

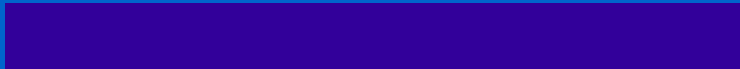


# Boots for Everyone



Ryan Labs Conference

April 8, 2002



•  
•  
•

## Swap (35% corporate tax)

Pension assets

- Bonds + S&P

+ Diversified Portfolio

+  $.65 * \text{Bonds} - .65 * \text{S\&P}$

= No change in s/h equity exposure

- 
- 
- 

# Base Case and Assumptions

Assets (\$1mm) = Bonds = Liabilities

Personal tax on bond income: 40%

Personal tax on equity returns: 15%\*

Risk-free return: 5%

\* Equivalent annual rate of tax

- 
- 
- 

# Tax Effects of Swaps

Pension swap: \$1mm Bonds --> S&P

Diversified swap: \$650k S&P --> Bonds

S/H Tax increase:

$$(650k)(.05)(.4-.15)=(.05)162.5k$$

- 
- 
- 

## PV S/H Tax Loss

$$PV = (.05)(162.5k)/(.05)(1-.4)=270.8k$$

In reverse, when a U.S. plan does a  
Boots-like reallocation, s/h gain =  
\$270.8k per \$1mm

•  
•  
•

## Comparative Value

- Reallocate \$1mm => s/h +270.8k
- S/H value of \$1mm pension asset:  
 $(650k)(1-.15) = 552.5k$
- Boots' swap adds 50% to s/h after-tax value of plan assets

•  
•  
•

## Comparative Value

- Boots' swap adds 50% to s/h after-tax value of plan assets
- Not based on statistical model or estimates.
- Based on risk-free arbitrage

•  
•  
•

## S/H Action Not Necessary

- Value arises from plan swap alone (with transparency)
- Reduced risk should cause s/h's to increase personal leverage
- Reduced risk may be captured via balance sheet leverage: Boots



- 
- 
- 

## New Equilibrium

- Firm leverage on balance sheets
- No pension leverage
- Less notional equity
- More notional debt
- Less cross-ownership

•  
•  
•

## First Mover Advantage

- How do we get new equilibrium?
- Not immediately, over time
- Poor equity returns during transition
- Transition demand for more bonds
- First movers win

- 
- 
- 

# Remember

- Ignoring taxes => shareholder indifference
- Actuarial error => equity investments
  - “Value” might look like 90% of assets
- Taxes + transparency => bonds
  - Value IS 50% of assets
- First mover advantage