Accounting & Tax Research

Don't Count on Pension Boost to Cash Flows

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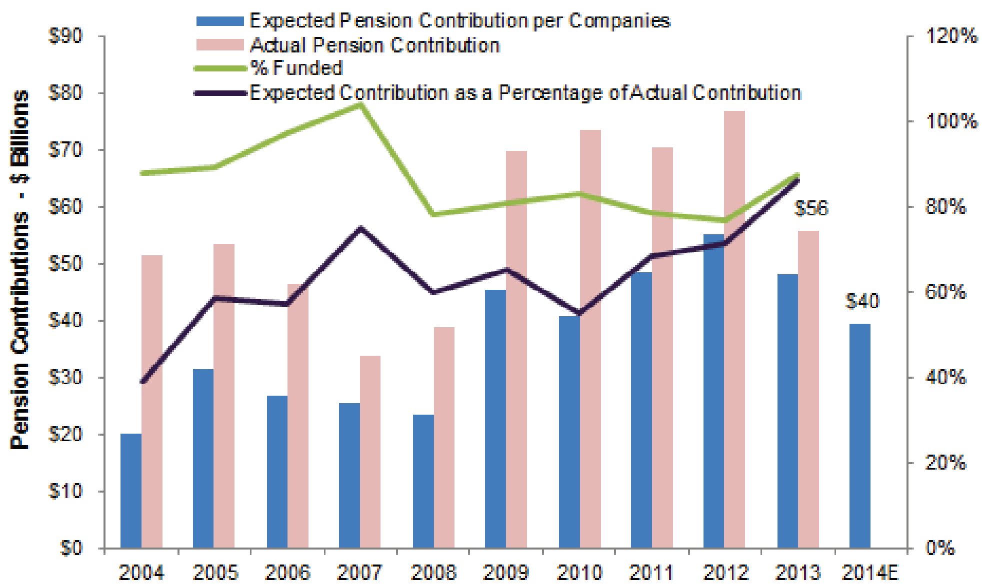
Contributions Tend to Be More than Expected, Plus a Few Headwinds

Exhibit 1: Actual and Expected Pension Contributions 2004-2014E, S&P 500



Note: Expected pension contributions are the company estimates disclosed in prior year 10-Ks.
Expected pension contributions are taken to be the midpoint when the company provides a range.
Source: Company filings and ISI Group estimates

- **S&P 500 companies are expecting to contribute $16 billion less to their pension plans in 2014, providing a potential boost to cash flows.** There are 44 companies where it could drive up cash flows by more than 5%. Lower pension contributions could mean more cash to reinvest in the business, pay a dividend, pay down debt, buy back stock, do some M&A etc.
- **Be careful with company estimates of pension contributions.** Over the past ten years the S&P 500 companies contributed more to their pension plans than they were expecting 71% of the time and their estimates aren't all that accurate as pension contributions were within plus or minus 10% of the company's "best estimate" only 28% of the time.
- **Don't count your cash flow chickens before they hatch.** Before counting on the cash freed up by lower pension contributions to be a sustainable source of funding for a buyback, increased capex, etc. don't forget that companies tend to contribute more to their pension plans than expected, pension contributions already fell by 27% last year to $56 billion (the lowest level since 2008) and last but not least the plans are facing a few headwinds which could keep contributions elevated, including new mortality tables coming this year (resulting in larger pension obligations), withering pension funding relief and it's been a tough year for pensions so far (interest rates are down and the stock market has produced very little return).

*See the last page for an important disclosure regarding these stocks and this report.

Don’t Count on Pension Boost to Cash Flows

2013 was a very good year for many defined benefit pension plans, the combination of a soaring stock market and higher interest rates helped the funded status of the S&P 500 pension plans improve by $235 billion, from $463 billion underfunded (77% funded) in 2012 to $228 billion underfunded (88% funded) at the end of 2013. That’s the biggest one year improvement in pension funded status in quite some time, but it was not as good as the $300 billion improvement that we had been looking for (see our January 9, 2014 report, *Pension Party, Rates Up + Stocks Up = Over $300 Billion Jump in Funded Status*). The biggest disconnect between our estimates and what actually happened was that the pension obligations did not shrink by as much as expected driven mostly by companies using lower discount rates than we had assumed.

Regardless, the plans got healthier last year and that’s good news for a number of reasons, including that it should result in lower pension costs (boosting earnings). More important in theory is that a better funded pension plan has less of a claim on the company (leaving more for the shareholders) and companies might contribute less to their pension plans (boosting cash flows). So instead of making pension contributions the company could reinvest in the business, pay a dividend, pay down debt, buy back stock, do some M&A etc.

Party Pooper, Improvement in Funded Status Might Not Be Sustainable

Higher earnings and higher cash flows sure do sound like a pension party. But before you start doing the Kid N Play dance ask yourself whether it’s sustainable. Because if the improvement in the pension plan is only temporary you might not want to give companies too much credit for it. In other words you need to take into account the risk in the plan, sure most pension plans are healthier but if the company hasn’t done anything to try and protect the plan’s health it could head right back down the pension roller coaster again resulting in increased pension underfunding, higher contributions (drag on cash flows) and higher pension costs (drag on earnings).

Especially since pension plans are facing a few headwinds including new mortality tables coming this year which will show people living longer resulting in larger pension obligations (that’s not in anyone’s numbers, yet), increased PBGC premiums and pension funding relief (MAP-21) is withering over the next few years which could eventually drive pension contributions higher (unless Congress provides yet another round of relief). In addition this year has been a tough one for pensions so far, interest rates are down around 50 basis points and the stock market is up only about 2.5% (S&P 500).

Pension Contributions Headed Lower in 2014…We’ll Believe It When We See It

But last year was a good one for pensions so companies will be contributing less to their pension plans this year, right? Not so fast, the big pension boost to cash flows might have already happened, last year. The S&P 500 companies contributed $56 billion to their pension plans in 2013, that’s down 27% from the $77 billion contributed in 2012 and the lowest level since 2008. The $21 billion drop in pension contributions may have helped drive cash flow from operations 1% higher in the aggregate (assuming that all pension contributions are in cash and tax deductible using a 35% tax rate). The sectors where cash flows benefitted the most are Industrials (4%), Telecom (4%) and Consumer Staples (2%).

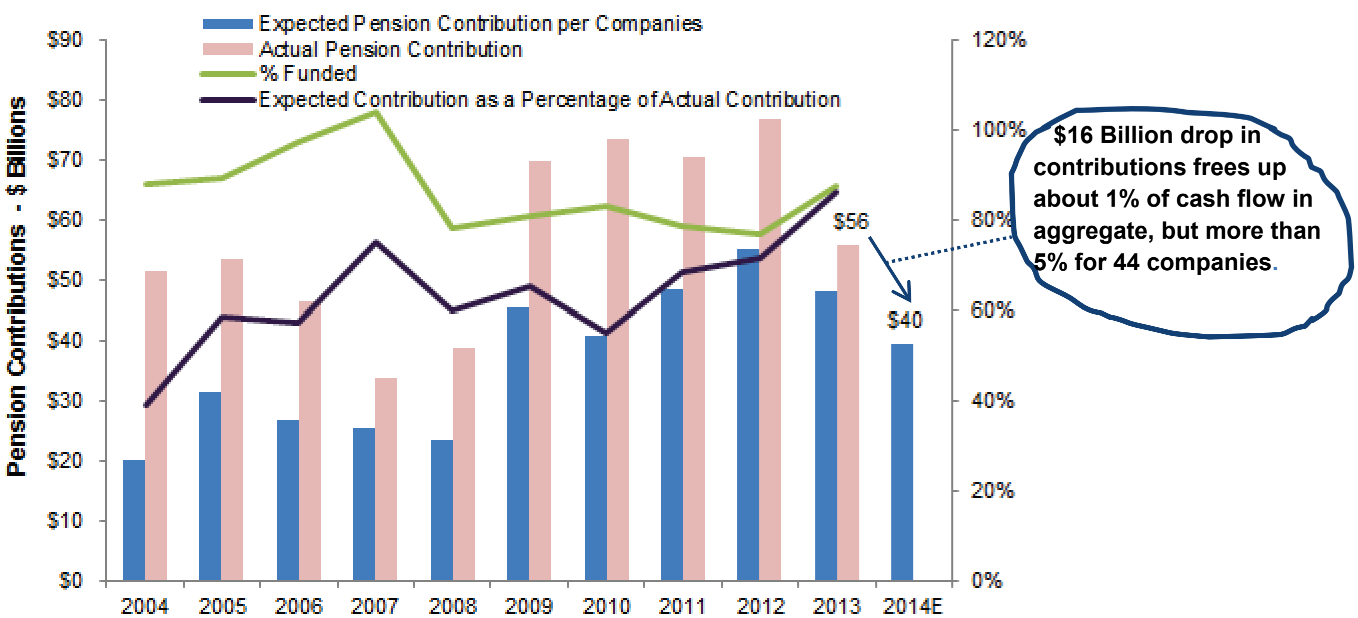
According to the companies' own estimates, pension contributions will head even lower in 2014 helping drive cash flows higher. Remember, companies are required to disclose (annually) their "best estimate" of the contributions they expect to make to the pension plan during the next fiscal year (there are even a handful of companies that go beyond that). The focus of this report is on pension contributions and how they might change this year relative to last year (we plan to follow up with a look at pension contributions in 2015 and beyond using our pension model which provides a five year forecast of required contributions).

Companies Tend to Contribute More to Pensions Than Expected

In *Exhibit 2* we compare expected pension contributions in the aggregate for the S&P 500 (that we pulled from the 10-Ks for each company) to actual contributions for the past ten years. As you can see the actual contributions came in higher than expected each year, the estimates were closest in 2013 (86% of actual).

When we look to 2014 we find that the S&P 500 companies are expecting to contribute $40 billion to their pension plans that's down $16 billion or 28% from the $56 billion contributed during 2013. We'll have to wait and see whether that actually results in lower pension contributions, if the past is any indicator look for contributions to come in higher than expected especially if the plans have a rough year.

Exhibit 2: Actual and Expected Pension Contributions 2004-2014E, S&P 500



Note: Expected pension contributions are the company estimates disclosed in prior year 10-Ks.
Expected pension contributions are taken to be the midpoint when the company provides a range.
Source: Company filings and ISI Group estimates

The expected drop off in pension contributions this year would impact some sectors more than others as you can see in *Exhibit 3.* Consumer Discretionary would see the biggest drop off in pension contributions at nearly $5 billion followed by Industrials, Health Care and Financials. On the other hand there are only two sectors where pension contributions are expected to increase in 2014, Energy and Telecom.

Exhibit 3: Expected Change in Pension Contribution This Year by Sector, S&P 500

$ in millions

	Pension Contribution		Increase / (Decrease) in Contribution		Expected Drop in Contribution			Expected Increase in Contribution			Pension Contribution Expected to Stay the Same
Sector	**2013**	**2014E**	**$**	**%**	**Companies**	**$**	**%**	**Companies**	**$**	**%**	**Companies**
Consumer Discretionary	$ 10,376	$ 5,440	$ (4,936)	(48%)	30	$ (5,236)	(58%)	11	$ 300	22%	2
Consumer Staples	4,651	3,419	(1,232)	(26%)	25	(2,431)	(65%)	8	1,198	133%	1
Energy	4,909	5,166	257	5%	20	(1,260)	(49%)	12	1,518	66%	4
Financials	5,409	2,968	(2,441)	(45%)	35	(2,699)	(54%)	13	258	63%	7
Health Care	4,807	1,931	(2,877)	(60%)	27	(2,907)	(61%)	5	30	134%	4
Industrials	13,615	9,716	(3,899)	(29%)	28	(4,668)	(48%)	20	770	20%	5
Information Technology	2,889	2,444	(445)	(15%)	12	(808)	(42%)	8	362	38%	3
Materials	3,756	2,836	(920)	(24%)	20	(1,197)	(45%)	9	277	25%	0
Telecommunication Services	553	2,442	1,889	342%	1	(23)	(16%)	4	1,912	470%	0
Utilities	4,925	3,820	(1,104)	(22%)	17	(1,645)	(51%)	12	541	32%	2
S&P 500	**$ 55,890**	**$ 40,182**	**$ (15,708)**	**(28%)**	**215**	**$ (22,873)**	**(54%)**	**102**	**$ 7,166**	**55%**	**28**

Note: Expected pension contributions are the company estimates disclosed in the 2013 10-K. Expected pension contributions are assumed to be the midpoint when the company provides a range.
Source: Company Filings and ISI Group estimates

When we drill down to individual companies we find that of the 345 companies in the S&P 500 with defined benefit pension plans there are 215 expecting a drop off in pension contributions in 2014, 102 companies are expecting to see an increase and 28 companies are expecting no change. At the top of the list are the ten companies on the left hand side of *Exhibit 4* expecting the biggest drop off in pension contributions (those companies account for 40% of the aggregate drop). On the right hand side of *Exhibit 4* are the ten companies that expect to see the biggest year-over-year increase in pension contributions.

Exhibit 4: Biggest Expected Drop & Increase in Pension Contributions This Year, S&P 500

$ in millions

		Pension Contribution		Expected Drop in Contribution				Pension Contribution		Expected Increase in Contribution	
Ticker	**Company**	**2013**	**2014E**	**$**	**%**	**Ticker**	**Company**	**2013**	**2014E**	**$**	**%**
F	FORD MOTOR CO	$ 5,387	$ 1,900	$ (3,487)	(65%)	VZ	VERIZON COMMUNICATIONS INC	$ 107	$ 1,400	$ 1,293	1208%
LMT [1]	LOCKHEED MARTIN CORP	2,250	1,000	(1,250)	(56%)	XOM	EXXON MOBIL CORP	1,020	2,200	1,180	116%
BA [2]	BOEING CO	1,542	750	(792)	(51%)	PG	PROCTER & GAMBLE CO	391	1,463	1,072	274%
CSC	COMPUTER SCIENCES CORP	748	123	(625)	(84%)	T [4]	AT&T INC	209	735	526	252%
ALL	ALLSTATE CORP	561	38	(523)	(93%)	GE	GENERAL ELECTRIC CO	898	1,328	430	48%
CVX	CHEVRON CORP	1,211	700	(511)	(42%)	ETR	ENTERGY CORP	163	400	237	145%
NOC	NORTHROP GRUMMAN CORP	579	74	(505)	(87%)	GT [5]	GOODYEAR TIRE & RUBBER CO	1,127	1,300	173	15%
JNJ [3]	JOHNSON & JOHNSON	565	74	(491)	(87%)	MSI	MOTOROLA SOLUTIONS INC	182	335	153	84%
KO	COCA-COLA CO	639	175	(464)	(73%)	AA [6]	ALCOA INC	473	625	152	32%
MMC	MARSH & MCLENNAN COS	646	185	(461)	(71%)	COP [7]	CONOCOPHILLIPS	400	494	94	24%

1: Company expects a CAS recovery of $1.6 billion in 2014 compared to expected contribution of $1.0 billion.
2: As a result of the amendments made to the company's retirement plans in the first quarter of 2014, about 80% of its workforce will be covered by defined contribution plans.
3: The expected contributions include the projected future minimum contributions to the unfunded retirement plans. These amounts do not include any discretionary contributions that the Company may elect to make in the future.
4: AT&T contributed preferred equity interest in its Mobility business worth about $9 billion to the pension trust in 2013. The trust is entitled to receive cumulative cash distributions of $560 million per annum and those amounts are considered as contributions to the plan. The preferred equity interest in Mobility is considered an asset under ERISA. However, since it is not unconditionally transferable to a third party, it is not considered an asset under GAAP. While the preferred equity contributions did not involve cash, they were tax deductible and reduced the cash taxes for 2013 and as a result boosted the 2013 cash flows.
5: Company expects to contribute approximately $1.3 billion to it's funded U.S. and non-U.S. pension plans in 2014, inclusive of it's first quarter 2014 U.S. pension contribution of approximately $1,150 million, which included discretionary contributions of approximately $900 million.
6: $90 million of $625 million relates to the shutdown of capacity at a smelter in Canada.
7: The company expects to pay $560 million to its pension and post-retirement plans. This amount was prorated based on the 2013 actual contributions to pension and post-retirement plans.
Note: Expected pension contributions are the company estimates disclosed in the 2013 10-K. Expected pension contributions are assumed to be the midpoint when the company provides a range.
Source: Company Filings and ISI Group estimates

Lower Pension Contributions Could Boost Cash Flow, If They Happen

In the aggregate we estimate the expected drop off in pension contributions of nearly $16 billion frees up about 1% of trailing five year average cash flow from operations (assuming all of the contributions are in cash and are tax deductible using a 35% tax rate). Not all that significant in the aggregate, but a different picture emerges when you take a look at specific companies, we find 44 companies where the projected drop in pension contributions would provide a more than 5% boost to cash flow from operations, including the ten companies in *Exhibit 5* that are at the top of the list where lower pension contributions could drive cash flow higher by more than 13%.

Exhibit 5: Biggest Boost to Cash Flow from Expected Drop in Pension Contributions

$ in millions		Pension Contribution		Expected Drop in Contribution		5-Year Average Trailing Cash Flow	Tax Effected Drop in Contribution as a % of Cash
Ticker	Company	2013	2014E	$	%	from Operations	Flow from Operations[1]
CSC	COMPUTER SCIENCES CORP	$ 748	$ 123	$ (625)	(84%)	$ 1,498	(27%)
MMC	MARSH & MCLENNAN COS	646	185	(461)	(71%)	1,146	(26%)
LMT [2]	LOCKHEED MARTIN CORP	2,250	1,000	(1,250)	(56%)	3,416	(24%)
X	UNITED STATES STEEL CORP	226	140	(86)	(38%)	255	(22%)
F	FORD MOTOR CO	5,387	1,900	(3,487)	(65%)	11,232	(20%)
PKI	PERKINELMER INC	57	11	(46)	(81%)	170	(18%)
JOY [3]	JOY GLOBAL INC	166	45	(121)	(73%)	524	(15%)
NOC	NORTHROP GRUMMAN CORP	579	74	(505)	(87%)	2,365	(14%)
HOG	HARLEY-DAVIDSON INC	177	-	(177)	(100%)	859	(13%)
BWA [4]	BORGWARNER INC	150	20	(130)	(87%)	639	(13%)

1: We assume the pension contributions are all in cash and are tax deductible with a 35% tax rate.
2: Company expects a CAS recovery of $1.6 billion in 2014 compared to expected contribution of $1.0 billion.
3: The Company expects to contribute approximately $40.0 million to $50.0 million in fiscal 2014.
4: The Company expects to contribute a total of $15 million to $25 million into its defined benefit pension plans during 2014
Note: Expected pension contributions are the company estimates disclosed in the 2013 10-K. Expected pension contributions are assumed to be the midpoint when the company provides a range.
Source: Company Filings and ISI Group estimates

There are some companies that have highlighted lower pension contributions as helping to free up cash for other purposes, for example Dan Glaser the President and CEO of Marsh & McLennan had the following to say during the first quarter earnings call:

> *With this level of growth combined with lower calls on our cash for pension and restructuring, we anticipate generating substantially higher levels of cash flow for dividends, share repurchase, and acquisitions. In 2013 we allocated $1.2 billion to these three items. In 2014, we expect capital available for dividends, share repurchase, and acquisitions to grow 75% to $2.1 billion*

Not the Highest Quality Cash Flow

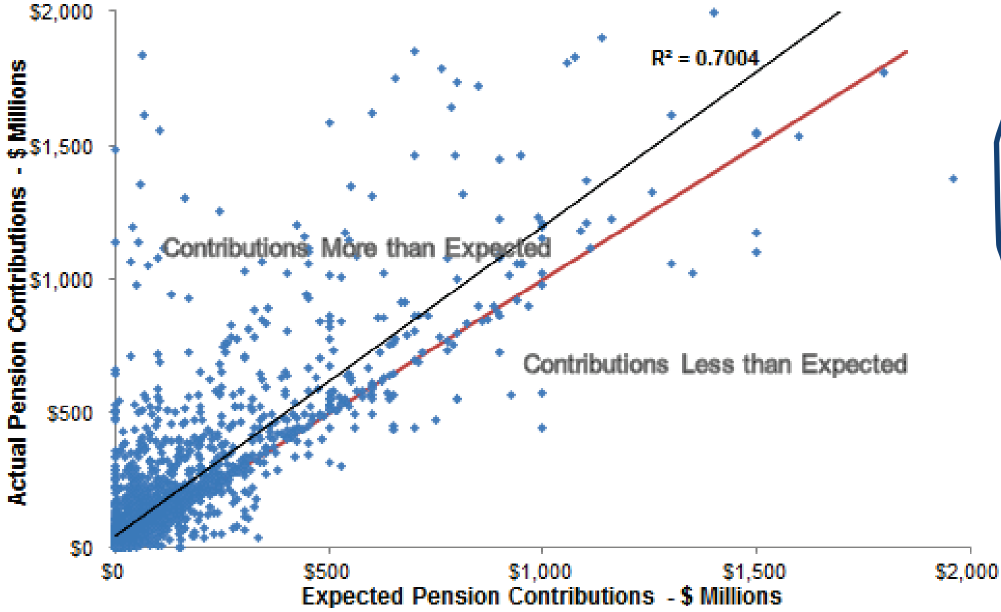
But we'd suggest some caution before counting on the cash freed up by lower pension contributions to be a source of funding for a buyback, dividend, increased capex, etc. For example, over the past ten years the companies in *Exhibit* 5 contributed more to their pension plan than expected 72% of the time, including three companies (Lockheed Martin, Northrop Grumman and Harley Davidson) where pension contributions came in higher than expected every year. The only company where contributions came in lower than expected more often than not was Ford, but that might be due to rounding more than anything else.

As for the 102 companies that are expecting to see an increase in pension contributions, there are only five (Goodyear Tire, Motorola, Northern Trust Corp, Alcoa Inc and LSI Corp) where the after-tax increase is more than 5% of the trailing five year average cash flow from operations.

Be Careful With Company Estimates

Before you get too carried away with the analysis so far and give companies credit for the additional cash flow that they could have in 2014 because of a drop in pension contributions, you might want to know whether these estimates are any good. To find out, we compared what companies have been saying they were going to contribute to their pension plans for the past 10 years (ever since the disclosure was required) with what companies actually put in the plan. As you can see in *Exhibit 6*, companies tend to contribute more to their pension plans than what they had been expecting. That said with an R-squared of 0.7, it appears as if the company estimates of expected contributions explain some of the changes in pension contributions from year-to-year.

Exhibit 6 : Actual vs Expected Pension Contributions, S&P 500 (2004-2013)



Note: Expected pension contributions are the company estimates disclosed in prior year 10-Ks.
Expected pension contributions are taken to be the midpoint when the company provides a range.
Source: Company filings and ISI Group estimates

S&P 500 companies have contributed more than expected to their pension plans 71%of the time over the past ten years.

Don't Count Your Cash Flow Chickens Before They Hatch

Clearly you might want to exercise some caution when it comes to trusting company estimates of future pension contributions or any other accounting estimate for that matter (remember every line in the financial statements is prone to some amount of manipulation but you should be the most skeptical about those line items that involve the greatest degree of management judgment).

Over the past ten years, the S&P 500 companies contributed more to their pension plans than they were expecting 71% (not the same as R-squared) of the time (maybe due to poor performance in the plan or the company came into some additional cash flow, not that we have yet to find a link to either) and contributed less than expected 20% of the time. In other words companies tend to set the expectations for pension contributions too low (so don't count your cash flow chickens before they hatch).

In addition the company estimates aren't even that close, over the past ten years actual pension contributions were within plus or minus 10% of expectations only 28% of the time (remember, these are the companies own "best estimates"). Heck, companies contributed more than double what they were planning 23% of the time. Moral of this story, be careful with company estimates.

That said the companies are pretty good at getting the direction right, when pension contributions are expected to drop year-over-year they did 62% of the time and vice versa pension contributions increased 87% of the time when companies were expecting them to head higher.

We also decided to take a look at whether any companies were consistently wrong, in other words did they consistently contribute more or less than expected. We found 70 companies where in each year for which we have data the actual pension contributions came in higher than what the company had been expecting. Including four companies that have each contributed over $5 billion more than what they had been expecting, General Motors, Lockheed Martin, Johnson & Johnson and Bank of America.

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