature and speed of any economic recovery will be of keen interest to those managing DB pension schemes.

In this analysis of the DB schemes of the FTSE350 companies, we look at the sectoral differences in economic performance over recent months and put the spiralling DB scheme deficits into context.

We also consider the challenges that will need to be overcome as we gradually emerge out of the crisis.



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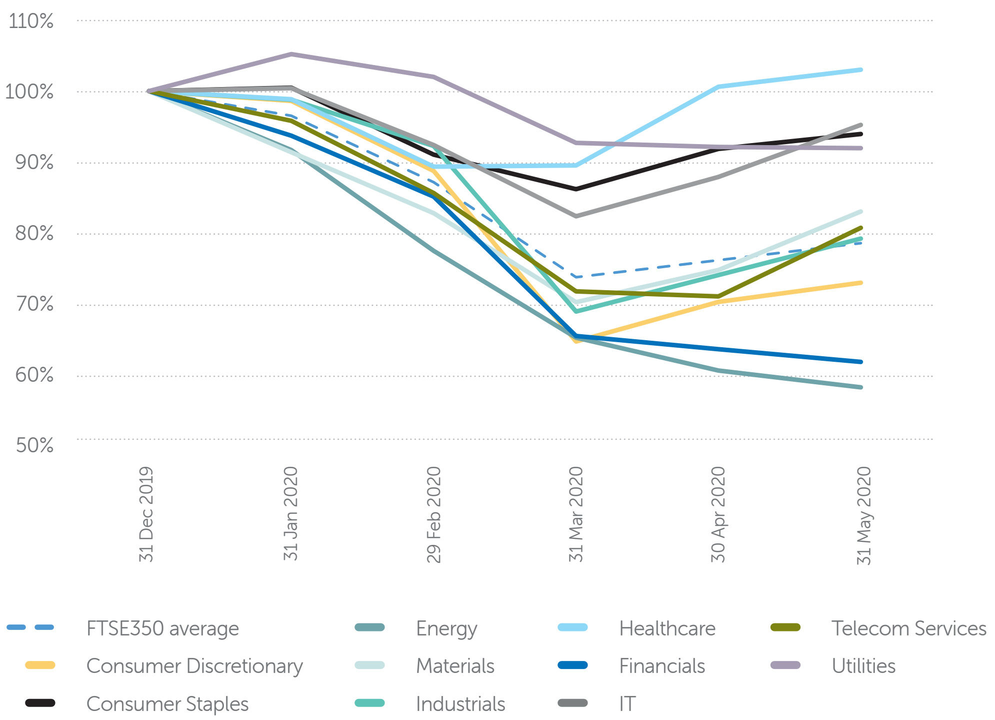
The market cap collapse

The chart below shows the relative falls in month-end market capitalisation values since the start of the year for the FTSE350 DB scheme sponsors on a sector-by-sector basis.

Overall, at the end of May, the total market capitalisation for these companies had reduced by 21%, showing a slight recovery from the end of March. However, there was a stark difference in performance between the different sectors. The Consumer Discretionary, Financials and Energy companies have suffered the most over recent months (with the latter's market capitalisation falling by over 40% by the end of May as the oil price tumbled). On the other hand, the Healthcare, Utilities, IT and Consumer Staples companies have performed relatively well (with the market capitalisation for these companies remaining within 10% of their year-end value at the end of May).

RELATIVE CHANGE IN MARKET CAPITALISATION FOR THE FTSE350 COMPANIES BY SECTOR



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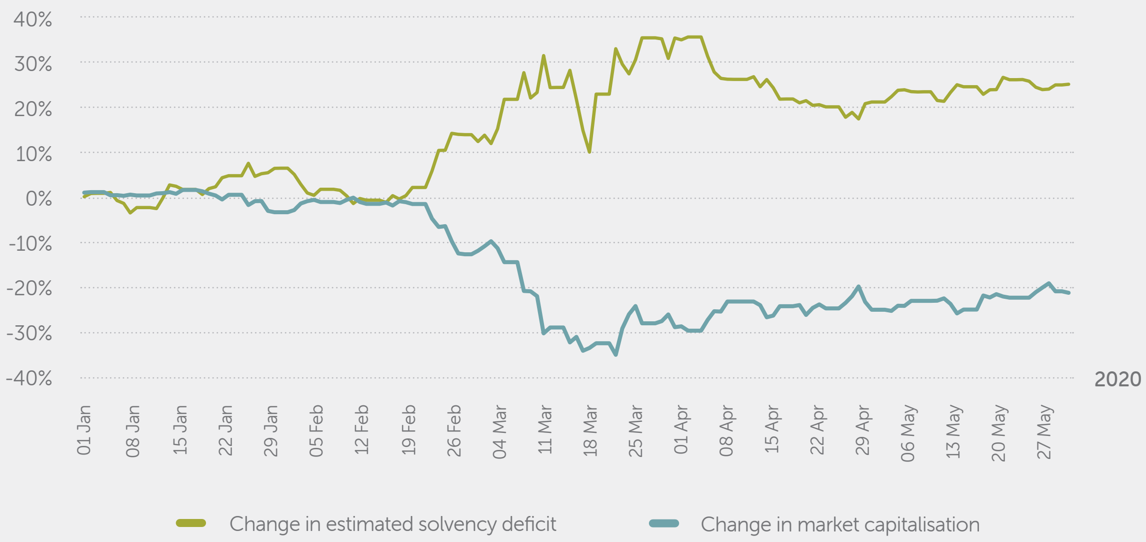
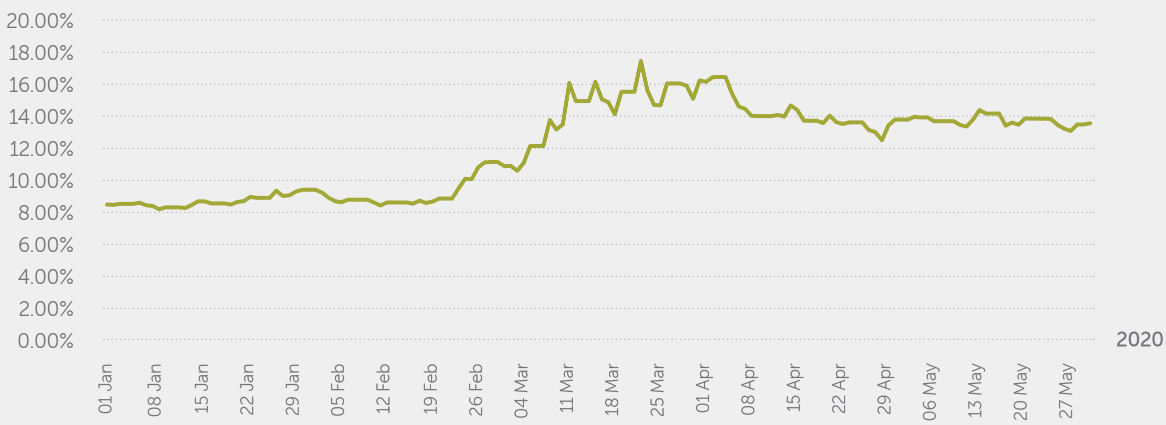
The DB funding gap

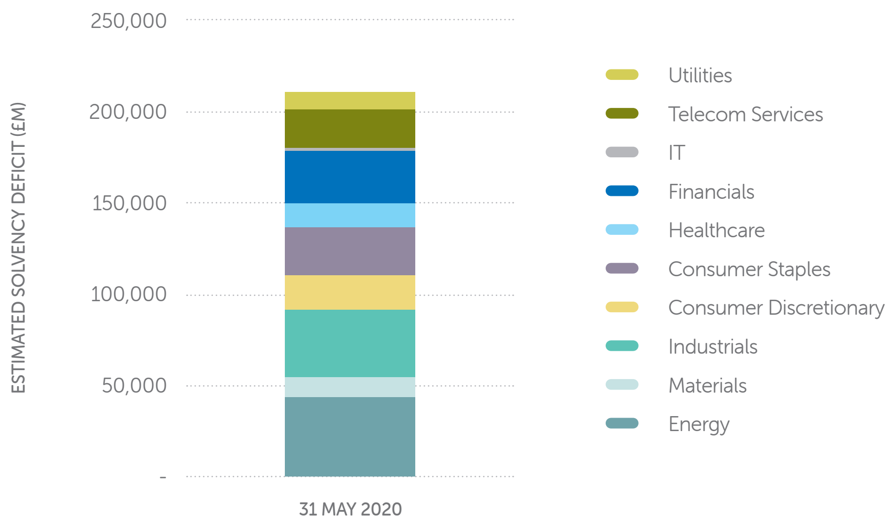
Unfortunately, for all of these companies, not only has the economic value of their business shrunk, the cost of ultimately settling their DB pension obligations has shot up. The chart below illustrates the fall in the market capitalisation of the FTSE350 organisations over recent months, alongside our estimate of the change in the overall FTSE350 DB pension scheme deficit, as measured on a solvency basis. The aggregate solvency deficit as a proportion of market capitalisation is shown on the chart underneath.



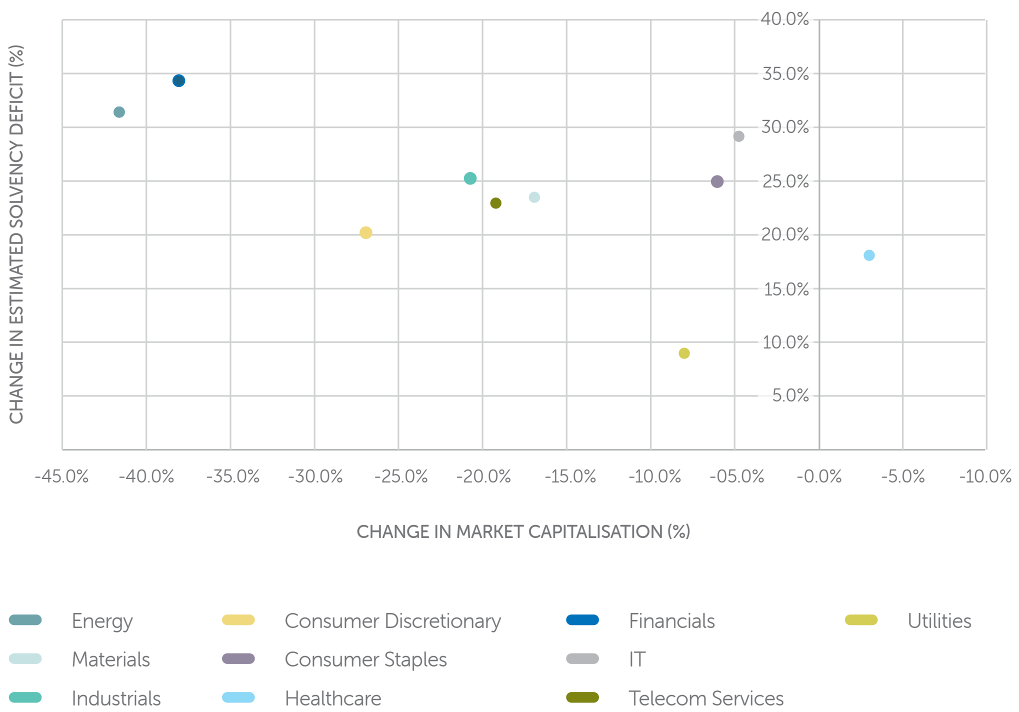


At the peak of the crisis, the FTSE350 solvency deficit exceeded 17% of the companies' total market capitalisation – double the proportion at the start of the year – before settling back to around 14% at the time of writing. While DB pension scheme funding is a long-term enterprise, and this shortfall will not need to be met any time soon, the regulatory direction of travel will be causing concern for some companies. TPR is not pushing for schemes to reach buyout funding levels, but the aim for schemes to fund up to a low dependency basis will require a material proportion of the current estimated £210bn FTSE350 solvency deficit to be covered over the coming years.

THE ESTIMATED FTSE350 SOLVENCY DEFICIT BY SECTOR AT 31 MAY 2020



Overall, we estimate that the solvency deficit for the FTSE350 companies increased by around £45bn over the five-month period to the end of May. A comparison of the sectoral change in solvency deficit against the change in market capitalisation from 31 December 2019 to 31 May 2020 is shown in the chart below.

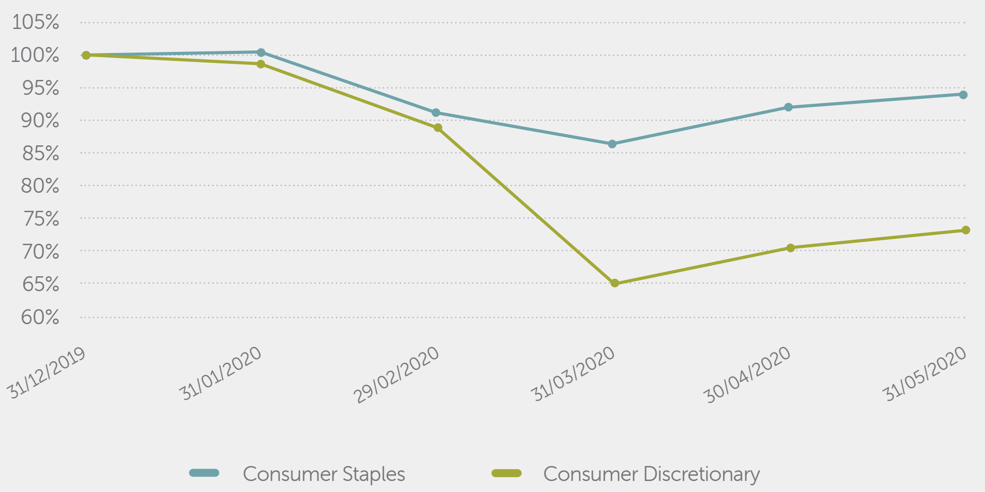


A tale of two sectors

The differing experience of the Consumer Discretionary and Consumer Staples industries is a good illustration of the sectoral differences underpinning the impact of the coronavirus pandemic.

The chart below shows the relative fall in market capitalisation for the Consumer Discretionary and Consumer Staples FTSE350 companies since the start of the year.

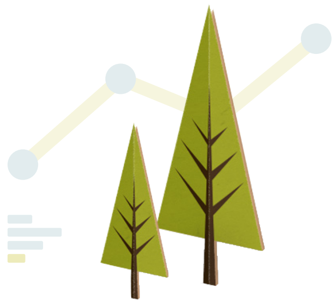
The Consumer Discretionary companies have been badly affected by the recent crisis (only the Financials and Energy companies have fared worse), as high street footfall declined steeply and consumers reined in non-critical spending. On the other side of the picture, Consumer Staples has been one of the few sectors to weather the coronavirus crisis relatively unharmed, with many companies needing to ramp up supply to cope with the increased demand from newly home-based consumers.



Both sectors are burdened by their DB pension scheme deficits, though the Consumer Discretionary companies face a potentially greater challenge. At the start of the year, the solvency deficit as a proportion of market capitalisation was around 6% for the Consumer Staples sector and 8% for the Consumer Discretionary sector, increasing to 8% and 13% respectively at the end of May.

As we start to emerge from this crisis, the contrasting performance of the two sectors and the strength of any recovery is likely to have a significant bearing on future DB pension scheme funding strategy. With TPR encouraging the pension industry to focus on the DB endgame, setting an appropriate journey plan that reflects the new post-crisis world will be a key objective for companies and trustees.

For the Consumer Discretionary industry, a key metric is likely to be the duration of each company's DB scheme. TPR's consultation has proposed that schemes should be fully funded on a low dependency basis once the scheme's duration reaches 12-14 years. The average duration of the schemes in this sector is around 18 years, so for most schemes this might suggest closing the gap to self-sufficiency over the next decade. Given that the solvency deficit for this sector currently stands at an estimated £19bn, careful thought will be needed to bridge the funding gap at a time of clear difficulty for the sector.



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The Consumer Staples companies could be facing a different challenge. While there will of course be competing demands for any additional cash generated during the last few months, some companies might see an opportunity to close the sector's estimated £26bn solvency deficit. Based on current contribution levels, around 30% of the Consumer Staples companies could buyout their DB scheme within 5 years. However, a trebling of contributions could result in around half of the Consumer Staples companies being in a position to buyout within 5 years.

Those responsible for endgame funding strategy should be carefully reviewing the impact of the recent crisis, and where necessary rethinking their journey plan to reflect the changed environment, incorporating the changes to covenant strength and funding position within the overall funding and investment strategy.

Journey plan evaluation

The recent crisis has had a considerable impact on DB scheme funding levels and the businesses of DB pension scheme sponsors. A company's industry sector will be a key factor in its recent performance and its prospects for recovery.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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