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Project Thor

Potential restructuring of the Thor business and possible pensions solution: Presentation to the Trustee of the Thor pension schemes

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Introduction

Introduction

- Deloitte LLP have been engaged by Arcadia Group (via Taveta Investments Ltd) ("Group") to advise on potential options for the future of the Thor business.
- Group appreciates that the Thor pension schemes are a major stakeholder in, and creditor of, the Thor business and has engaged Deloitte Total Reward and Benefits Limited to advise on the potential pensions implications of the options being considered.
- This presentation considers, at high level, Group's preferred option of a solvent restructuring of the Thor business. This would involve a restructuring of the Thor pension arrangements (referred to in this presentation as "the pensions solution").
- Group appreciates that the trustee will need to engage with its advisors on the pensions solution, and looks forward to constructive discussions in the coming weeks.

Background to Thor pension schemes

Background to Thor pensions

- Thor operates two pension arrangements: the Thor Pension Scheme ("Thor PS") and the Thor Senior Management Scheme ("Thor SMS") (together the "Thor Schemes").
- The Schemes are now closed to future accruals of benefits.
- An estimated updated funding position of the Schemes as at 31 December 2013 on a number of actuarial bases is set out in Appendix 1.
- Following the 31 March 2012 valuations of the Schemes, the following Recovery Plans were agreed between Thor and the Trustees in September 2013:
  - Thor PS: contributions of £792,333 pcm
  - Thor SMS: contributions of £41,000 pcm

  where the term of both Recovery Plans is 22 years and 8 months (from 1 September 2013 to 30 April 2036). We understand that dialogue with the Pensions Regulator is ongoing.
- The Schemes benefit from a guarantee from Davenbush Limited for an amount required to bring the Schemes up to 105% funded on the PPF basis.

Financial position of the Thor business

Financial position of the Thor business

- As part of the Covenant Review last year Group provided the trustees and their advisors with the following (which have therefore not been included in this presentation):
  - The August 2012/13 Statutory Accounts for BHS Limited.
  - A note on the accounts, including a reconciliation of the statutory accounts to the management accounts.
  - Key schedules from the management accounts as at P8 2013/14 (i.e. as at end April 2013).
  - A copy of the 3 year strategy/recovery pack prepared by the brand.
- The following slides summarise the recent negative trading performance and set out the impact on the balance sheet of Thor. These use figures from the final 2012/13 actual accounts and the P4 2013/14 management accounts which will be provided to the trustees and their advisors following this presentation.
- Given a relatively stable working capital position, the losses have been funded via cash support from Group. If this support is not ongoing then Thor will face a liquidity and solvency issue. It is the view of Group that if it withdraws its support, Thor will become insolvent immediately.
- Group is unwilling to support the Thor business given the accumulated and forecast losses. Group requires the Thor business to be restructured in order to continue to provide its support.

Financial position of the Thor business

- The table below sets out a high level summary of the financial performance of Thor extracted from management accounts showing sustained loss making over the last three years:

£m		FY12 Actual	FY13 Actual	FY14 Forecast
Total Sales		722	702	715
Gross Profit		347	348	352
Net loss		(89)	(78)	(72)
Cumulative net loss		(89)	(167)	(239)

Financial position of the Thor business

- The losses made by Thor have in turn weakened its balance sheet and increased the level of Group support required:

		As at 25 August	
£'m		**2011**	**2012**
Fixed assets net book value		239	239
Stock and debtors		139	134
Cash		8	7
Total assets		**386**	**380**
Current liabilities		(196)	(246)
Long term liabilities (ex pension)		(109)	(143)
Pension deficit		(79)	(73)
Total liabilities		**(384)**	**(462)**
Net (liabilities)/assets		**2**	**(82)**

Potential restructuring of the Thor business

Potential restructuring of the Thor business

- Absent any form of solvent restructuring the Thor business will enter Administration, which is a form of insolvency and would have a significant impact on all stakeholders including the Thor Schemes. Group believes that the Thor Schemes would enter the PPF. As a result, all members would receive scaled back benefits.
- Group wishes to avoid insolvency, and would prefer a solvent restructuring of the business. This will require the support of all stakeholders, including the pension trustees.
- Group is willing to suffer a significant loss in terms of a write off of the majority of the existing inter-company loan.
- Group will also require landlords and suppliers to suffer losses.
- In addition, Group will require the Thor pension schemes to “share in the pain”. Group would like the trustees to sign up to heads of terms whereby, if Group, landlords and suppliers suffer appropriate losses, the trustees will agree to a restructuring of the Thor Schemes. More detail on the proposed “pensions solution” is included later in this presentation.

Estimated outcome statement and impact of restructuring on stakeholders

Estimated outcome statement

- Deloitte has undertaken an exercise to produce an estimated outcome statement, which is summarised in the next slide. This provides an indication of the financial outcomes to the different creditors of the Thor business under various scenarios involving Administration of the Thor business. The estimated return to unsecured creditors is c13p in the £.
- This means that on insolvency of the Thor business:
  - Group would receive a return of only £27m on its loan of £200m;
  - Other unsecured creditors would make similar losses (the estimated outcome statement assumes that landlords have unsecured claims equal to one year's rent in a closure scenario through administration); and
  - the Schemes would receive a recovery of £49m.
- In addition it has been estimated that the Schemes would receive around £5m from the guarantee currently in place from Davenbush Limited.
- Neither Thor Pensions Scheme would have sufficient assets to exceed a s179 calculation and so we expect they would be eligible for the PPF following an assessment period.

Estimated outcome statement

- It is noted that the buy-out deficit used for the purposes of this estimated outcome statement (£368m) is different to that quoted in the estimated updated funding numbers in Appendix A (£441m). This is because they are as at different dates and were derived using different base numbers. Before finalising the terms of the pensions solution, an up to date estimated outcome statement will be produced. In practice, we would not expect a significant impact on the final outcome.

Estimated outcome statement

Indicative summary of financial outcomes

£m	Book Value or Valuations	Administration with closure	Administration with sale to 3rd party	Fund a purchase out of a trading Administration	Fund a prepack purchase immediately after Administration
Real Estate	76.5	76.5	76.5	76.5	76.5
Stock	74.4	22.3	22.3	22.3	22.3
	150.9	98.8	98.8	98.8	98.8
Cash	7.1	7.1	7.1	7.1	7.1
Book Debts	16.1	9.0	9.0	9.0	9.0
Asset realisations or CVA funding	**174.1**	**114.9**	**114.9**	**114.9**	**114.9**
Professional costs/Preferential Claims		(7.0)	(7.0)	(7.0)	(4.0)
Available to unsecured creditors		**107.9**	**107.9**	**107.9**	**110.9**
Unsecured creditors		(802.8)	(802.8)	(802.8)	(802.8)
Unsecured dividend rate (p/£)		0.13	0.13	0.13	0.14
Shortfall to Trade/expense creditors (£m)		(66.4)	(66.4)	(66.4)	(66.1)
Return to Parent Loan (£m)		26.9	26.9	26.9	27.6
Return to PPF for DB Scheme (£m)		49.4	49.4	49.4	50.8
Net Funding Requirement by Owner					
Deal Consideration		-	-	(98.8)	(98.8)
CVA Funding		-	-	-	-
Unsecured dividend to Parent Loan		26.9	26.9	26.9	27.6
		26.9	**26.9**	**(71.9)**	**(71.2)**

Source: Management Information & Deloitte

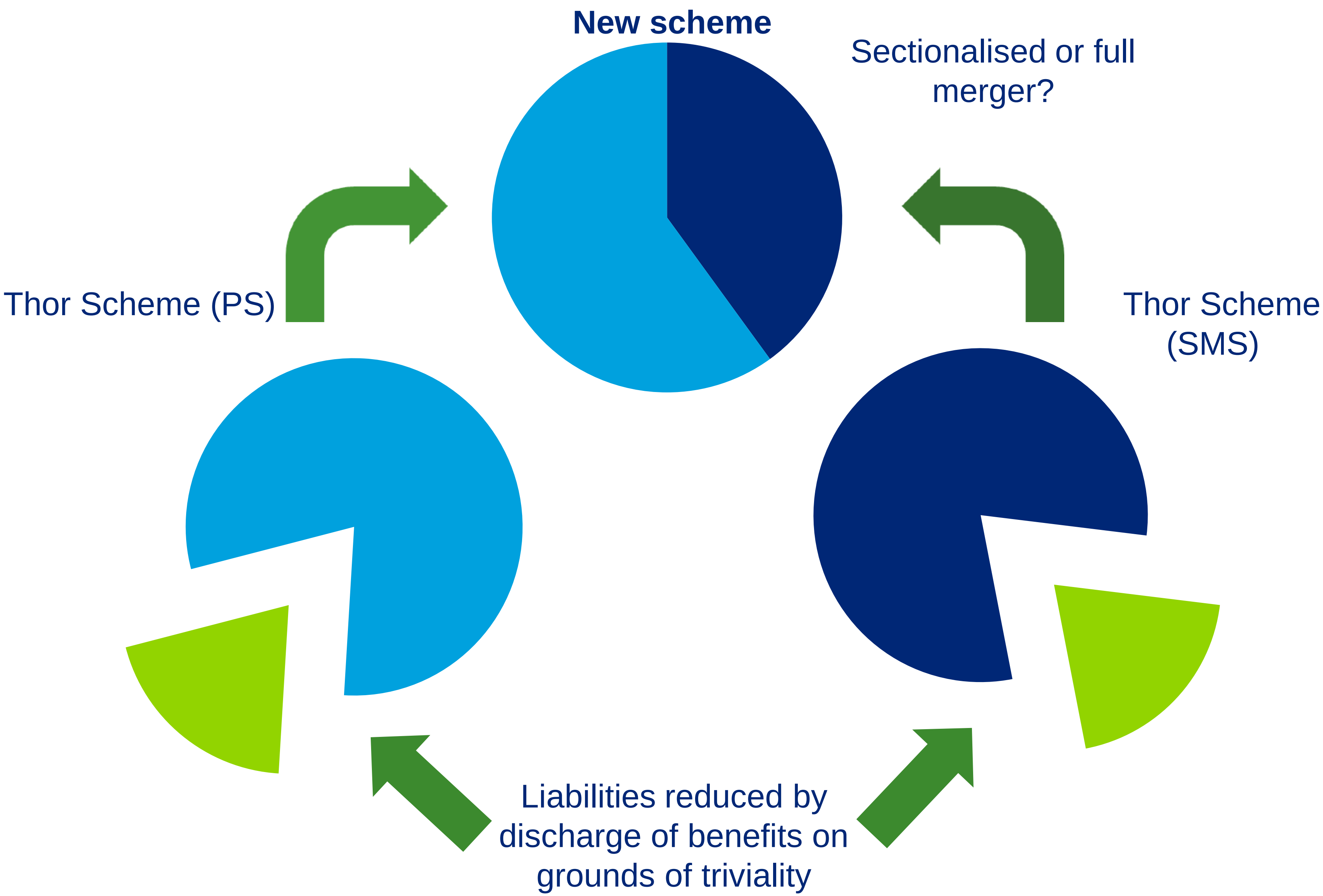
Note: £803m unsecured creditors includes £76m external trade/expense creditors, £53m external other creditors, £200m Parent Loan, £368m DB scheme full buy-out deficit and £105m landlords (i.e. 12m rent)

A possible pensions solution

A possible pensions solution

- The restructuring would involve Group establishing a new pension scheme and transferring the assets and liabilities of the Thor Schemes in to this scheme.
- The assets and liabilities transferred would relate to members who have benefits with values in excess of £18,000 each. Members with benefits of value less than £18,000 would be offered trivial commutation via Wind Up Lump Sums (i.e. an immediate lump sum in full settlement of their benefits under the scheme i.e. the current Thor Schemes would be wound up after the transfers). Deloitte's analysis of the data suggests that around 16,500 of the 22,000 members of the Thor Schemes would be eligible for Wind Up Lump Sums.
- The next slide shows the suggested solution pictorially.
- The new scheme would provide benefits (in terms of increases to pensions in deferment and payment) which are lower than those provided under the Thor Schemes, but at least as generous as, and in some cases better than, those payable from the PPF.
- Group's view is that the outcome for members via a restructuring is better than the outcome following insolvency.

A possible pensions solution



A possible pensions solution

- If the trustees were to agree to this proposal, Group would pay an amount of £54m (to be agreed) in to the new scheme (being the amount the Thor schemes would receive in insolvency scenario – see previous section). This payment would be in addition to the loss suffered on the inter company loan.
- The combination of (i) the cash injection from Group (ii) the WULS exercise and (iii) the scaling back of benefits in the new scheme should mean that the new scheme would be well funded on a prudent self-sufficiency basis – see next slides. Group would wish to agree the future investment strategy in the new scheme – see later in this presentation.
- Group appreciates that the trustees would require an actuarial report in order to agree to transfers without member consent, and believes that the scheme actuary should be willing to sign such a report if the only alternative is the PPF. This point must be clearly established as the fall back result of failure to reach an agreement to restructure consensually.
- Going forwards the restructured business would provide reasonable covenant to support the new scheme.
- Group would seek clearance for the proposed restructuring from the Pensions Regulator. Group will require trustee support for the Clearance Application as a condition of the restructuring.

A possible pensions solution - Deloitte analysis

Potential impact of WULS payments, benefit changes and cash injection from Group

	Ongoing funding basis				
	Current position	Post WULS (90% take up) Replica benefits Illustrative Group payment of £54m	Post WULS (90% take up) CPI revaluation Illustrative Group payment of £54m	Post WULS (90% take up) Statutory minimum pension increases Illustrative Group payment of £54m	Post WULS (90% take up) Statutory minimum pension increases apart from 1% for pre '97 Illustrative Group payment of £54m
Assets (£m)	476	432	432	432	432
Liabilities (£m)	673	490	427	357	380
Surplus/(deficit) (£m)	**(197)**	**(58)**	**5**	**75**	**52**
Funding level	71%	88%	101%	121%	114%
WULS payable (£m)		98	98	98	98
WULS funding improvement (£m)		85	148	218	195

A possible pensions solution - Deloitte analysis

Potential impact of WULS payments, benefit changes and cash injection from Group

	Self sufficiency basis				
	Current position	Post WULS (90% take up) Replica benefits Illustrative Group payment of £54m	Post WULS (90% take up) CPI revaluation Illustrative Group payment of £54m	Post WULS (90% take up) Statutory minimum pension increases Illustrative Group payment of £54m	Post WULS (90% take up) Statutory minimum pension increases apart from 1% for pre '97 Illustrative Group payment of £54m
Assets (£m)	476	432	432	432	432
Liabilities (£m)	750	545	472	390	416
Surplus/(deficit) (£m)	**(274)**	**(113)**	**(40)**	**42**	**16**
Funding level	63%	79%	92%	111%	104%
WULS payable (£m)		98	98	98	98
WULS funding improvement (£m)		107	180	262	236

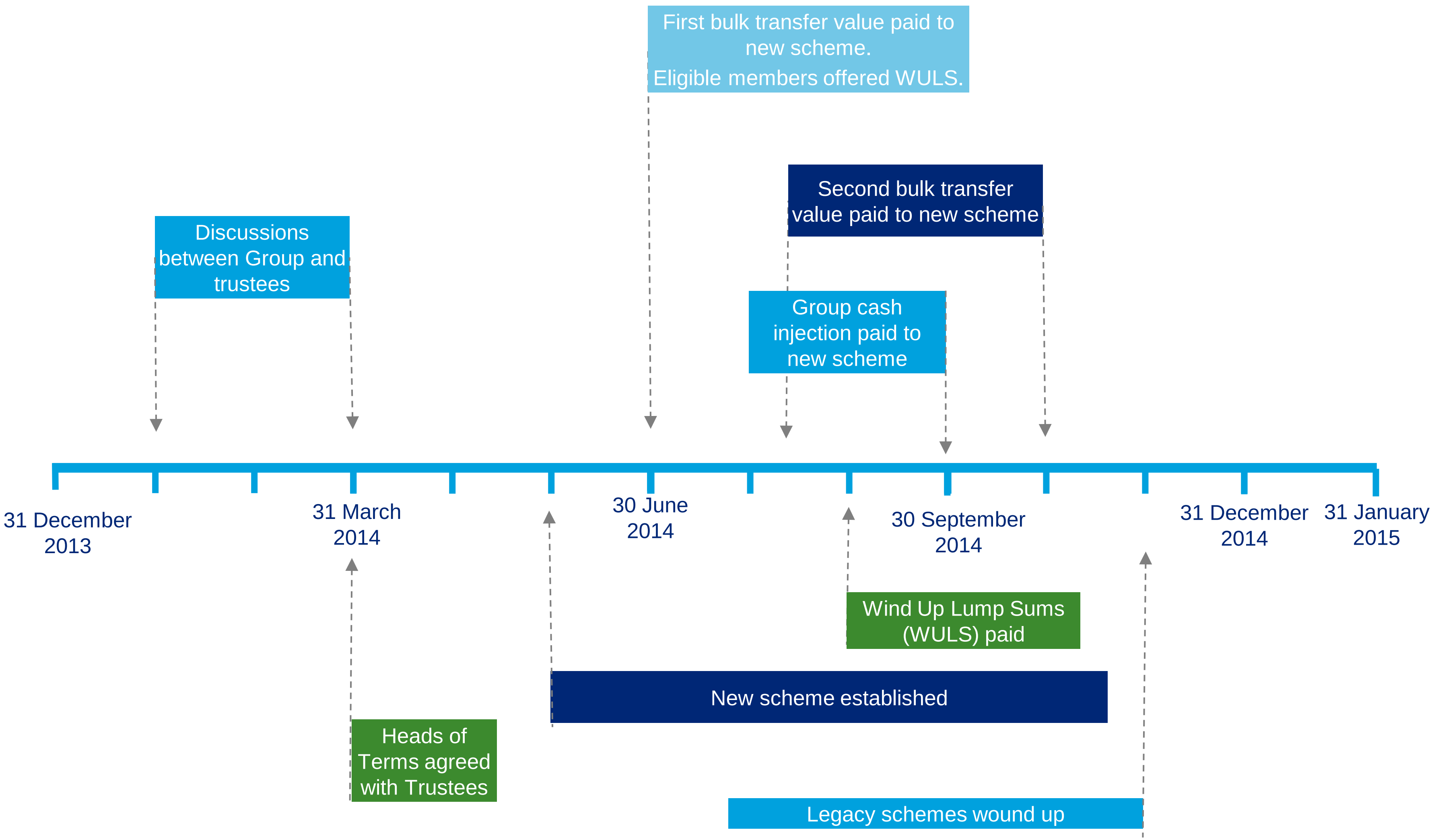
Next steps

Next steps

We see the next steps as being:

- The trustees ask their advisors to review the proposed pensions solution. We think that as a first step it would be helpful for the respective financial, actuarial and legal advisors of the Group and trustees to meet to discuss the proposal and agree principles. We should consider these as the three key work steams. Deloitte will act as co-ordinator and project manager throughout the process.
- Heads of Agreement signed confirming trustee agreement to restructure the Thor Pension Schemes on the basis that other stakeholders also suffer losses broadly consistent with insolvency.
- Detailed project plan developed (see next slide for an illustrative, high level timeline).
- Implementation of pensions solution coincident with a solvent restructuring of Thor as a trading business.

A possible pensions solution – timeline



Appendix A: Funding update of the Thor pension schemes

Thor Schemes

Estimated funding position as at 31 December 2013

£m	Accounting	Cash funding	Self-sufficiency	Buyout
Liabilities	588	673	750	917
Assets	476	476	476	476
Surplus/(Deficit)	**(112)**	**(197)**	**(274)**	**(441)**
Funding level	81%	71%	63%	52%
Comments	Consistent with 2012 accounting methodology	TW funding update	Broad brush estimate based on a typical self sufficiency basis (Gilts+0.5% for deferreds and pensioners).	Broad brush estimate based on a typical buyout basis (Gilts for deferreds, gilts-0.2% for pensioners).

Source: Deloitte estimates, TW funding update at 31 December 2013

Appendix B: Data summary of the Thor pension schemes

Data summary

BHS Main	Membership as at 1 April 2012	No. of members who could receive WULS	Membership post WULS
Deferred pensioners	14,199	11,592	2,607
Pensioners	7,299	4,920 (1,527 over age 80)	2,379
Total	21,498	16,512	4,986

BHS SMS	Membership as at 1 April 2012	No. of members who could receive WULS	Membership post WULS
Deferred pensioners	122	3	119
Pensioners	115	1 (under age 80)	114
Total	237	4	233

The above analysis is a possible scenario on the calculation basis assumed. The number of members eligible for a WULS payment will depend on the basis agreed/ adopted by the Schemes' Trustees.

Appendix C: WULS - Deloitte analysis

WULS - Deloitte analysis

- The analysis in this report sets out the estimated financial position of the Thor Schemes before and after the payment of possible winding up lump sums (WULS) and assuming transfers to a new scheme offering different levels of benefit. It is assumed that £54m (to be agreed) is received from the Group. The analysis is presented on the on-going funding basis and a self-sufficiency basis.
- The approach taken to determine the financial impact of the WULS exercise (i.e. amount of the WULS payment of £98m) is based on the current actuarial factors in place for the Schemes (i.e. cash commutation and early retirement factors).
- Details of the number of members for each scheme potentially qualifying for a WULS is set out in Appendix B. We have no applied an upper age limit for those offered a WULS.
- The WULS option will be offered to members rather than imposed. Each member will have different preferences on the time value of money – the value of cash now relative to a small income future stream in the future. Experience indicates that for the vast majority of members, the option to receive a lump sum in lieu of a small pension is very attractive (almost regardless of the commutation terms).
- Any member who positively declines a WULS will have their benefit discharged by transfer to the new pension scheme rather than secured as an annuity.

Appendix D: HMRC & WULS

HM Revenue & Customs and WULS

HMRC's approach to trivial commutation/ WULS

The following are extracts from HMRC's Registered Pension Scheme Manual ("RPSM"):-

*"In recognition of the disproportionate costs and difficulties often encountered in providing very small pensions under a **registered pension scheme**, the tax legislation provides for small or trivial benefit rights to be commuted and paid as a one-off lump sum in a number of cases"* **RPSM09105410**

*"The legislation provides specifically for trivial or small benefit rights under a **registered pension scheme**, to be commuted and paid as a one-off authorised lump sum"* **RPSM09104905**

*"The amount of lump sum paid may not necessarily be the same as the value attributed to those benefits, as valued on the nominated date on the prescribed basis. There is no objection to this, provided the benefits are still valued on the prescribed basis for commutation limit purposes. Under a **money purchase arrangement** the payment will be the funds held in that **arrangement**. However, in a **defined benefits arrangement**, or where a pension in payment is being commuted, it is for the scheme to attribute a capital value to the pension benefit entitlement being commuted"* **RPSM09104940**

Appendix E: New scheme investment strategy

New scheme investment strategy

Current Position

- Following the pension scheme restructuring outlined in this paper, the new Scheme will be well funded on a self-sufficiency basis.
- The Group wishes to minimise future funding risks. In order to do this, the new Scheme's assets and liabilities should be matched as far possible as measured on the self-sufficiency basis.
- The self-sufficiency basis assumes a long-term return of gilts + 0.5% per annum.

Current Investment Strategy

Thor Schemes 30 November 2013	Asset Allocation %
Equity	47
Bonds and Emerging Market Exposure	41
Property	12
Total	**100**

- The current investment strategy has a large allocation to equities which tend to be highly volatile ("equity market risk").
- Over the longer term we expect equities and property to provide some inflation expectation, however it is important to note they do not provide a perfect match and will not protect the funding level between valuations ("inflation risk").

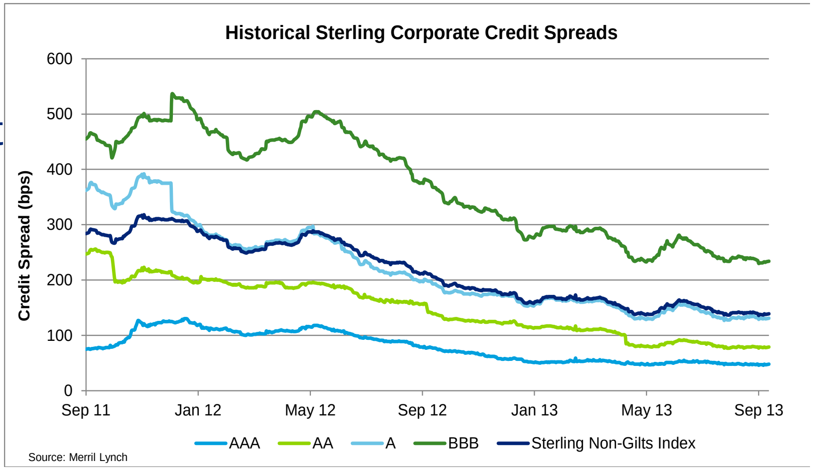
- The Schemes' current bond allocation should provide an element of interest rate protection however there still remains a significant amount of risk, particularly under a gilts + 0.5% basis (" interest rate risk").

New scheme investment strategy

Proposal

- Given the new Scheme will be well funded on a self-sufficiency basis, we believe the Group has the opportunity to de-risk, reducing the main funding risks.
- Note that mortality risk can also be hedged through the use of longevity swaps however this market is still relatively small which makes this type of hedging expensive.
- The new investment strategy should consist mainly of high quality corporate bonds, as well as adding exposure to nominal and inflation swaps to hedge the real rate risk.
- It is important to note that the duration of any credit portfolio is likely to be shorter than the duration of the new Scheme's liabilities. This mismatch in duration means the value of the bonds will move by a smaller amount when yields change.

- To reduce this risk the Scheme could invest in a duration neutral credit portfolio with an overlay of nominal swaps, more in line with that of the liabilities.
- The graph opposite shows how credit spreads have narrowed in recent times. As at 31 December 2013 the spread on the Merrill Lynch Sterling Non-Gilts index was118 bps.



New scheme investment strategy
Proposal

- Holding inflation/nominal swaps will require cash to be held for collateral purposes - an allocation to cash will cause a drag on the expected return of the Scheme.
- However, after allowing a margin for prudence, we believe the Scheme could achieve a return of gilts + 0.5% p.a. with a portfolio of corporate bonds, cash and inflation/nominal swaps - where the swap positions have a similar sensitivity to movements in interest rates and inflation as the liabilities.

Thor Schemes Our Proposal	Asset Allocation %
Corporate Bonds	90
Cash	10
Inflation Swaps	-
Nominal Swaps	-
Total	**100**

- It is also worth considering that there has been recent innovation in the senior secured debt market and there are now structures available which provide access to both credit and inflation exposure.
- This may be a more complex approach. However, once the structure has been set up the issuer will tend to take full responsibility for the day-to-day management, including managing the collateral requirements.