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Pension Perspectives: Q4 2011

- Pensions
- Quarterly

Higher deficits in year-end results

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- **Deficits up again** — UK and European pension deficits rose in Q4, resulting in significant deficit increases during 2011 overall. The FTSE 350 pension deficit was £59bn at year-end, with the funding ratio (assets/liabilities) falling from 93% to 89% during 2011. The Stoxx 50 funding ratio also fell, from 72% to 65%. Rising pension liabilities have been the driver of the increased deficits in the UK, while falling long run inflation assumptions provided some relief. In Europe, poor asset performance appears to have been the main reason for the increased shortfall.

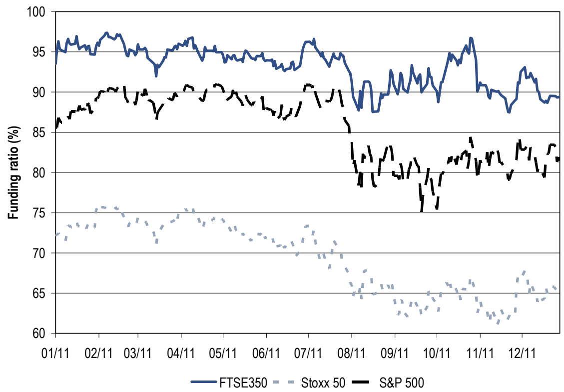
- **Company case study** — We have used ITV as a case study on how to estimate the movement in pension deficits during 2011. Our analysis suggests ITV's deficit has risen from £313m to £508m during 2011, driven by higher valuation of pension liabilities.

- **Regulatory risk** — Draft EU proposals to overhaul the regulation of pension schemes have the potential to increase the pension funding requirements for UK companies. The proposals have yet to be finalised but if enacted would result in higher funding liability valuation, and also require schemes to hold a capital surplus (as required of insurers).

- **UK's most exposed** — UK companies most exposed to increasing pension liabilities include IAG (pension liabilities 557% of market cap), Invensys (369%), C&W Worldwide (325%), Go-Ahead Group (311%), and BT Group (244%).

- **Europe's most exposed** — European companies most exposed to poor equity market performance in 2011 include Alcatel-Lucent (pension scheme equities 134% of market cap), Lufthansa (60%), Banco Espirito (41%), Peugeot (37%), and Baloise (34%).

Figure 1. FTSE 350, Stoxx 50 and S&P 500 pension funding ratio 2011



Source: Hewitt, CIRA. Note: Funding level defined as assets/liabilities. Absolute funding levels of Stoxx 50 lower due to prevalence of unfunded schemes.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

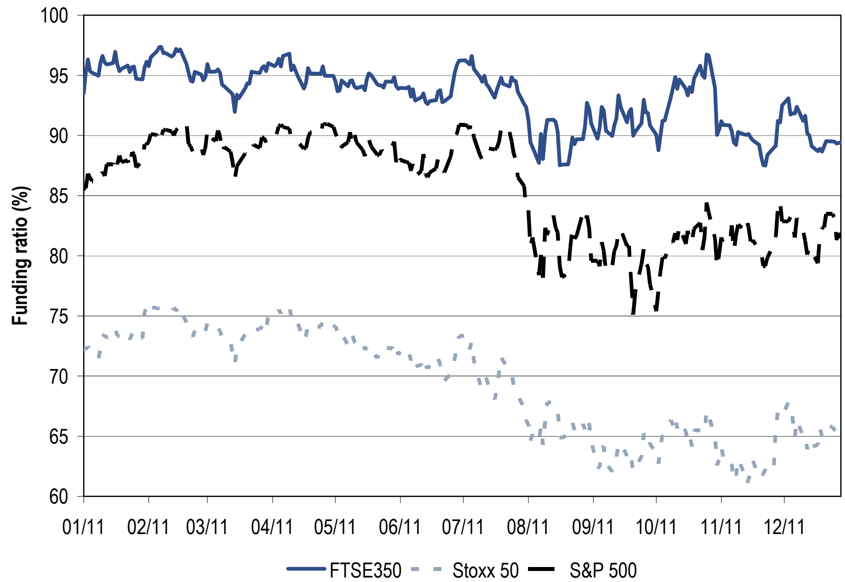
Higher deficits in year-end results

Pension funding ratios falling in UK, Europe and US

Despite the partial recovery in equity markets in Q4 2011, both the FTSE 350 and Stoxx 50 pension deficits ended the year significantly higher than they started it, according to actuarial firm Hewitt. Figure 2 shows the pension funding ratio[1] of the FTSE 350 and Stoxx 50 schemes, both of which deteriorated significantly. The FTSE 350 funding ratio was 93% at year-end 2010 (meaning that companies hold pension assets worth 93% of pension liabilities), but fell to 89% by year-end 2011. This represented a deficit increase of £27bn to £59bn. Similarly, the Stoxx 50 funding ratio fell from 72% to 65%, taking the collective deficit of the Stoxx 50 companies to €128bn at end 2011. The lower absolute funding level of Stoxx 50 company schemes reflects the prevalence of unfunded schemes in some European countries while schemes must be funded in the UK.

Stoxx 50 lower absolute funding ratio reflects prevalence of unfunded schemes in Europe

Figure 2. FTSE 350, Stoxx 50 and S&P 500 pension funding ratio 2011



Source: Hewitt, CIRA. Note: Funding level defined as assets/liabilities. Absolute funding levels of Stoxx 50 lower due to prevalence of unfunded schemes.

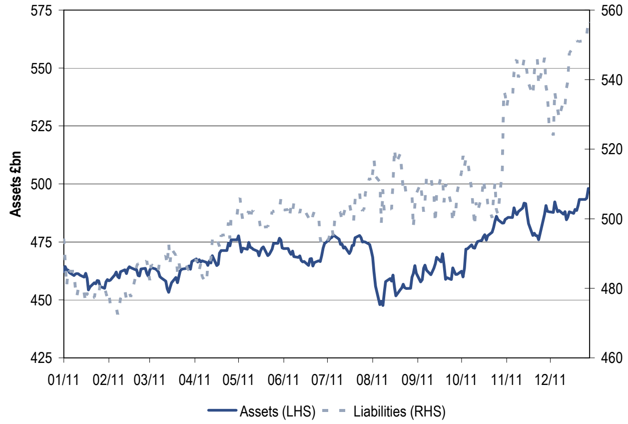
Decoupling of UK and European pension assets and liabilities in 2011

Interestingly, 2011 saw a decoupling of the movement on UK and European pension assets and liabilities, as can be seen in comparing Figure 3 and Figure 4. Figure 3 shows the movement on the pension assets and liabilities of the FTSE 350, and highlights that the increased deficit in 2011 has been driven primarily by an increase in pension liabilities of 13% to £556m, 10% of which was recorded in Q4. FTSE 350 pension assets rose by 8% to £497m, all of which is attributable to Q4, but the asset side recovery has been overshadowed by an apparent spike in liabilities.

On the other hand, the main driver of the increased Stoxx 50 pension deficit appears to have been poor asset performance. Stoxx 50 pension assets fell by 6% in 2011, from €257bn to €241bn, in spite of a 2% rise during Q4. Pension liabilities increased only 3% to €369bn over the year, and did not increase materially during Q4.

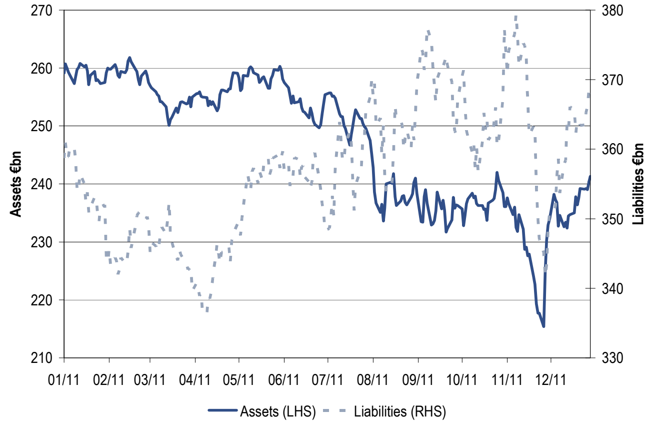
[1] Funding ratio defined as assets/liabilities.

Figure 3. FTSE 350 pension assets and liabilities 2011



Source: Hewitt, CIRA

Figure 4. Stoxx 50 pension assets and liabilities 2011



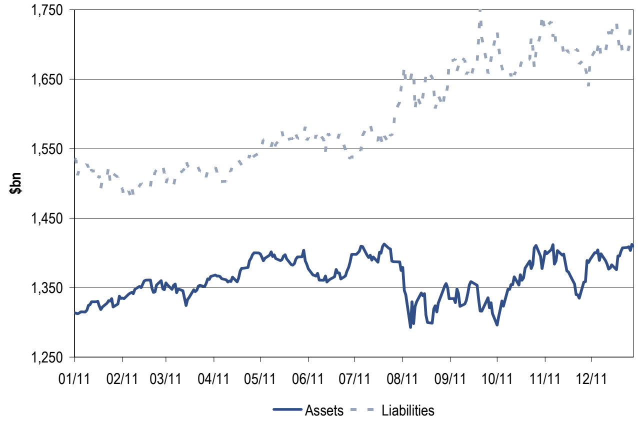
Source: Hewitt, CIRA

Gilt outperformance in 2011 likely to have aided UK pension asset

We see two main reasons for the differing performance of pension assets and liabilities in the UK and Europe in 2011, both related to the Euro area sovereign debt crisis. Firstly the outperformance of gilts compared to Euro area sovereigns during 2011, explaining part of the difference in asset returns. Secondly, the substantial fall in AA sterling corporate bond yields, particularly during Q4, which has increased pension liabilities. We discuss each of these factors in more detail in sections below on discount rates (page 4) and asset returns (page 7).

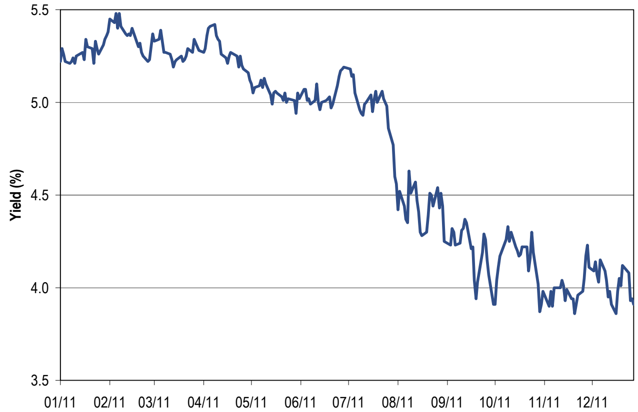
US company pension deficits have also increased in 2011. Figure 5 shows the movement on the S&P 500 pension assets and liabilities. Similarly to the UK, the S&P 500 assets performed reasonably, returning 8% overall to reach $1,410m. However, the increase in pension liabilities appears to have outstripped the assets, rising 12% to $1,730bn, and this resulted in an $82bn deterioration in the deficit, a reduction of 3% in the S&P funding ratio to 81% (as shown in Figure 2).

Figure 5. S&P 500 pension assets and liabilities 2011



Source: Hewitt, CIRA

Figure 6. Moody's long term AA corporate bond index yield 2011



Source: Bloomberg, CIRA

As in UK, falling bond yields have pushed up US pension liabilities

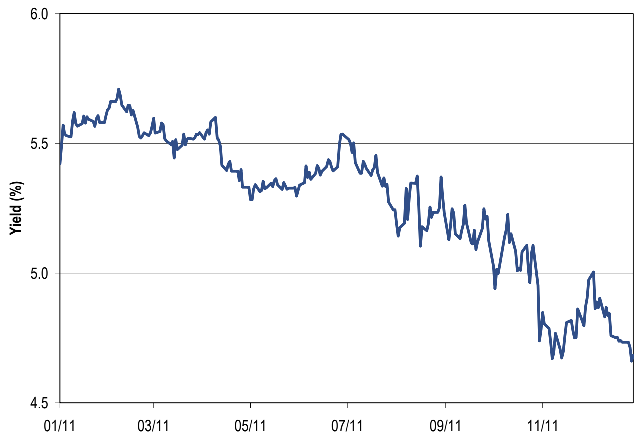
As we discussed in the Q3 edition of *Pension Perspectives* (6 October 2011), the falling yields on US treasuries and corporate debt are a significant cause of the rising deficit. Figure 6 shows the yield on the Moody's long term AA corporate bond index. The yield on this index fell from 5.2% at end 2010 to 3.91% at end 2011, or 124 basis points. However, unlike the UK deficit, the US position does not appear to have deteriorated in Q4, with Hewitt in fact estimating a partial recovery since Q3.

Discount rates

UK discount rates fell 44bps in Q4

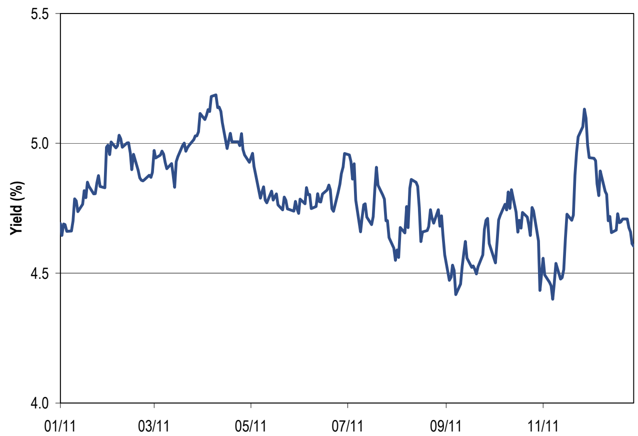
The movement in corporate bond yields is the most significant contributory factor to the volatility in pension liability valuation under IFRS. AA corporate bond yields are used as the discount rate when calculating the present value of pension obligations. We use iBoxx indices as a suitable benchmark for these discount rates, as shown in Figure 7 and Figure 8. During 2011, as shown in Figure 7, the yield on the relevant iBoxx sterling index fell by 74bps to 4.68%. Most notably, of the total fall 44bps was in Q4. This implies potential for significant deficit deterioration among UK schemes reporting full year results as of 31 December 2011; we calculate (based on last available annual reports) that every 10bps fall in the discount rate increases the pension liability by 1.6% on average.

Figure 7. iBoxx £ 15+ AA corporate bond yields 2011



Source: DataStream, CIRA

Figure 8. iBoxx € 10+ AA corporate bond yields 2011



Source: DataStream, CIRA

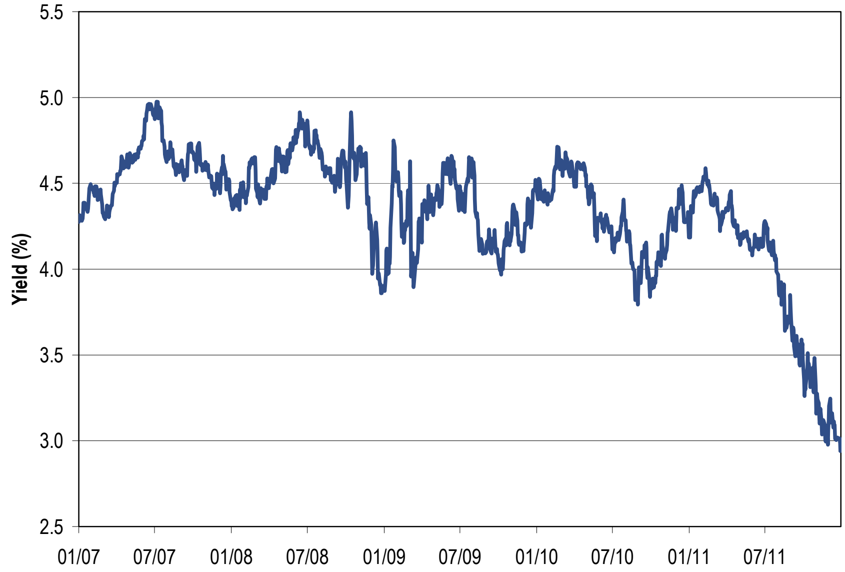
Europe discount rates largely unchanged during 2011

On the other hand, Figure 8 shows that the yield on the iBoxx Euro corporate index has not changed significantly in Q4 or in 2011 overall, despite significant volatility. The yield at end 2011 was 4.60%, which compared to 4.61% at the end of Q3 and 4.68% at end 2010. However, in our experience Eurozone companies' pension discount rates track this index less closely than the UK companies track the sterling iBoxx index.

The Q3 *Pension Perspectives* included analysis of the cash funding position of the UK pension funds of the most exposed stocks. Pension deficits are valued differently for the purposes of determining the funding shortfall and required cash contributions, compared to the reported IAS 19 figures. A key differential is the basis of the discount rate applied, as funding deficits do not require reference to corporate bond yields as required under IFRS. Instead, scheme trustees are responsible for determining an appropriate rate (while overseen by the Pensions Regulator), and commonly consider the yield on long dated gilts as the starting point for rate selection. The significant fall in gilt yields, as shown in Figure 9, is therefore noteworthy.

2011 fall in gilt yields raises UK scheme funding risk

Figure 9. iBoxx 15+ gilt yield 2007 - 2011



Source: DataStream, CIRA

The iBoxx gilt index yield ended 2011 at 2.97%, almost 100bps less than the end 2008 level of 3.9%. Upcoming triennial valuations may therefore be calculated using a lower discount rate than in previous years, which could increase liabilities significantly. Figure 10 shows upcoming triennial valuations for pension exposed UK stocks.

Figure 10. Upcoming triennial reviews

Company	RIC	Next review date
Aviva	AV.L	31-Mar-12
BT Group	BT.L	31-Dec-11
Carillion	CLLN.L	Main schemes: 31-Dec-10 or 31-Dec-11
FirstGroup	FGP.L	Next valuations over 2012 and 2013
IAG	ICAG.L	31-Mar-12

Source: Company reports, CIRA

For example, BT Group's next triennial review will be as of 31 December 2011, and we expect BT to advise the market on the results of this review as part of its full year results, due in May, or possibly before. CIRA analysts forecast a likely range for the triennial review deficit of between £3.4bn and £6.2bn (gross of tax)[2]. Despite the likely fall in discount rate, this compares favourably with the previous triennial review deficit of £9.0bn, because BT has contributed c. £1.6bn in the intervening period and benefitted from the switch from RPI to CPI inflation which the company estimated reduced liabilities by £2.9bn. Citi's Telecoms team expects that a deficit reduction could result in a shorter deficit recovery period.

PPF deficit measure reaches new record high

The risk of higher funding requirements for some companies was further highlighted by a recent data release by the Pension Protection Fund (PPF)[3]. The PPF 7800[4] index of UK company pension deficits reached a new record high of £255bn (the index began in 2003), representing a funding ratio of 80%. It should be noted however that neither the absolute deficit nor the funding ratio are directly comparable with the FTSE 350 figures, as the PPF deficit is calculated on a different basis and the PPF index includes data on all UK defined benefit schemes, not just those of large listed companies.

[2] See *The Phone Book*, 6 January 2012, page 47.

[3] As discussed by CIRA Economists in *UK - Corporate Pension Deficits Reach New Record High*, 10 January 2012.

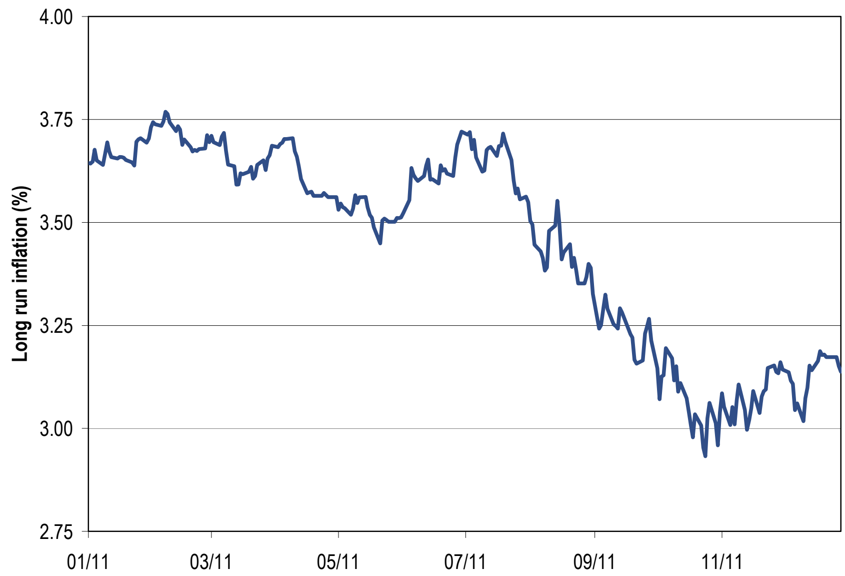
[4] The PPF is a scheme sponsored protection scheme providing compensation for employees of insolvent scheme sponsors.

Inflation

In the UK, the second key driver of pension liability valuation aside from discount rates is the assumption for long run inflation. UK law requires scheme member pensions to be inflation linked when the employee has left the company (both pre and post retirement). Companies typically estimate long run inflation using market implied measures (our calculation uses RPI linked gilts). The reduction in this inflation rate during Q3 2011 (from 3.71% at 30 June to 3.21% at 30 September) partially offset the increase in deficits resulting from the market sell-off in August. As shown in Figure 11, our long run RPI proxy was 3.14% at end 2011, a minor further reduction of 8bps from the Q3 position.

Falling UK inflation expectations provided some relief to deficits in H2

Figure 11. UK long run (15+ years) implied RPI inflation 2011



Source: DataStream, CIRA

Government study suggests spread between RPI and CPI will be wider in future…

Since a 2010 change in legislation, many UK companies now provide pension indexation linked to CPI inflation rather than RPI inflation (which is usually higher). Estimating log run CPI inflation is less straightforward than with RPI inflation as no market based measures are currently available as reference. We reviewed the spread between RPI and CPI assumed by companies in 2010 annual reports[5], noting a range between 50bps and 100bps, and an average of 71bps. The average is broadly in line with the historical average differential between RPI and CPI since 1989 of 70bps.

…which could reduce estimated pension liabilities further

However, a recent study by the Office for Budget Responsibility (OBR) calculates a plausible range for this spread in future of 130bps – 150bps[6], and pension consultants JLT expect the average spread to increase to 100bps following publication of the OBR paper[7]. This implies scope for potential further relief from applying the CPI measure. Our calculation, based on most recent annual reports, is that a 10bps inflation decrease results, on average, in a 1.2% fall in pension liabilities.

[5] See *Pension Perspectives*: Q2 2011, published 19 July 2011

[6] Working Paper No. 2: The long-run difference between RPI and CPI inflation, OBR, November 2011.

[7] See www.jltpcs.com, January 2012.

In Figure 12 we highlight those companies that have been able to move onto CPI indexation for at least some of their pension schemes and that therefore disclosed CPI assumptions. Estimating long run CPI remains judgmental, so it is not clear whether companies will widen their estimates of the spread between RPI and CPI.

UK companies CPI inflation estimates varied in 2010/2011

Figure 12. UK company RPI and CPI inflation assumptions, 2010/11 annual reports

Company	RIC	Last Year End	UK RPI Inflation	UK CPI Inflation	RPI / CPI Spread
Serco	SRP.L	12/10	3.10%	2.60%	0.50%
Balfour Beatty	BALF.L	12/10	3.40%	2.90%	0.50%
ITV	ITV.L	12/10	3.40%	2.90%	0.50%
Lloyds Banking Group	LLOY.L	12/10	3.40%	2.90%	0.50%
IAG	ICAG.L	12/10	3.55%	2.95%	0.60%
Standard Life	SL.L	12/10	3.65%	3.05%	0.60%
BAE Systems	BAES.L	12/10	3.40%	2.80%	0.60%
Carillion	CLLN.L	12/10	3.40%	2.80%	0.60%
National Express	NEX.L	12/10	3.50%	2.90%	0.60%
Howden Joinery Group	HWDN.L	12/10	3.50%	2.80%	0.70%
Rio Tinto	RIO.L	12/10	3.40%	2.70%	0.70%
Pearson	PSON.L	12/10	3.50%	2.80%	0.70%
C&W Worldwide	CWP.L	03/11	3.40%	2.70%	0.70%
Marks and Spencer	MKS.L	04/11	3.40%	2.70%	0.70%
Centrica	CNA.L	12/10	3.70%	3.00%	0.70%
Rentokil	RTO.L	12/10	3.70%	3.00%	0.70%
Invensys	ISYS.L	03/11	3.70%	2.95%	0.75%
FirstGroup	FGP.L	03/11	3.20%	2.40%	0.80%
Melrose	NYN.L	12/10	3.45%	2.60%	0.85%
Kier Group	KIE.L	06/11	3.60%	2.70%	0.90%
Brown N	BWNG.L	02/11	3.80%	2.80%	1.00%
BT Group	BT.L	03/11	3.40%	2.40%	1.00%
Stagecoach Group	SGC.L	04/11	3.30%	2.30%	1.00%
Tate & Lyle	TATE.L	03/11	3.60%	2.60%	1.00%

Source: Company annual reports, CIRA

Outside the UK, indexation rules are less straightforward and not all schemes may guarantee inflation increases. Disclosure of Eurozone inflation assumptions are relatively rare and tend to be within a very tight range between 1.8% and 2.0% (consistent over the last three years).

Asset Returns

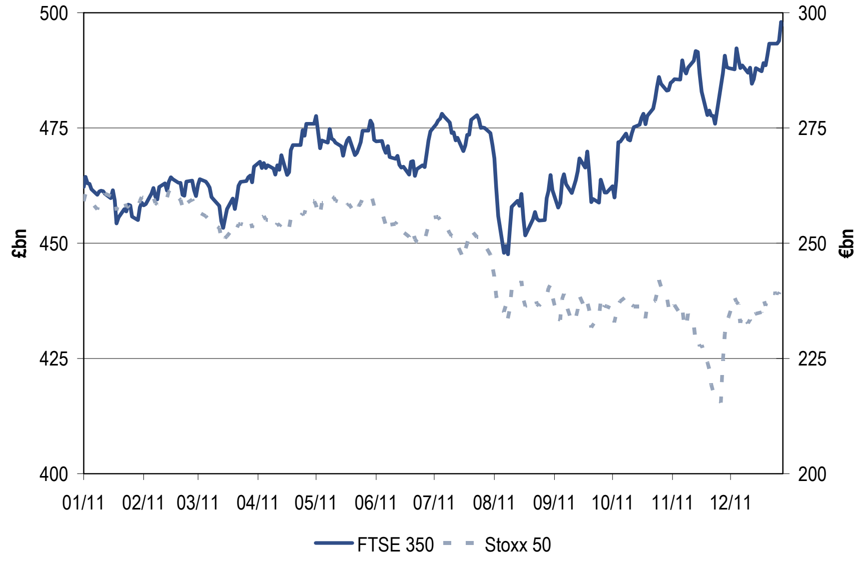
Higher equity allocation for UK companies on average

Companies are likely to report a relatively wide range of pension fund asset performance figures. The pension deficits of schemes with equity focused allocations are likely to have suffered relative to those that have high fixed income allocations, particularly in the UK. In the UK the average allocation disclosed in 2010 annual reports was 43% to equities and 41% to bonds. In Europe the average equity allocation is lower; 32% in equities and 52% in bonds.

There also appears to be a differential between the asset performance of UK company schemes and those in the Eurozone; this is highlighted by the Hewitt figures for the FTSE 350 and Stoxx 50 shown in Figure 13.

Outperformance of UK pension assets relative to European pension assets

Figure 13. FTSE 350 and Stoxx 50 pension assets 2011



Source: Hewitt, CIRA

Hewitt estimate FTSE 350 pension fund assets increased 8% in 2011, compared to a 6% fall in Stoxx 50 assets. Of the 14% differential, 6% of this is attributed to Q4, with all 8% of the FTSE 350 asset increase attributed to the final quarter, while the Stoxx 50 assets rose only 2% over the same period. Figure 14 and Figure 15 below show the total return on relevant asset indices for UK and European pension schemes in 2011.

Figure 14. Selected UK asset class total returns 2011

Asset class	Index	2011 total return
UK equities	FTSE 350	-3%
Global equities	MSCI AC World £	-6%
Corporate bonds	iBoxx £ corporate AA all maturities	9%
Government bonds	iBoxx £ gilts all maturities	17%

Source: DataStream, CIRA

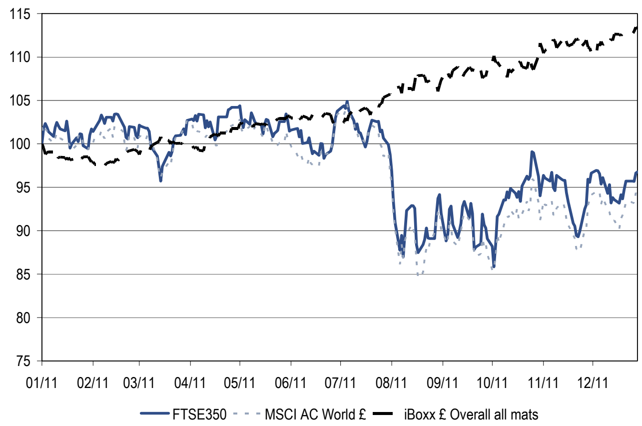
Figure 15. Selected Europe asset class total returns 2011

Asset class	Index	2011 total return
Europe ex UK equities	MSCI Europe ex UK	-12%
Global equities	MSCI AC World €	-4%
Corporate bonds	iBoxx € corporate AA all maturities	4%
Government bonds	iBoxx € sovereign all maturities	3%

Source: DataStream, CIRA

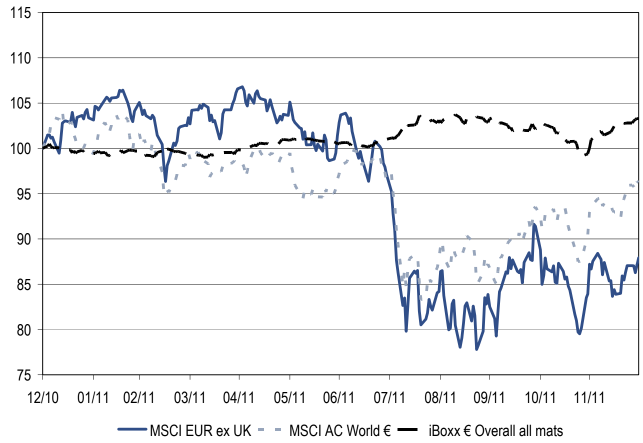
Figure 16 and Figure 17 provide a graphical summary of the differences in UK and European returns shown above. The charts show the clear differential between both equity and fixed income performance in the UK and Europe, with the FTSE 350 outperforming the MSCI AC World index in 2011 while the Stoxx 50 underperformed global equities by 8%.

Figure 16. Re-indexed total return on UK asset indices 2011



Source: DataStream, CIRA

Figure 17. Re-indexed total return on European asset indices 2011



Source: DataStream, CIRA

Overall performance of Euro fixed income may cloud performance differentials among EMU sovereigns

While a broad generalisation, reviewing index performance does go a way towards explaining the significant variation between Hewitt's expectation of asset performance for UK and European pension schemes. The exceptional performance of sterling bonds (particularly gilts) is shown in Figure 16. The total returns of 4% and 3% from the equivalent Euro corporate and government indices may cloud significant performance differentials from individual assets, particularly between Eurozone sovereigns.

On equities, the total return of the FTSE 350 in 2011 was a loss of 3%, compared to a loss of 12% from the MSCI Europe ex UK index. Allocating assets to global rather than local equities would have been of benefit to European pension schemes in 2011, as the MSCI AC World index returned a loss of 6% in sterling and 4% in euro.

Some pension schemes have significant holdings of other assets outside of the two most common asset classes. The range of assets held, from hedge funds and private equity to property and infrastructure, means that assessing likely overall performance is difficult, but we think it is worthwhile for investors to review company asset allocation disclosures in order to get an idea of the likely performance of pension assets in the period. Given the fall in yields during the year, it is likely that schemes with interest rate linked investments (asset liability matching) are likely to have performed well.

ITV deficit roll-forward case study

Company level deficit analysis has many moving parts

The above analysis is useful in assessing the likely movement in pension deficits at the index level. However, when looking at specific companies it is possible to assess the likely movement in more detail, as shown in Figure 18 below. There are a number of moving parts to the movement in pension deficits under IFRS, and we use the example of ITV to illustrate an approach to estimating this for 2011.

Estimated increase in deficit driven by increased pension liabilities

Figure 18. Estimated movement on ITV IFRS pension deficit 2011

	Pension assets	Pension liabilities	Pension deficit
Opening at 1 January 2011	**2,433**	**2,746**	**313**
Current service cost		5	5
Interest cost / unwind of discount		148	148
Employee contributions	2	2	0
Employer contributions	62		-62
Benefits paid	-130	-130	0
Return on assets	126		-126
Longevity swap		50	50
Actuarial gains/losses:			
- Impact of changing discount rate		317	317
- Impact of changing inflation		-137	-137
- Impact of changing longevity estimate		0	0
Closing at 31 December 2011	**2,493**	**3,001**	**508**

Source: Company reports, CIRA estimates

Figure 18 shows our calculation of the deficit for 2011 year-end of £508m, up from £313m at end 2010, driven primarily by a lower discount rate which pushes up the value of the liabilities. The key inputs are as follows:

- The current service cost, employee contributions and benefits paid are assumed unchanged from reported 2010 figures. Current service cost and employee contributions are not material, and benefits paid reduce both assets and liabilities and therefore do not impact the pension deficit. ITV's current service cost is relatively low for a scheme remaining open to accrual, as less than 3% of scheme members remain employed by the company.

- Liabilities increase due to unwind of discount; this represents the fact that a year has passed and the average liability is therefore a year closer, increasing the present value of the pension obligation. We have estimated this by applying the discount rate disclosed by ITV in the 2010 annual report to the opening pension liabilities.

- The employer contributions (cash paid into the pension fund) are based on company disclosures and include both normal and deficit funding contributions.

- The return on assets is the opening asset position multiplied by our estimate of total asset returns based on appropriate benchmarks, as calculated in Figure 19.

- ITV entered into a longevity swap to hedge the risk of some employees living longer than expected in August 2011[8]. ITV noted that pension liabilities would increase by £50m because of this hedge (a one-off increase).

- Actuarial gains/losses are calculated based on marking discount rate and inflation assumptions to market, as well as updating longevity assumptions. We have adjusted the pension liabilities to reflect the move in our discount rate and inflation proxies. ITV notes that a 50bps decrease in the discount rate increases liabilities by 8%, and an equivalent decrease in inflation decreases liabilities by 5%. Our calculation suggests that the significant fall in the discount rate will increase the liability, albeit partially offset by the fall in inflation. We have not assumed any change to the RPI/CPI spread of 50bps disclosed by ITV in 2010. If ITV determine that a wider spread is appropriate (as discussed on page 6), this could reduce pension liabilities significantly.

[8] As discussed in the Q3 *Pension Perspectives*, published 6 October 2011.

- We have not assumed a change in longevity assumptions, in part due to the longevity hedge now in place covering some scheme members. ITV notes that a one year increase in average life expectancy adds 2% to pension liabilities.

As noted above, Figure 19 shows the composition of our expected asset return for the year based on company asset allocation disclosures and appropriate benchmarks. Asset returns are difficult to estimate, as pension schemes may adjust asset allocation during accounting periods, and the indices selected are unlikely to accurately reflect the performance of the actual scheme assets.

High level analysis of expected asset returns suggests 2011 gain of 5%

Figure 19. Calculation of ITV expected total return on pension assets 2011

Asset class	Index proxy	Asset allocation 2011E	Total return 2011E
UK equities	FTSE 350	8%	-3.2%
International equities	MSCI AC World ex UK £	29%	-6.6%
Gilts	iBoxx £ gilts all maturities	31%	16.6%
Corporate and other bonds	iBoxx £ AA corporate all maturities	22%	9.1%
Other	Assumed 2%	10%	2.0%
Total		**100%**	**5.2%**

Source: Company reports, DataStream, CIRA estimates. Note: asset allocation estimated based on actual 2010 asset allocation and planned 2011 asset allocation disclosed in ITV's 2010 annual report. For simplicity we have assumed no FX hedging although ITV hedges 60% of overseas investments against FX movements.

Irrespective of any deficit increases, ITV has agreed cash pension contributions through 2014

IFRS pension deficits are volatile, but the extent to which a higher deficit translates into higher cash funding costs is determined by triennial valuation, which is calculated on a different basis to IFRS. In the case of ITV, the company has agreed the contributions for the main section of the scheme through to 2014 and we do not therefore see significant cash flow risk from pensions in the near term.

When reviewing company disclosures to make an assessment as we have done with ITV above, there are a number of other items which may affect the deficit, and are therefore worthy of note:

- A number of pension schemes are closing to further accrual and most final salary schemes are no longer open to new members (Shell became the last FTSE 100 to close its final salary scheme to new members recently). The closure to new members or to future accrual by existing members will reduce the pension expense (current service cost will be reduced in either case and is unlikely to be significant once a scheme is closed to accrual)

- Asset-backed pension funding structures have become increasingly common in recent years. Despite revisions to UK tax law in this area (see page 12), companies remain likely to use such transfers as a means of reducing cash funding costs and the IFRS deficit in some cases

- Companies' discount rate and inflation estimates are generally in line with market benchmarks and therefore comparable. However, this is not always the case and it is worthwhile to check these assumptions, which can have a significant effect on the value of the pension deficit. A recent example is that of Debenhams. In its 28 August 2010 annual report, Debenhams reported a discount rate of 5.00%, 14bps above the relevant iBoxx index at that date (a normal variation). However, in the 3 September 2011 annual report the discount rate reported was 5.75%, 52bps above iBoxx on 2 September. We calculate the discount rate differential to be worth approximately 8% of pension liabilities. Debenhams reported a pension surplus of £3.9m, against a deficit of £80.7m, at 28 August 2010

Other Pension Developments in Q4

EU proposals could increase UK pension funding needs

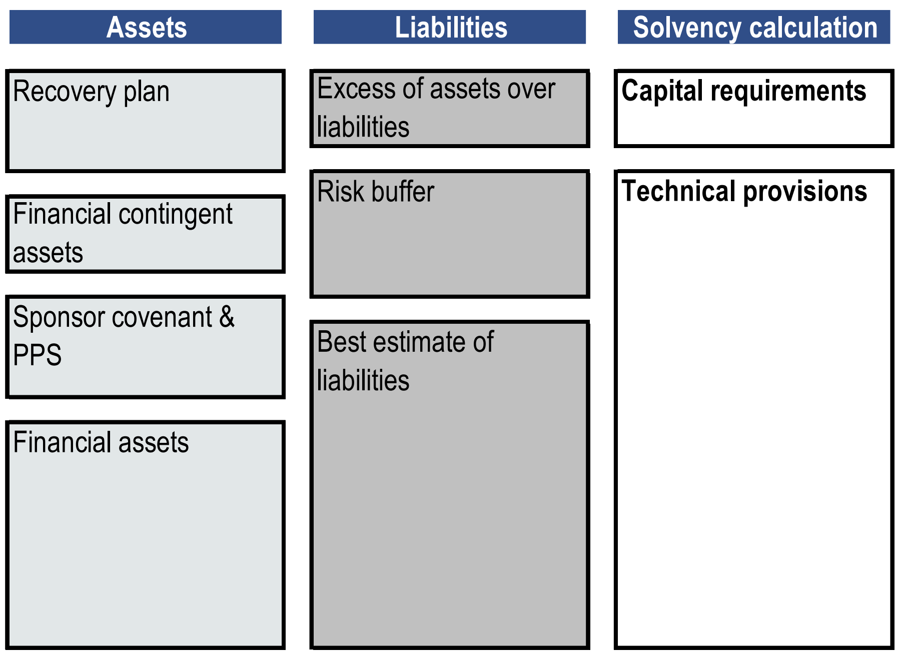
EIOPA proposals on pension regulation may be significant risk to UK pension schemes

The European Insurance and Pensions Authority (EIOPA) has published its draft response to the call for advice from the European Commission on the Institutions for Occupational Retirement (IORP) directive[9]. The call for advice was wide-ranging, but among the most significant proposals included in the draft response are proposed changes to the calculation of pension liabilities and deficits for regulatory purposes, which have similarities to the Solvency II regime due to take effect for EU insurers in 2013.

Present EU regulation allows for two types of pension schemes. Where the pension scheme itself provides the pension guarantees, as common in the Netherlands, the schemes must hold excess capital. There are no such schemes in the UK. The other type of scheme is sponsor backed which is the model used by UK companies. The EIOPA was asked to draft regulation aimed at ensuring the same level of pensioner security irrespective of scheme type, and the response considers two policy options. One is essentially to continue the status quo, and the other is to apply a holistic balance sheet approach, as summarised in Figure 20.

Holistic balance sheet approach similar to Solvency II regulation for insurers

Figure 20. Conceptual presentation of proposed holistic balance sheet



Source: EIOPA, CIRA

Among EU countries, the holistic balance sheet approach is most closely aligned with current pension regulation in the Netherlands. Defined benefit pensions are most common in the Netherlands and the UK, and UK companies therefore appear most at risk from these proposals.

[9] See eiopa.europa.eu/consultations, October 2011.

Liability valuation would be significantly higher under EIOPA proposals

The crux of the holistic balance sheet approach is to incorporate not just financial assets held against pension liabilities, but also explicitly assess the quantifiable value of the employer covenant, contingent assets and possible recourse to a pension protection scheme (PPS). The key proposals under the holistic balance sheet approach are:

- Assets would be required to exceed liabilities under the proposed regulation. In the Netherlands, regulatory requirements are for minimum coverage of 105% of liabilities, and in addition a risk buffer is required bringing the average target funding ratio to 125%. There are currently no equivalent rules in the UK. Under the proposals, including the explicit value of contingent assets and the sponsor covenant (which are generally only implicitly considered under UK regulation), there would be a requirement for pension schemes to hold surplus capital.

- The best estimate of pension liabilities would be valued using a risk-free rate, which would result in significantly higher liability valuations. This is similar to the current basis of valuation in the Netherlands. But in the UK schemes are permitted to determine an appropriate discount rate, which is often calculated using the risk-free rate plus a risk margin. Therefore liability valuation (best estimate plus risk buffer) would be significantly higher for UK schemes, with some commentators suggesting the valuations would be similar to buy-out levels, ie the price at which a third party would be willing to take ownership of the pension liabilities.

Proposals very controversial in the UK

The proposals have been criticised by many commentators in the UK. The main arguments given against them are:

- Less generous pensions and lower pensioner security. The proposals, by requiring significantly higher capital to be held by the pension scheme, could encourage employers to reduce the pension benefits given to employees, and a higher level of required contributions increases the risk of financial difficulty in the sponsor company.

- As defined benefit pension schemes are offered only to a company's employees, rather than to the public at large, it is not necessary to require a capital buffer be held by the scheme, as legal recourse to the sponsor company is available to the extent necessary to pay pensions.

- The explicit valuation of contingent assets, and in particular the sponsor covenant (excluding any agreed funding plan) and recourse to a PPS, could be problematic in practice. The valuation would be purely theoretical and subject to significant judgement.

The draft proposals were open for public comment until 2 January 2012. It is expected that EIOPA will publish a summary of the feedback received in the coming months, before presenting its recommendations to the European Commission.

Revised tax rules for asset-backed pension contributions

UK tax law on asset-backed pension funding clarified

The UK government enacted a change to the tax treatment of asset-backed pension funding arrangements which may cost companies £450m per year, according to HMRC[10]. A number of UK companies have used non-financial assets such as property as part of structured funding arrangements which reduce pension deficits and/or funding requirements in recent years. Most recently, TUI Travel used the

[10] Source: HM Treasury Autumn Statement, November 2011

Thomson and First Choice brands in a funding deal with its pension scheme resulting in cash savings of £38m p.a.[11].

Structures enable use of illiquid assets to reduce cash funding burden

Companies generally transfer contingent ownership of an asset to a partnership structure, to which the pension scheme is granted partial or total ownership rights. At the same time a series of payments are agreed between the company and the pension scheme (royalties for the use of the transferred asset), with a potentially large (based on the remaining deficit at that point) final payment after a number of years through which the company repurchases the assets transferred. The TUI Travel deal is an example of such a transfer, with annual payments of around £16.5m for 15 years, followed by a contribution of up £275m after these 15 years in order to eliminate any remaining deficit and to repurchase the assets contributed.

Companies have been able to claim up-front tax relief both on the value of the asset transferred, and further relief on the element of cash contributions deemed an interest payment by the company. However, the government believes that excess tax relief is obtained from these transfers in some cases if the final payment is not made or if the final payment is less than the tax relief obtained on transfer.

No significant short-term impact for qualifying transfers

The proposals define two types of transfers, each with different rules for transfers made on or after 29 November 2011 (when the revised rules were enacted). Only transfers that qualify as structured finance arrangements (SFAs)[12] will continue to receive up-front tax relief on the value of the asset transferred. Existing non-SFA structures will no longer qualify for relief on the contributions paid, and all structures will be subject to a true-up of the level of tax relief obtained at the conclusion of the arrangement.

The impact of the revised rules will be assessed by each company. We expect that companies will continue to make use of these structures to manage pension funding as obtaining up-front tax relief remains available, offering a near-term cash flow benefit.

UK pensions minister discusses abolition of indexation

UK pensions minister suggests abolition of indexation could prevent cessation of defined benefit pensions in private sector

The UK pensions minister, Steve Webb, has indicated that the UK government could abolish the minimum indexation rules within UK law, which protect the pension benefits accrued by deferred members and pensioners (those no longer employed by the sponsoring company)[13]. Mr Webb suggested the measure could help prevent closure of defined benefit pension schemes in the private sector.

Pension benefits are required to be indexed in the UK, meaning that former employees maintain the spending power of the benefits accrued during their employment. In 2010 the minimum indexation measure was changed from RPI to CPI inflation, which has been on average 70bps lower since 1989. This resulted in a significant reduction in pension liabilities of 4% on average for some UK companies. The elimination of minimum indexation would likely offer significant further relief to those UK company pension schemes whose rules require only the legal minimum indexation (some schemes' rules require a certain measure or level of inflation above the statutory minimum).

However, it is unclear at this stage whether any official proposals will be put forward. The Department of Work and Pensions has noted that there are currently

[11] We discussed this asset contribution arrangement in more detail in the Q2 *Pension Perspectives*, published 19 July 2011.

[12] To qualify as an SFA the transfer must result in a financial liability in the sponsoring company.

[13] See Financial Times, 13 January 2012.

no firm plans to end indexation for pension schemes. Furthermore, in our view, removing minimum indexation is unlikely to meet Mr Webb's stated objective of re-introducing any form of risk-sharing in pension schemes, at least among large public companies. The experience of recent years suggests that both company managements and shareholders would be very reluctant to resume offering employees any future pension guarantee, particularly now that defined contribution schemes appear to have become the normal expectation of employees not already a member of a defined benefit scheme.

Company exposure

We are happy to provide clients with data on all pension-exposed FTSE 350 and MSCI Europe ex UK companies. We can also provide screens of pension-exposed companies in the US and Japan. To request data email neil.dawson@citi.com

We include three screens to assess a company's exposure to pension risk, current underfunding, and exposure to equity markets through the pension scheme. We emphasise that this screening is a crude tool for identifying pension risk. It does not identify the extent to which pension risks have been mitigated, e.g. through asset-liability matching techniques.

Companies may have special circumstances that affect the nature and risks of the pension liabilities, such as specific regulatory treatment of pensions or employee risk-sharing arrangements. Nevertheless companies appearing on these screens have potential material exposure to pension risk that we believe warrants further investigation.

While updating our screens, we noted that a number of companies that previously featured had fallen out of the relevant indices. For the FTSE 350, we note this to be the case for both Premier Foods and Thomas Cook. Air France-KLM, BCP, Dexia, PostNL, and TUI AG were all removed from the MSCI Europe ex UK index.

Screen 1: Pension Liabilities

Our primary screening is by calculating pension liabilities as a percentage of market capitalisation. We use the most recent annual report data for pensions and compare this to current market cap. Varying company year-ends reduce comparability, and many companies most recent annual reports are as of December 2010, and are therefore relatively out of date. Companies with the largest pension liabilities are generally most at risk of large changes in pension deficits due to changes in discount rate, inflation, mortality assumptions and asset returns[14].

[14] Assuming the pension liabilities are backed by assets.

FTSE 350 companies most exposed to pension risk: IAG, Invensys, C&W Worldwide, Go-Ahead Group, and BT

Figure 21. FTSE 350 Pension Liabilities as a percentage of market cap

Company	RIC	Curr	Year End	Price (local)	Mkt cap	Liabilities	Liabilities as % Mkt Cap
IAG[1]	ICAG.L	GBP	12/10	1.56	2,898	16,142	557%
Invensys	ISYS.L	GBP	03/11	1.82	1,476	5,452	369%
C&W Worldwide	CWP.L	GBP	03/11	0.17	453	1,470	325%
Go-Ahead Group[2]	GOG.L	GBP	07/11	13.16	566	1,762	311%
BT Group	BT.L	GBP	03/11	2.06	16,003	39,052	244%
FirstGroup[2]	FGP.L	GBP	03/11	3.09	1,487	3,615	243%
Dixons Retail	DXNS.L	GBP	04/11	0.11	395	950	240%
BAE Systems	BAES.L	GBP	12/10	3.05	9,884	21,158	214%
WS Atkins	ATKW.L	GBP	03/11	6.90	691	1,282	186%
Dairy Crest	DCG.L	GBP	03/11	3.20	427	779	183%
Kier Group	KIE.L	GBP	06/11	14.01	543	869	160%
Interserve	IRV.L	GBP	12/10	3.20	403	642	160%
Carillion	CLLN.L	GBP	12/10	3.12	1,341	2,129	159%
Mitchells & Butlers	MAB.L	GBP	09/11	2.52	1,033	1,509	146%
Balfour Beatty	BALF.L	GBP	12/10	2.91	1,998	2,785	139%
Taylor Wimpey	TW.L	GBP	12/10	0.42	1,345	1,853	138%
Lloyds Banking Group	LLOY.L	GBP	12/10	0.30	20,331	26,862	132%
Stagecoach Group	SGC.L	GBP	04/11	2.75	1,584	2,050	129%
Qinetiq Group	QQ.L	GBP	03/11	1.35	892	1,106	124%
Aviva	AV.L	GBP	12/10	3.25	9,444	11,419	121%

Source: dataCentral, DataStream, Company annual reports, CIRA. Market data as of 17 January 2012. Pension data as of last annual report. [1]IAG (BA/Iberia) based on BA Dec-10 annual report. [2]Companies participate in Railways Pension Scheme where liability is limited by duration of franchise agreements, but we have included 100% of reported liabilities.

MSCI Europe ex UK companies most exposed to pension risk: Alcatel-Lucent, Lufthansa, Akzo Nobel, Philips, and Banco Espirito

Figure 22. MSCI Europe ex UK Liabilities as a percentage of market cap

Company	RIC	Curr	Year End	Price (local)	Mkt cap	Liabilities	Liabilities as % Mkt Cap
Alcatel-Lucent	ALUA.PA	EUR	12/10	1.41	3,276	28,054	856%
Lufthansa	LHAG.DE	EUR	12/10	9.57	4,383	11,162	255%
Akzo Nobel	AKZO.AS	EUR	12/10	38.25	8,975	14,171	158%
Philips	PHG.AS	EUR	12/10	14.79	14,918	20,166	135%
Banco Espirito	BES.LS	EUR	12/10	1.27	1,856	2,205	119%
Peugeot	PEUP.PA	EUR	12/10	14.22	3,328	3,610	108%
RWE	RWEG.DE	EUR	12/10	28.90	17,700	17,095	97%
Finmeccanica	SIFI.MI	EUR	12/10	2.92	1,688	1,567	93%
ThyssenKrupp	TKAG.DE	EUR	09/10	20.31	10,447	8,664	83%
Thales	TCFP.PA	EUR	12/10	25.05	5,066	4,196	83%
Commerzbank	CBKG.DE	EUR	12/10	1.44	7,338	6,073	83%
Atos Origin	ATOS.PA	EUR	12/10	36.23	3,026	2,504	83%
Swiss Life Holding	SLHN.VX	CHF	12/10	90.85	2,915	2,370	81%
Deutsche Post	DPWGn.DE	EUR	12/10	12.57	15,197	12,349	81%
Delta Lloyd	DLL.AS	EUR	12/10	13.38	2,281	1,843	81%
DSM	DSMN.AS	EUR	12/10	37.92	6,880	5,543	81%
Baloise	BALN.VX	CHF	12/10	66.35	3,318	2,628	79%
EDF	EDF.PA	EUR	12/10	18.02	33,307	26,064	78%
Salzgitter	SZGG.DE	EUR	12/10	44.19	2,656	1,934	73%
AEGON	AEGN.AS	EUR	12/10	3.57	6,817	4,877	72%

Source: dataCentral, DataStream, Company annual reports, CIRA. Market data as of 17 January 2012. Pension data as of last annual report. Note: IAG excluded from MSCI Europe ex UK index as also appears in FTSE 350.

Screen 2: Pension Deficits

Secondly, we screen for large pension deficits by calculating the pension deficit (as reported in the most recent annual report) as a percentage of market cap. This indicates which companies have the largest net liability relating to pensions and therefore potential cash outflows in forthcoming years. However, companies with small pension deficits or surpluses may be exposed to significant pension risk if the scheme is large. Pension deficits can be volatile from quarter to quarter so may have changed significantly since the last annual report.

Note that the pension deficits shown below are gross of any associated tax asset. For valuation purposes (e.g. in Enterprise Value or DCF calculations) we prefer to take the net-of-tax pension deficit, but unfortunately these figures are generally not disclosed consistently by all companies.

Largest deficits: Dixons, WS Atkins, BAE Systems, IAG, and Invensys

Figure 23. FTSE 350 Pension Deficits as a percentage of market cap

Company	RIC	Curr	Year End	Price (local)	Mkt cap	Liabilities	Assets	Deficits	Deficits as % Mkt Cap
Dixons Retail	DXNS.L	GBP	04/11	0.11	395	950	706	244	62%
WS Atkins	ATKW.L	GBP	03/11	6.90	691	1,282	944	338	49%
BAE Systems[1]	BAES.L	GBP	12/10	3.05	9,884	21,158	17,076	3,386	34%
IAG[2,3]	ICAG.L	GBP	12/10	1.56	2,898	16,142	15,316	949	33%
Invensys[3]	ISYS.L	GBP	03/11	1.82	1,476	5,452	5,024	458	31%
TUI Travel plc	TT.L	GBP	09/11	1.73	1,935	1,736	1,222	514	27%
Balfour Beatty	BALF.L	GBP	12/10	2.91	1,998	2,785	2,344	441	22%
Howden Joinery Group	HWDN.L	GBP	12/10	1.06	672	731	595	136	20%
C&W Worldwide	CWP.L	GBP	03/11	0.17	453	1,470	1,379	91	20%
DMGT	DMGOa.L	GBP	10/11	4.34	1,675	1,921	1,585	336	20%
GKN	GKN.L	GBP	12/10	2.06	3,204	3,260	2,660	600	19%
Carillion[3]	CLLN.L	GBP	12/10	3.12	1,341	2,129	1,889	249	19%
Taylor Wimpey	TW.L	GBP	12/10	0.42	1,345	1,853	1,604	249	18%
Whitbread	WTB.L	GBP	03/11	16.20	2,873	1,745	1,257	488	17%
Kesa Electricals	KESA.L	EUR	04/11	0.70	448	379	305	74	17%
FirstGroup[3,4]	FGP.L	GBP	03/11	3.09	1,487	3,615	3,289	243	16%
DS Smith	SMDS.L	GBP	04/11	2.10	919	879	732	148	16%
Dairy Crest	DCG.L	GBP	03/11	3.20	427	779	719	60	14%
Qinetiq Group	QQ.L	GBP	03/11	1.35	892	1,106	981	125	14%
Go-Ahead Group[4]	GOG.L	GBP	07/11	13.16	566	1,762	1,492	77	14%

Source: dataCentral, DataStream, company annual reports, CIRA. Market data as of 17 January 2012. Pension data as of last annual report. [1]BAE Systems attributes portion of deficit to other companies; we include 100% of assets and liabilities but include the adjusted deficit as reported. [2]IAG (BA/Iberia) based on BA Dec-10 annual report. [3]Deficit reflects unrecognised surplus due to application of asset ceiling. [4]Company participates in Railways Pension Scheme where liability is limited by duration of franchise agreements. We have included 100% of assets and liabilities but include adjusted deficit as reported.

Largest deficits: Lufthansa, Salzgitter, Alcatel-Lucent, Swiss Life, and ThyssenKrupp

Figure 24. MSCI Europe ex UK companies Pension Deficits as a percentage of market cap

Company	RIC	Curr	Year End	Price (local)	Mkt cap	Liabilities	Assets	Deficits	Deficits as % Mkt Cap
Lufthansa[1]	LHAG.DE	EUR	12/10	9.57	4,383	11,162	7,487	3,912	89%
Salzgitter	SZGG.DE	EUR	12/10	44.19	2,656	1,934	8	1,926	73%
Alcatel-Lucent[1]	ALUA.PA	EUR	12/10	1.41	3,276	28,054	27,538	2,344	72%
Swiss Life Holding	SLHN.VX	CHF	12/10	90.85	2,915	2,370	289	2,081	71%
ThyssenKrupp[1]	TKAG.DE	EUR	09/10	20.31	10,447	8,664	2,053	6,616	63%
EDF	EDF.PA	EUR	12/10	18.02	33,307	26,064	11,451	14,613	44%
Deutsche Post[1]	DPWGn.DE	EUR	12/10	12.57	15,197	12,349	7,019	5,337	35%
AEGON	AEGN.AS	EUR	12/10	3.57	6,817	4,877	2,507	2,370	35%
AXA[1]	AXAF.PA	EUR	12/10	10.86	25,599	15,732	7,834	7,900	31%
Volkswagen[1]	VOWG.DE	EUR	12/10	118.50	57,427	19,871	4,554	15,339	27%
UniCredit[1]	CRDI.MI	EUR	12/10	3.01	17,448	7,816	3,324	4,545	26%
OTE	OTEr.AT	EUR	12/10	2.88	1,412	340	0	340	24%
Thales[1]	TCFP.PA	EUR	12/10	25.05	5,066	4,196	2,999	1,210	24%
EADS	EAD.PA	EUR	12/10	25.79	21,160	9,645	4,662	4,983	24%
Peugeot	PEUP.PA	EUR	12/10	14.22	3,328	3,610	2,902	708	21%
Capgemini	CAPP.PA	EUR	12/10	26.22	4,084	2,548	1,713	835	20%
National Bank	NBGr.AT	EUR	12/10	1.57	1,501	402	102	300	20%
Wacker Chemie	WCHG.DE	EUR	12/10	74.31	3,875	2,128	1,377	750	19%
Baloise	BALN.VX	CHF	12/10	66.35	3,318	2,628	1,997	631	19%
Fiat	FIA.MI	EUR	12/10	4.25	5,335	1,333	327	1,006	19%

Source: dataCentral, DataStream, company annual reports, CIRA. Market data as of 17 January 2012. Pension data as of last annual report. Note: IAG excluded from MSCI Europe ex UK index as also appears in FTSE 350. [1]Deficit reflects unrecognised surplus due to application of asset ceiling.

Screen 3: Equity Exposure

Thirdly, we provide a screen for companies with significant equity exposure in the pension fund. We compare the value of equities held in the pension fund (as published in the most recent annual report) to the market cap of the company. This indicates which companies might be most exposed via the pension fund to a decline in equities, and indicates riskier asset allocation. A large equity holding relative to the company's market cap should (theoretically) increase the beta of the company's share price.

Most exposed to equities in pension fund: IAG, Go-Ahead Group, C&W Worldwide, Dixons, and Kier Group

Figure 25. FTSE 350 equity exposure from pension funds

Company	RIC	Curr	Year End	Price (local)	Mkt cap	Assets	Equities %	Bonds %	Other %	Exposure *
IAG[1]	ICAG.L	GBP	12/10	1.56	2,898	15,316	44%	38%	19%	231%
Go-Ahead Group[2]	GOG.L	GBP	07/11	13.16	566	1,492	73%	6%	21%	193%
C&W Worldwide	CWP.L	GBP	03/11	0.17	453	1,379	47%	16%	36%	144%
Dixons Retail	DXNS.L	GBP	04/11	0.11	395	706	67%	26%	7%	120%
Kier Group	KIE.L	GBP	06/11	14.01	543	840	77%	21%	2%	119%
BAE Systems	BAES.L	GBP	12/10	3.05	9,884	17,076	60%	31%	9%	104%
Stagecoach Group[2]	SGC.L	GBP	04/11	2.75	1,584	1,970	66%	19%	15%	83%
FirstGroup[2]	FGP.L	GBP	03/11	3.09	1,487	3,289	35%	24%	41%	78%
WS Atkins	ATKW.L	GBP	03/11	6.90	691	944	54%	40%	6%	74%
Carillion	CLLN.L	GBP	12/10	3.12	1,341	1,889	51%	48%	1%	72%
Interserve	IRV.L	GBP	12/10	3.20	403	591	48%	41%	11%	70%
BT Group	BT.L	GBP	03/11	2.06	16,003	37,222	30%	28%	42%	70%
Qinetiq Group	QQ.L	GBP	03/11	1.35	892	981	58%	33%	10%	63%
Lloyds Banking Group	LLOY.L	GBP	12/10	0.30	20,331	26,382	45%	35%	20%	58%
DMGT	DMGOa.L	GBP	10/11	4.34	1,675	1,585	54%	36%	11%	51%
Balfour Beatty	BALF.L	GBP	12/10	2.91	1,998	2,344	42%	53%	6%	49%
Howden Joinery Group	HWDN.L	GBP	12/10	1.06	672	595	54%	32%	14%	48%
DS Smith	SMDS.L	GBP	04/11	2.10	919	732	60%	40%	0%	47%
National Express	NEX.L	GBP	12/10	2.22	1,130	807	66%	24%	11%	47%
Babcock Intl	BAB.L	GBP	03/11	7.58	2,722	2,580	47%	47%	7%	44%

Source: dataCentral, DataStream, company annual reports, CIRA. Market data as of 17 January 2012. Pension data as of last annual report. *Pension fund equity exposure as percentage of market cap. [1]IAG (BA/Iberia) based on BA Dec-10 annual report. [2]Companies participate in Railways Pension Scheme where liability is limited by duration of franchise agreements, but we have included 100% of reported assets.

Most exposed to equities in pension fund: Alcatel-Lucent, Lufthansa, Banco Espirito, Peugeot, and Baloise

Figure 26. MSCI Europe ex UK equity exposure from pension funds

Company	RIC	Curr	Year End	Price (local)	Mkt cap	Assets	Equities %	Bonds %	Other %	Exposure*
Alcatel-Lucent	ALUA.PA	EUR	12/10	1.41	3,276	27,538	16%	65%	19%	134%
Lufthansa	LHAG.DE	EUR	12/10	9.57	4,383	7,487	35%	45%	20%	60%
Banco Espirito	BES.LS	EUR	12/10	1.27	1,856	2,206	34%	20%	46%	41%
Peugeot	PEUP.PA	EUR	12/10	14.22	3,328	2,902	42%	58%	0%	37%
Baloise	BALN.VX	CHF	12/10	66.35	3,318	1,997	56%	19%	24%	34%
RWE	RWEG.DE	EUR	12/10	28.90	17,700	13,833	36%	53%	11%	28%
Philips	PHG.AS	EUR	12/10	14.79	14,918	20,080	20%	70%	10%	27%
DSM	DSMN.AS	EUR	12/10	37.92	6,880	5,440	34%	57%	9%	27%
Lafarge	LAFP.PA	EUR	12/10	29.52	8,478	3,654	60%	36%	4%	26%
Thales	TCFP.PA	EUR	12/10	25.05	5,066	2,999	43%	49%	8%	25%
Capgemini	CAPP.PA	EUR	12/10	26.22	4,084	1,713	59%	35%	6%	25%
Michelin	MICP.PA	EUR	12/10	50.54	9,097	4,681	48%	38%	14%	25%
ING	ING.AS	EUR	12/10	6.51	24,947	17,364	35%	52%	13%	24%
Akzo Nobel	AKZO.AS	EUR	12/10	38.25	8,975	13,122	16%	73%	11%	23%
Finmeccanica	SIFI.MI	EUR	12/10	2.92	1,688	1,258	30%	21%	49%	23%
AEGON	AEGN.AS	EUR	12/10	3.57	6,817	2,507	57%	37%	6%	21%
Electrolux	ELUXb.ST	SEK	12/10	119.50	37,134	18,069	42%	41%	17%	20%
KPN	KPN.AS	EUR	12/10	8.69	12,840	6,632	39%	40%	21%	20%
Alstom	ALSO.PA	EUR	03/11	24.68	7,268	3,763	38%	50%	12%	20%
Atos Origin	ATOS.PA	EUR	12/10	36.23	3,026	2,201	26%	69%	5%	19%

Source: dataCentral, DataStream, company annual reports, CIRA. Market data as of 17 January 2012. Pension data as of last annual report. *Pension fund equity exposure as percentage of market cap. Note: IAG excluded from MSCI Europe ex UK index as also appears in FTSE 350.

ITV PLC

(ITV.L; £0.75; 1)

Valuation

We base our absolute valuation on a DCF analysis (WACC of 9.5% and a LT growth assumption of 2%) which gives a fair value of 99p. We also use a SOTP-based analysis as a sanity check (fair value of 106p). Both methodologies support our new 100p target price.

At our 100p TP, near-term valuation for ITV would be relatively extreme at c.13.6x 2012E P/E. We note, however, that EV/Sales, at 2.0x, would be more in line with medium-term margin expectations (20%+ from 2012E). We also note the potential for material upgrades from both a better macro environment, as well as greater operational/capital structure efficiency. We note that on our ‘bull case’ EPS scenario (9.1p by 2012E), ITV would trade at just over 11x at 100p.

Risks

The major downside risks to ITV, which may prevent achievement of our target price are: investment-driven downgrades; audience attrition; loss of share for TV to the internet; technology shifts; the UK economy; and concerns around the pension deficit. The major upside risks are: continued improvement in advertising; relaxation of regulation, material improvement to the schedule over time; M&A activity.

Appendix A-1

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ITV PLC (ITV.L)

Ratings and Target Price History
Fundamental Research

Analyst: Thomas A Singlehurst, CFA
Covered since April 30 2010

	Date	Rating	Target Price	Closing Price
1	6-Aug-09	1H	*0.55	0.43
2	7-Sep-09	1H	*0.60	0.50
3	22-Jan-10	1H	*0.70	0.58
4	21-Apr-10	1H	*0.80	0.67
5	7-Dec-10	1H	*1.00	0.71
6	2-Mar-11	1H	*1.25	0.93
7	11-May-11	1H	*1.15	0.72
8	8-Sep-11	1H	*1.00	0.56
9	7-Oct-11	Stock rating system changed		
10	7-Oct-11	*1	1.00	0.63

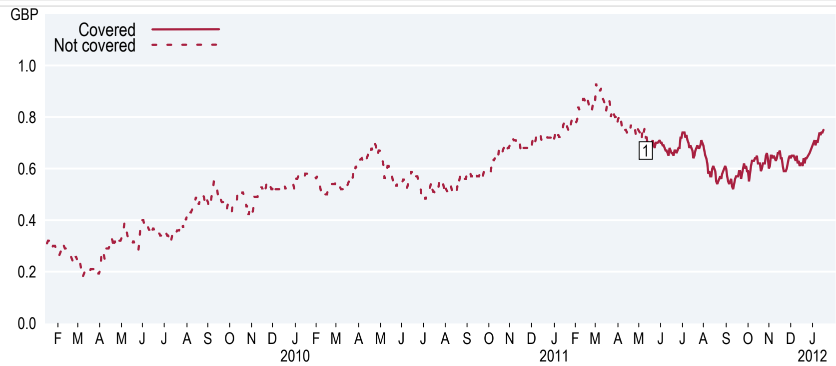
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

ITV PLC (ITV.L)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Thomas A Singlehurst, CFA
Covered since April 30 2010



	Date	Rating	Target Price	Closing Price
1	11-May-11	*ADD MP	-	0.72

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 31 Dec 2011	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Investment Research & Analysis Global Fundamental Coverage	57%	34%	9%	10%	79%	10%
% of companies in each rating category that are investment banking clients	45%	41%	40%	49%	43%	41%

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