FitchRatings
KNOW YOUR RISK

Corporate Finance

Criteria Report

Analysis of U.S. Corporate Pensions

Analysts

Jamie Rizzo, CFA
+1 212 908-0548
james.rizzo@fitchratings.com

Timothy Greening
+1 312 368-3205
timothy.greening@fitchratings.com

Olu Sonola, CFA, CPA
+1 212 908-0583
olu.sonola@fitchratings.com

Dina Maher, CPA
+1 212 908-9175
dina.maher@fitchratings.com

Mark Oline
+1 312 368-2073
mark.oline@fitchratings.com

Related Research

- "The Evolving Pension Landscape," September 24, 2007.
- "Health Care Costs: The Continuing Burden for General Motors and Ford," February 26, 2007.
- "RBOC Pension Plans (A Competitive Issue?)," Oct. 19, 2005.
- "U.S. Utility Sector Pension Funding Update," Sept. 27, 2005.
- "OPEB – A Credit Perspective," Aug. 12, 2003.
- "The European Pensions Debate," Oct. 16, 2006.
- "European Pensions—The Debate Continues," Oct. 16, 2006.

Contents

Overview

The majority of non-financial U.S. Corporates rated by Fitch that have defined benefit pension plans are currently underfunded. As supplemental information, Fitch adjusts several credit metrics for pension liabilities and cash outflows in order to assess any potential liquidity concerns that may arise due to future funding requirements. Specifically, Fitch analysts will look at the following ratios on a qualitative and quantitative basis to assess the state of a company's pension plan.

- Funded status of pension plan: Fair value of assets/projected benefit obligation (PBO);
- Leverage adjusted for pension obligations ([debt + pension unfunded liability]/[EBITDA + pension expense]);
- Adjusted leverage including pension ([debt + off-balance-sheet obligations + operating lease adjustments + pension unfunded liability]/[EBITDA + rent expense + pension expense]);
- Expected pension contributions/adjusted funds from operations (FFO).

The first ratio listed above acts as an initial screening process since a company with a funded status >100% typically will not require much further analysis. The two adjusted leverage ratios also provide a level of materiality for Fitch analysts when assessing the company's obligations in relation to its operations and other obligations. Importantly, the final ratio—expected pension contributions/adjusted FFO—allows the analyst to see what portion of cash flows is claimed by the company's future funding requirements as mandated by the Pension Protection Act of 2006 [PPA]. Forecasting these outflows helps the analyst determine if adequate funding resources are available and whether or not potential liquidity concerns could arise. This paper generally focuses on the FFO analysis.

Pension unfunded liabilities can vary materially year to year due to changes in stock market returns and actuarial assumptions that are used in calculating such liabilities, as well as changes in regulatory guidelines. This variability makes the liability less predictive from an obligation standpoint than scheduled amortization, lease obligations, guarantees, etc. In addition, there is flexibility related to the timing and amount of funding such obligations. As such, Fitch only uses this data as supplemental information to indicate if further cash flow analysis and discussions with management must take place related to future funding strategies.

Fitch's analysis focuses on the cash aspects of pension obligations, recognizing that there can be a wide variance between reported pension expense from the income statement and actual cash contributions, particularly during periods of market volatility. This report is applicable for all non-financial industrial U.S. Corporates; however, we note certain nuances may be relevant for specific industries that are not fully covered in this report. For example, utilities regulated on a cost-of-service basis may be able to apply for higher tariffs to recoup pension expenses. Please see the Related Research on page 1 for additional detail.

PPA Guidelines and Pension-Funded Status of Fitch-Rated Companies

A company's pension liability (or underfunded status) is simply the present value of the existing and future benefits the company has agreed to pay in the form of the pension, also known as the PBO, less the fair value of the plan's assets. Calculating the PBO is complex, as it includes assumptions about future wage increases, inflation, attrition, employees' life spans and other factors.

Pension funding requirements continue to be manageable for the majority of companies under Fitch's U.S. Corporate coverage universe. The median funding level for the companies under Fitch's coverage stood at 88% at fiscal year-end 2006, up from 80% at year-end 2005. The improvement in funding levels was primarily the result of significant returns on plan assets, representing broad stock index gains, combined with higher company contributions. The average unfunded pension liability per company fell to $212 million as of year-end 2006 from $500 million at year-end 2005.

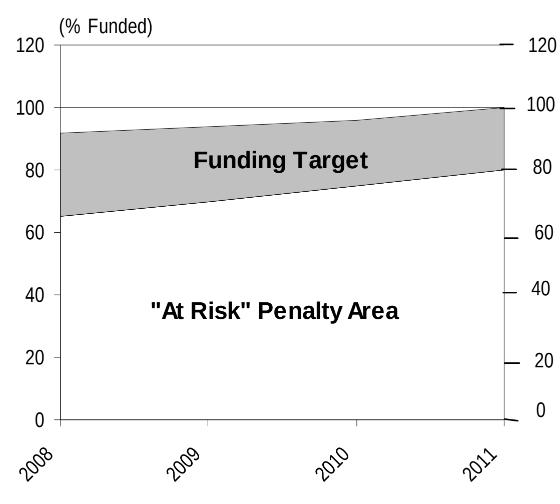
Historically, minimum funding requirements were based on a variety of factors, including meeting Employee Retirement Income Security Act (ERISA) requirements, taking advantage of tax benefits, or avoiding Pension Benefit Guaranty Corporation (PBGC) premiums. With the introduction of the PPA, Fitch analysts typically will tie a company's expected minimum funding requirement back to what is required under Title I of the PPA, which establishes new minimum funding standards for qualified defined benefit pension plans. The PPA does not govern funding of non-qualified plans other than to restrict funding if qualified plans are less than 80% funded. Non-qualified plans typically refer to pensions for existing or former executives of the company, the contributions of which are not tax-deductible. Therefore companies typically do not pre-fund their non-qualified plans and generally have greater flexibility around the funding of such obligations.

At present, Fitch analyzes two funding thresholds under the PPA guidelines:

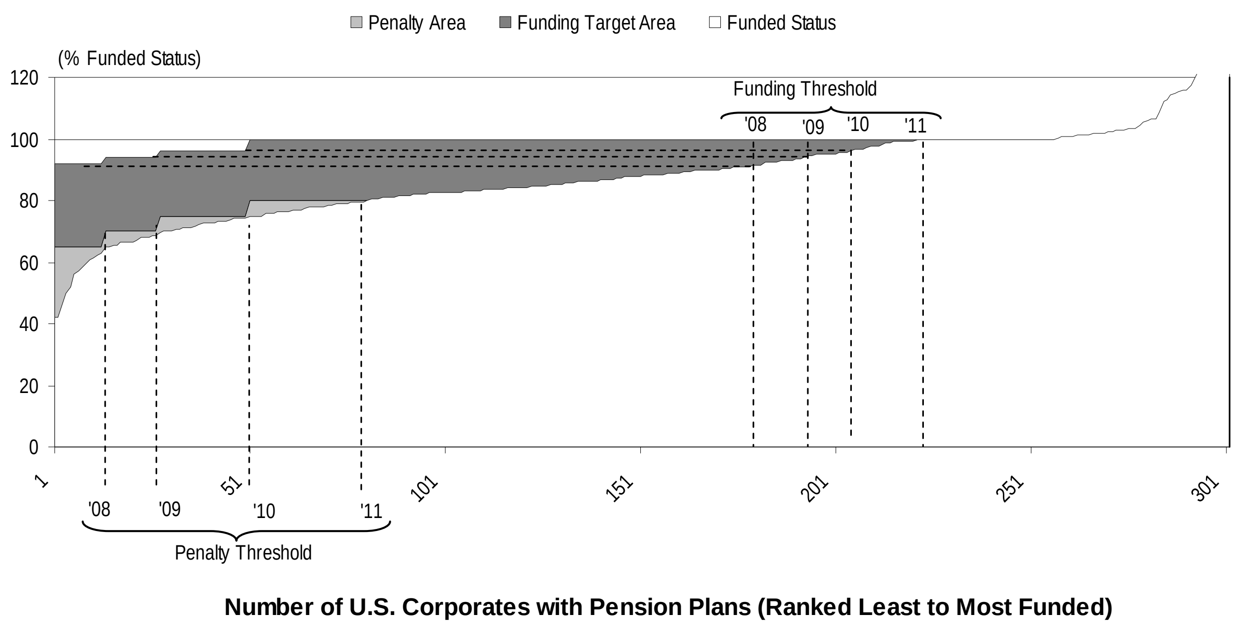
- **Funding Target Threshold:** Under the PPA provision, plans would be required to fund 100% of their PBO (the 100% goal being referred to as the company's "funding target"). The PPA provides transition relief by phasing in the funding target over four years—92% for 2008, 94% for 2009, 96% for 2010 and 100% for 2011.
- **"At Risk" Threshold:** In addition, the PPA introduced special rules for severely underfunded plans that are designated as "at-risk" plans—i.e., plans that are less than 80% funded under normal actuarial assumptions. (Note: At-risk plans can also include plans that are less than 70% funded using worst-case scenario assumptions, e.g., using the earliest possible retirement dates for employees; however, for the illustrative purposes of this report we only focus on the normal definition.) The PPA provided a transition provision by reducing the 80% criteria to 65% for 2008, 70% for 2009 and 75% for 2010.

As the Funded Status chart on page 3 shows, approximately 224 total non-financial U.S.

Target Funding Requirements



2006 Funded Status Versus Future PPA Thresholds



PPA – Pension Protection Act of 2006.

Corporates rated by Fitch fall below the 2011 funding target threshold of 100%. This represents approximately 56% of the approximately 400 non-financial U.S. Corporates rated by Fitch (and approximately 74% of the approximately 300 non-financial Corporates rated by Fitch with a pension plan). Importantly, the majority of the underfunded companies currently have a funded status between 80%–99%, which puts them outside of the at-risk penalty area. Of the companies that are less than 80% funded, only 15 (4% of total companies under Fitch coverage) have a funded status below the 2008 threshold of 65% (with the median funded status of these companies at 58%), and 80 companies (20% of the total) have a funded status below the 2011 at-risk threshold of 80% (the median funded status of these companies is 73%). It is important to point out that these statistics are based on 2006 pension data and that the majority of underfunded companies have adequate cash flows to support funding their shortfall over the applicable period mandated by the PPA.

Fitch's Analysis of Future Pension Outflows

Fitch's analysis of U.S. Corporate pension liabilities has always revolved around near-term expected minimum funding requirements and the impact to company cash flows and liquidity, while still recognizing that longer-term pension liabilities and their potential volatility remain risk factors.

"At-Risk" Analysis

Plans that have been at risk for at least two of the past four years will have to pay a penalty (loading factor) of 4% of plan liabilities plus an additional $700 per participant.

Fitch's analysis of the at-risk penalty looks at two scenarios: 1) Does the company have adequate liquidity and cash flows to withstand the loading factor penalty?; and 2) Does the company have adequate liquidity and cash flows to meet the at-risk minimum threshold through company contributions (and therefore avoid the penalty all together)?

Fitch factors in funding of future service cost, in addition to closing the current deficit, as any incremental service cost not funded would expand the deficit. Fitch generally will use the most recent year's service cost as a general proxy for future year service costs. Future interest costs and actual return on plan assets are estimated to be net neutral for the purposes of projecting future funding requirements; however, Fitch may run sensitivity analysis related to shortfalls in actual return on plan assets when applicable.

Example #1: Funding to the "At-Risk" Threshold — Company A

($ Mil.)

	2008	2011
Existing PBO	500	500
Existing Funded Status (%)	50	50
PPA "At Risk" Threshold (%)	65	80
Deficit (%)	15	30
Gross Deficit	75	150
Service Cost	30	30
Subtotal	105	180
Funds from Operations (FFO)	2,000	2,000
Plus: Pension Contributions *	25	25
Adjusted FFO	2,025	2,025
Outflow As % of Adjusted FFO (%)	**5**	**9**

*Represents most recent year contribution. PBO – Projected Benefit Obligation. PPA – Pension Protection Act.

Example #2: Funding to the 100% Funding Target Over 7 Years — Company A

($ Mil.)

Pension Underfunded Status	250
Pension Funded Status (%)	50

	2008P
Annual Funding Requirements*	36
Annual Service Cost	30
Plus: At-Risk Penalties	20
Gross Subtotal	86
Funds from Operations (FFO)	2,000
Plus: Pension Contributions**	25
Adjusted FFO	2,025
Outflow as % of Adjusted FFO (%)	**4**

*Underfunded status divided by 7 years. **Represents most recent year contribution.

Since the initial screening process is used to determine which companies may require further analysis, pension liabilities and contributions are initially calculated on a before-tax basis. Should the analyst determine that future funding could be material and that further analysis is needed, the analyst will then take into account the potential tax deductibility when projecting FFO and free cash flow.

Even though the PPA determines “at risk” status by the percentage of the PBO which is funded, that percentage alone is an unreliable guide to the potential future cash contributions and the materiality of those contributions to the company’s overall cash flows. For example, Company A’s pension plan currently sits at 50% funded (see example #1 above). In order for the company to meet the 65% 2008 at-risk threshold, it would have to make gross contributions of $75 million. Factoring in service cost, the company would have to make contributions of 5% of expected FFO, not a material amount from a credit perspective. Looking out to the 2011 at-risk threshold of 80%, the company would have to make contributions of approximately 9% aggregate of existing FFO. Again, this is not a material amount from a credit perspective, especially when considering that the company has four years to meet the 2011 threshold, amounting to approximately 2% of FFO over each of the next four years (before any increases in FFO or tax deductions are taken into account).

Funding Target Analysis

Per the PPA, if a plan does not meet the 100% funding target, the minimum required funding contribution for the year will be equal to the present value (PV) of benefits earned by participants during the current year (i.e., service cost) plus the amount needed to amortize any funding shortfall over no longer than 7 years (down from 30 years under prior ERISA rules). As such, Fitch analysts will review funding the company’s shortfall from the funding target over a seven-year horizon to determine if a liquidity issue could arise (Fitch notes that the four-year transition relief period gives companies additional flexibility and would take such flexibility into account when applicable).

Looking at Company A under the funding target scenario (example #2 above) yields a similar result as their at-risk threshold—that is, given that the company has seven years to fund its existing shortfall, total cash outflows needed to get to 100% funded status is not a material portion of annual FFO (4%) even when the loading factor is included since the plan is below the 65% at-risk threshold (the company would likely fund to the at-risk threshold in order to avoid this penalty all together).

So while the initial 50% funded status of Company A may be an outlier in the screening process, the small claim on annual FFO as a result of meeting PPA funding requirements lets the analyst determine that no further analysis is necessary.

If the analyst determines that, in conjunction with the current business prospects of the company and its industry, a liquidity issue could arise in funding its pension plan to the 100% target, further discussions will take place with management regarding specific plans, funding sources, the expected tax shield from such funding, and time frames for meeting the PPA requirements. This is an important qualitative point that combines various aspects of the company's operations and capital structure. Cyclical companies with sensitive business operations could experience material swings in their pension obligations in relation to cash flow if business cyclicality hits a downturn at the same time that pension assets decrease or obligations increase due to extenuating factors.

Additional Considerations

As a different example, Company B's pension plan currently sits at 80% funded and therefore avoids any "At Risk" penalties (example #3). On the surface, one might think that Company B is in a much better position relative to Company A given the differential in funded status. However, because of the absolute size of its PBO under funded status, its near-term cash obligations needed to bridge its 100% funding target over the next 7 years are far greater than Company A's (relative to its FFO). Specifically, Company B will have to allocate 9% of its annual FFO over the next seven years toward bridging the funding target gap that currently exists.

Pinpointing a specific level of materiality of pension outflows as a percentage of FFO is dependent on many factors, including the general stability of cash flows, growth prospects of the business, other claims on cash flows (working capital usage, large dividend, significant maintenance capital expenditures) and liquidity resources (cash, "available for sale" [AFS] securities, non-core assets). Generally, for a business with predictable cash flows and good growth prospects, anything in excess of 10% would cause Fitch analysts to further discuss funding strategy with management.

The material claims on Company B's cash flows are somewhat mitigated by its strong cash balance. As shown, Company B's cash balance exceeds its pension underfunded status by 3.0 times (x), which, if ever funded 100%, would significantly drop the claims on the company's FFO. In addition, Company B is currently and expected to continue to be profitable, thereby giving the company a tax benefit in its pension funding. On the flip side, the company does have a significant dividend commitment that results in pension outflows being a material portion of annual free cash flow.

Fitch analysts will also take into account PBO assumptions that it believes are overly aggressive, by adjusting the PBO based on sensitivity estimates that companies are required to provide in their financial statement footnotes. The PPA guidelines address such assumptions and somewhat alleviate the need for material adjustments. Specifically, Titles III and IV of the PPA bring a more standardized format for interest rates used in PBO calculations by segmenting interest rates based on when the liabilities come due, thereby reducing the possibility of a material variance between companies.

Example #3: Funding to the 100% Funding Target Over 7 Years — Company B

($ Mil.)

General Information:	
Pension Underfunded Status ($)	1,050
Pension Funded Status (%)	80

Pension Funding Requirement ($)*	150
Service Cost ($)	40
Multi-employer contribution ($)	30
Plus: At-Risk Penalties ($)	0
Gross Subtotal ($)	220
Funds from Operations (FFO) ($)	2,250
Plus: Pension Contributions ($)**	315
Adjusted FFO ($)	2,565
Outflow As % of Adjusted FFO	**9**
Other Considerations:	
Cash and Equivalents ($)	3,250
Annual Dividend ($)	700
Cash/Pension Underfunded Status (x)	3.0
Service Cost/Adjusted FF0 (%)	2

*Underfunded status divided by 7 years. **Represents most recent year contribution.

Summary of Example Companies

(%)

Company	Pension Funded Status	Pension as a % of Annual FFO	Concerns/Mitigants
A	50	4	Despite only 50% funded pension, expected cash outflows are immaterial relative to FFO.
B	80	9	Despite having a better Funded status than Company A, claims on cash flows are material especially when factoring in its large dividend. Credit concerns somewhat mitigated by large cash balances, stable cash flows, and expected tax-deductibility of future contributions.

After initial screener data, if applicable, Fitch analysts take the following additional factors into account when determining the magnitude of pension funding obligations on future cash flows:

- Stability of business, cash flows, industry;
- Other claims on cash flows (dividends, discretionary versus maintenance capital expenditures, etc.);
- Portion of underfunded status attributable to non-qualified plans;
- Tax-deductibility of future contributions;
- Liquidity resources (cash, non-core assets);
- Growth prospects;
- Other considerations.

Finally, Fitch analysts will also take into account cash outflows related to when a company is party to a multi-employer pension plan. If there is a material underfunded status present and/or significant cash outflows related to the multi-employer plan, analysis will take into account committed annual cash funding requirements, potential flexibility to renegotiate contributions, and the financial profile and liquidity of other members of the plan.

Summary

Fitch's analysis and the above examples are mainly intended to provide an indication of a company's ability to meet its future cash outflows. In assessing a company's pension obligations, Fitch will first analyze "screener" data such as funded status, adjusted leverage ratios, and expected pension contributions as a percentage of FFO in determining whether or not further analysis needs to take place. If so, Fitch analysts' main objective is to assess future cash outflows (as mandated by the PPA) in conjunction with the company's future cash flow projections. If warranted by the screener output, the more detailed analysis will take into account the stability of the business, growth prospects, tax-deductibility of pension outflows, timing of funding, existing liquidity, other significant investment/ financing outflow commitments, and the portion of commitments that is from non-qualified plans, among other things, to determine the true magnitude of such funding obligations.