

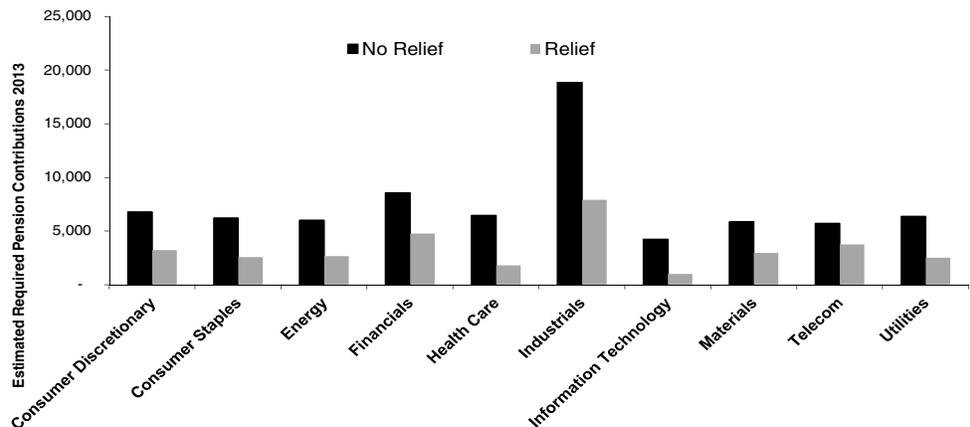
How Do You Spell Pension Funding Relief?

ACCOUNTING

C-O-N-G-R-E-S-S

Research Analysts
David Zion, CFA, CPA
 212 538 4837
 david.zion@credit-suisse.com
Amit Varshney, CFA, FRM
 212 538 8049
 amit.varshney@credit-suisse.com
Nichole Burnap, CPA
 212 325 5417
 nichole.burnap@credit-suisse.com

Exhibit 1: Estimated 2013 Pension Funding Requirements With and Without Pension Funding Relief¹ by Sector, S&P 500
US\$ in millions



¹Using 100 bps increase in funding discount rates

Note: S&P 500 as of June 20, 2012, excluding 17 companies for which we did not have all relevant data.

Source: Company data, Credit Suisse estimates

- **Higher discount rate = Pension funding relief.** The U.S. Congress (with the help of Corporate America) is conjuring up yet another round of pension funding relief. This time it looks like the relief (included in the Senate Highway Bill) will come from a higher discount rate based on high grade bond yields averaged over 25 years (we can't make this stuff up). The higher discount rate makes the plans appear healthier from a funding perspective (no impact on the balance sheet) reducing pension funding requirements.
- **Pension contributions for the S&P 500 in 2013 could drop by \$45 billion or 58% if discount rates were to go up 100 basis points.** We estimate that the "savings" from pension funding relief in 2013 is more than 5% of trailing cash flow for 107 companies in the S&P 500.
- **Kicking the can down the road, again.** Pension funding relief does not change the company's underlying pension obligation it only delays when the plans need to be funded (which can be very important to a company facing a liquidity crunch). That reduction in liquidity risk could provide a valuation boost to companies in the short-term. However, reducing the funding requirements in the short-term could result in larger required pension contributions and more pension risk in the long-term.

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How Do You Spell Pension Funding Relief? C-O-N-G-R-E-S-S

With most pension plans underfunded and many in bad shape, companies are facing a big increase in pension funding requirements. In our January 9, 2012 report, *Pensions Punished, Look for Pension Contributions to Go Up*, we had estimated higher contributions this year (maybe one year early) and for the foreseeable future. The Society of Actuaries was also expecting a “significant increase in the level of future contributions” through 2017 with funding requirements really picking up next year.

As a result the U.S. Congress (with the help of Corporate America) is conjuring up yet another round of pension funding relief (only for single-employer pension plans). This time around it looks like the relief (included in the Senate Highway Bill which could get passed over the next few days) will come from a higher discount rate, which makes the plans appear healthier from a funding perspective (it has no impact on the pension funded status reflected in the balance sheet) lowering pension funding requirements. We estimate that the relief could reduce required contributions for the S&P 500 companies by \$45 billion in 2013 if discount rates were to rise by 100 basis points.

Higher Discount Rate = Pension Funding Relief

Today most companies use the IRS segment rates to set the discount rate when measuring their pension obligation for funding purposes. The segment rates are based on the two-year average of monthly yields on high-grade corporate bonds split into three segments, short-term (0-5 years); mid-term (5-20 years); and long-term, beyond twenty years. The IRS publishes the rates monthly on its web site and as of January 2012 the segment rates were 1.98%, 5.07% and 6.19%. The discount rate used by each company depends upon when their future pension benefits are expected to be paid: the rate from the first segment is used to discount all pension benefits due over the next five years, the rate from the second segment is used to discount all pension benefits due between five and twenty years, and the rate from the third segment is used to discount all the pension benefits due beyond 20 years. Alternatively companies can choose to use the full yield curve where rates are averaged over 30 days instead of the segment rates.

The proposed relief (i.e., Pension Funding Stabilization) in the Senate Highway Bill would put a cap and a floor on the discount rate used for funding purposes (it has no impact on the discount rate used for GAAP financial reporting). The idea behind this is to stabilize the pension funding discount rate from the effects of interest rate volatility. Of course, companies could protect themselves from interest rate risk through their asset allocation; they don't need Congress to do it for them. The cap and floor would be based on a 25-year average of the segment rates (i.e., a 25-year average of 2-year average yields on high grade bonds) that the Treasury will calculate once a year through September 30 (we can't make this stuff up). If the IRS segment rates fall in between the cap and floor the segment rates are used as the discount rate, if they fall below (as is the case today) the floor is used and if they come in above the cap is used (if rates go up by that much they'll probably just change the rules again). If passed the relief is effective for plan years beginning after December 31, 2011 (i.e., the 2012 plan year which drives the 2013 funding requirements).

So how the heck does this work? Let's use a hypothetical example, if the 25-year average segment rates were 4%, 6% and 8% for 2012 and we applied the funding relief rules then the cap is 110% of the 25-year average (4.40%, 6.60%, 8.80%) and the floor is 90% (3.60%, 5.40%, and 7.20%). As you can see in Exhibit 2 the percentages used to set the cap and floor widen each year until they hit 130% and 70% respectively for 2016 and beyond (yes, this is a permanent change to how discount rates are determined for funding purposes).

Exhibit 2: Proposed Floor and Cap on Funding Discount Rates for Pension Plan Years Starting in 2012

For calendar years:	Percentage of 25-year average segment rates	
	Floor:	Cap:
2012	90%	110%
2013	85%	115%
2014	80%	120%
2015	75%	125%
2016 or later	70%	130%

Source: Joint Explanatory Statement of the Committee Conference for the Highway Bill

If we compare the IRS segment rates from January 2012 (1.98%, 5.07% and 6.19%) to the hypothetical cap and floor above it's clear that each of the segment rates comes in below the floor. As a result the floor of 3.60%, 5.40% and 7.20% would be used to set the discount rate. If we assume a 15% weighting on the first segment, 50% on the second segment and 35% on the third segment, the weighted average discount rate would increase by 76 basis points from 5% to 5.76% in our hypothetical example. Assuming a 12-year duration, a 100 basis point increase in the discount rate would shrink the pension obligation by about 12% on a present value basis.

A smaller pension obligation helps reduce pension funding requirements by reducing the amount that the plan is underfunded. Remember companies are required to contribute to their pension plan the amount of any "funding shortfall" (i.e., underfunding) over seven years with interest plus the normal (i.e., service) cost of the plan.

Required contributions are typically due 20.5 months after the pension plan is measured which is at the beginning of the plan year (e.g., the contribution is not due until September 15, 2013 for a plan that was measured on January 1, 2012). However, a company may have to start making quarterly contributions earlier if the pension plan is underfunded two years in a row. For example, a company with a pension plan that is underfunded on both January 1, 2011 and January 1, 2012 would make quarterly contributions on April 15, July 15, October 15, 2012 and on January 15, 2013 (with a catch-up contribution due September 15, 2013). The amount of the quarterly contribution is based on 90% of the current years' required contribution or 100% of the prior year, whichever is smaller.

Kicking the Can Down the Road

Don't forget that pension funding relief does not change the company's underlying pension obligation (the retirement benefits that will eventually be paid to pension plan participants) it only shrinks the present value of that obligation which delays when the plans need to be funded (which can be very important to a company facing a liquidity crunch). That reduction in liquidity risk could provide a valuation boost to companies in the short-term. However, pension funding relief is just kicking the can down the road. Reducing the funding requirements in the short-term could result in larger required pension contributions and more pension risk in the long-term (unless the markets bail the plans out). Burying our head in the sand seems to be the preferred "solution" to many pension issues in the U.S.

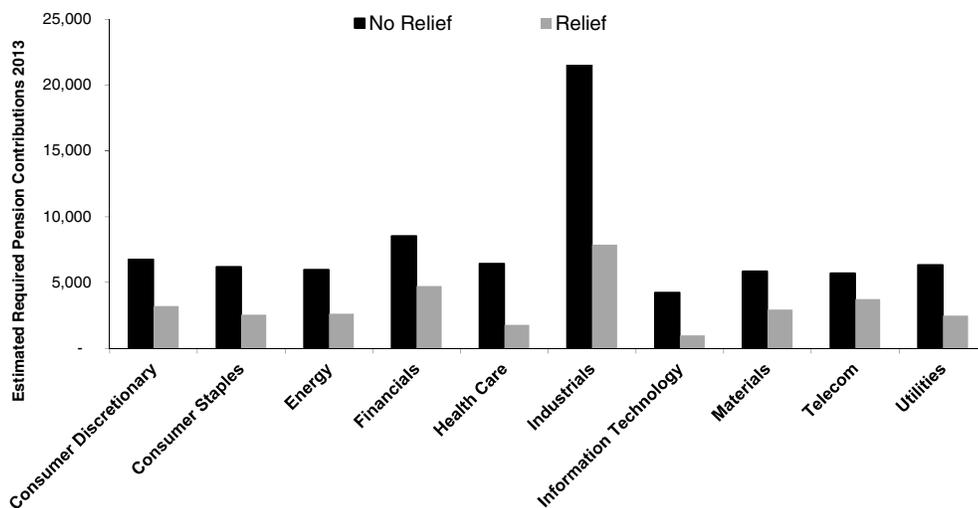
Estimated Impact of Pension Funding Relief on 2013 Contributions

With the 25-year average segment rates still up in the air we decided to run three scenarios through our pension forecast model to get a feel for the potential impact of the proposed funding relief on the 2013 funding requirements for the S&P 500 companies. We compared our estimate of 2013 pension contributions with relief assuming discount rates increased 50, 100 and 150 basis points to estimated pension contributions with no relief (using unadjusted segment rates).

At the low end, we estimate a 50 basis point increase in the discount rate could cut aggregate required pension contributions for the companies in the S&P 500 by \$22 billion in 2013. On the other hand a 150 basis point increase could cause the contributions to fall by \$63 billion next year. Smack dab in the middle, a 100 basis point increase in the

discount rate could drop S&P 500 pension contributions in 2013 by 58% from \$78 billion without relief to \$33 billion with relief. Focusing on the 100 basis point increase in discount rates, you can see in Exhibit 3, it's the companies in the Industrials sector that would "save" the most as a result of pension funding relief with 2013 required contributions falling by \$14 billion. We use the term "savings" to describe the benefits from pension funding relief loosely as the "savings" are temporary.

Exhibit 3: Estimated 2013 Pension Funding Requirements With and Without Pension Funding Relief¹ by Sector, S&P 500
US\$ in millions



¹Using 100 bps Increase in Funding Discount Rates

Note: S&P 500 as of June 20, 2012, excluding 17 companies for which we did not have all relevant data.

Source: Company data, Credit Suisse estimates

As for individual companies, we estimate that 2013 pension contributions could drop by more than \$100 million for 100 companies in the S&P 500 if discount rates were 100 basis points higher. To measure how significant the savings might be as a result of pension funding relief we compared the "savings" in 2013 to trailing five year average pre-pension cash flow from operations (that's cash flow from operations before pension contributions adjusted for taxes using a 35% tax rate). We estimate that the "savings" from pension funding relief in 2013 (assuming a 100 basis point increase in discount rates) is more than 5% of trailing cash flow for 107 companies in the S&P 500. Exhibit 4 includes the 10 companies with the largest estimated "savings" from pension funding relief as a percentage of trailing cash flow.

Exhibit 4: Top 10 Estimated “Savings” from Pension Funding Relief¹ in 2013 as a % of Trailing Five-Year Average Pre-Pension Cash Flow from Operations²
US\$ in millions

Company	Ticker	No Relief		Relief		D = B - C	D / A
		A	B	C	D = B - C		
		Trailing 5-Year Avg. Pre-Pension Cash Flow from Ops.	2013E Pension Contribution	2013E Pension Contribution	Pension	Estimated "Savings"	"Savings" / Trailing 5-Year Avg. Pre-Pension Cash Flow from Ops.
Boeing Co	BA	\$ 4,776	\$ 2,655	\$ -	\$ 2,655		56%
United States Steel Corp	X	762	355	134	221		29%
United Parcel Service Inc B	UPS	5,929	1,620	47	1,573		27%
Northrop Grumman Corp ³	NOC	3,015	734	-	734		24%
Goodyear Tire & Rubber	GT	730	498	324	175		24%
Rockwell Automation Inc	ROK	582	299	176	123		21%
Lockheed Martin	LMT	4,766	2,356	1,402	954		20%
Allegheny Technologies Inc	ATI	472	148	62	86		18%
PG&E Corporation	PCG	3,173	550	-	550		17%
Motorola Solutions, Inc ⁴	MSI	1,111	480	293	187		17%

¹Using 100 bps increase in funding discount rates

²Pre-Pension cash flow from operations represents cash flow from operations before pension contributions, adjusted for taxes assuming a 35% tax rates.

³Effective as of March 31, 2011, the company completed the spin-off of Huntington Ingalls Industries, Inc. (HII), a wholly owned subsidiary.

⁴Effective as of January 4, 2011, the company completed the split-off of Motorola Mobility Holdings Inc.

Note: S&P 500 as of June 20, 2012, excluding 17 companies for which we did not have all relevant data.

Note: When estimating pension contributions we make a number of simplifying assumptions in our S&P 500 model including not separating U.S., non-U.S., and non-qualified pension plans.

Note: See our January 9, 2012 report, *Pensions Punished, Look for Pension Contributions to Go Up* report for a discussion of government contractor pension cost reimbursement.

Source: Company data, Credit Suisse estimates

To further illustrate this analysis, let's take a look at Lockheed Martin as an example. We estimate that without pension funding relief, Lockheed Martin would have to contribute \$2.3 billion to its pension plan in 2013 (not too far off from the \$1-2 billion range that company CFO, Bruce Tanner gave during the first quarter earnings call.). However, if pension funding relief is put in place we estimate a required contribution of \$1.4 billion, providing a temporary “savings” of \$954 million which is 24% of trailing five year average pre pension cash flow from operations.

We make a number of simplifying assumptions to estimate required pension contributions in our S&P 500 pension forecast model, (see our January 9, 2012 report for a further discussion) including that we combine the U.S. and non-U.S. pension plans (along with qualified and non-qualified plans) when estimating the contributions. However, the pension funding requirements in the Pension Protection Act only apply to qualified U.S. pension plans, as would pension funding relief. This may be why we are estimating Boeing's 2013 required contribution to be \$2.7 billion without funding relief, while in the company's 2011 10-K they claim that their pension plans are 99% funded on an ERISA-basis and that they have minimal required contributions in 2012. Differences between our estimate and what the company is saying could be due to us including foreign and non-qualified plans in our estimate (which Boeing does not breakout separately). Another reason why our estimates may differ from the actual pension funding requirements is that we don't factor in ERISA funding credits. Remember ERISA funding credits are “excess” contributions that companies have made over the years which can be carried forward and used to offset their pension funding requirements.

Pension Funding Relief Good for Cash Flow, Not So Good for Earnings

Pension funding relief is typically not a positive for earnings. Why? Because of the magic of pension accounting, pension contributions are earnings accretive as long as the

expected rate of return on plan assets is above the cost of funding the contribution. Therefore, fewer contributions mean higher pension costs and lower earnings all else equal.

Even with Relief Companies May Contribute More Than What's Required

There are a few reasons why we might see companies (even with pension funding relief) contribute more than what's required to their pension plans, including: it might provide a boost to earnings, it provides a tax shield, it reduces PBGC premiums and it can help a company avoid benefit limitations that are triggered when certain funding levels are reached. For instance, if a plan drops below 80% funded on an ERISA basis, it can't pay full lump-sum benefits and among other restrictions it can't use its ERISA funding credits. As a result some companies may have a policy to fund their pension plan so that it remains above 80% funded.

That said don't be surprised if more companies borrow (at low current rates) to fund their pension plans (of course it's trading one piece of debt for another, but it can boost earnings and provide a big tax shield). There should be plenty of demand from other pension plans looking to get their hands on long duration fixed income assets.

Pension Funding Relief Plays Well in Washington

There are a few reasons why we expect the proposed pension funding relief to become the law of the land. For one, it's been done before. It seems like Washington hasn't met a pension funding relief it doesn't like. In fact each year since the Pension Protection Act has been in effect (which was meant to strengthen pension funding requirements) there has been one form of pension funding relief or another (see our March 10, 2010 report, *Pension Funding Relief, Again, Kicking the Can Down the Road*).

Pension funding relief plays so well in Washington since it's pitched as a job saver/creator (fewer pension contributions leaves more cash to hire workers) while at the same time raising revenue for the U.S. treasury. Why does pension funding relief result in more tax revenue? Because pension contributions are tax deductible, so the less that companies contribute to their plans the more taxes that they pay. In fact, pension funding relief is expected to generate over \$9 billion in tax revenue (that might be a bit high if the companies that benefit the most from the relief don't pay much in taxes).

There's another angle this time around, pension plan sponsors are looking for relief from the Fed and its low interest rate policy. John Quaid U.S. Steel's Treasurer highlighted this point at an investor day earlier this month: "As you know the Federal Reserve has been holding rates at exceptionally low levels and has stated their intention to continue to do so through 2014. While this can be helpful to the economy, it has the effect of significantly increasing defined benefit plan liabilities for funding calculation purposes under the Pension Protection Act as is currently written, and generally results in accelerated and excessive funding requirements for many plans." He went on to note that U.S. Steel and "many other plan sponsors are seeking targeted legislative reform to stabilize funding discount rates" in periods "of abnormally low or exceptionally high interest rates."

Companies Mentioned (Price as of 28 Jun 12)

Allegheny Technologies Inc. (ATI)
 Boeing (BA, OUTPERFORM, TP 85.00)
 Con Edison (ED, NEUTRAL, TP 60.00)
 Goodyear Tire & Rubber (GT)
 Lockheed Martin (LMT, NEUTRAL, TP 86.00)
 Motorola Solutions, Inc. (MSI, OUTPERFORM, TP 62.00)
 Northrop Grumman Corporation (NOC, NEUTRAL, TP 65.00)
 Raytheon Company (RTN, OUTPERFORM, TP 61.00)
 Rockwell Automation (ROK, OUTPERFORM, TP 92.00)
 United Parcel Service Inc. (UPS, OUTPERFORM, TP 95.00)

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