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The Math Doesn't Add Up

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A bear market and new regulations have left many plans underfunded.

WITH THE STOCK-MARKET ROUT DECIMATING corporate pension assets this year, some of America's largest companies may need to funnel additional money into sponsored retirement plans, potentially trimming next year's reported profits. Companies in the Standard & Poor's 500 collectively face a pension deficit of at least $200 billion, according to a Credit Suisse analysis. That's the largest shortfall since 2002, when pension liabilities exceeded assets by a record-setting $218 billion in the aftermath of the dot-com bust.

P.C. Vey for *Barron's*

Corporate pension funds are at the center of a perfect storm: A global bear market has drained assets from funds just as the Pension Protection Act of 2006 has increased funding requirements, beginning with 2008. The legislation, aimed at bolstering underfunded plans, mandates that pension assets, or money invested, equal at least 94% of projected liabilities, or payouts, as of Jan. 1, 2009. Any shortfall could require additional contributions and impose other restrictions.

Credit Suisse calculates that 128 S&P companies could face a pension-related hit to earnings in 2009. The table Running Short of Money focuses on the funding outlook for 10 companies with some of the largest pension plans in the index, including No. 1-ranked General Motors (ticker: GM), while the bottom table highlights the estimated cost per share likely to be incurred by nine companies projected to have underfunded plans, and a tenth -- J.C. Penney (JCP) -- which has incurred a steep drop in assets, even though its funding status is expected to remain positive.

Such costs are a function not only of the health -- or lack thereof -- of a pension plan, but how a company applies pension accounting. Some companies "smooth" or amortize changes in assets or liabilities over a number of years. Even if a pension is overfunded, a company may face pension-related costs.

Credit Suisse analyst David Zion cautions that actual costs will differ in some cases from the firm's estimates, due to differing assumptions about amortization rates, interest rates, asset returns and other key factors. The biggest difference may be the presumed rate of return on assets, as the average pension portfolio was about 60% in stocks last year. FirstEnergy (FE), for instance, expects to take a 29-cent charge in 2009 related to pension costs, according to a spokeswoman for the Ohio utility, while Credit Suisse estimates the impact could be closer to 42 cents a share.

To be sure, some companies fearful of future pension shortfalls made extra contributions to their plans when times were good, and those plans now are flush with cash. But concerns about the new accounting rules are evident in the hundreds of companies that recently signed letters to Congress seeking a reprieve.

AT A TIME WHEN 401(K) PLANS, in which employees assume the investment risk, dominate the corporate retirement-planning landscape, pension plans -- and their problems -- remain the province largely of old-line industrial companies that established defined-benefit plans for future retirees. There are exceptions: Companies such as Penney favored defined benefit plans to attract the best employees, closing them to new workers only in 2007.

Among the companies on our list, General Dynamics (GD) says pension costs will have a minimal impact on earnings, since most of its profits come from government-related work and it can pass a majority of such costs on to the government. That isn't factored into Credit Suisse's 60-cent estimate of GD's '09 pension-related costs, Zion says.

Northrop Grumman (NOC), another defense contractor, could face a threefold increase in after-tax pension costs of $1.74 a share next year, Credit Suisse estimates. And that's despite having cut its equity exposure in half, to 25% by late September. Northrop executives have said they will consider using cash to pre-fund pension obligations, as well as acquisitions, dividend increases and stock buybacks.

Five industrial companies on Credit Suisse's short list -- Ryder System (R), Ashland (ASH), Goodyear Tire & Rubber (GT), Eastman Chemical (EMN) and PPG Industries (PPG) -- could have pensions that are less than 80% funded for 2008, the firm says. Shortfalls of such magnitude could, in some cases, require additional contributions -- and entail costs.

Ryder CEO Greg Swienton told analysts in October that productivity and cost-cutting will offset some of the "significant increase" in pension expenses expected in 2009. According to a company spokesman, Ryder estimates 2008 pension liabilities will be $1.5 billion, slightly higher than Credit Suisse estimates. Credit Suisse expects Ryder to take an 83-cent hit to '09 earnings due to pension-related costs, six times higher than this year's likely penalty.

Although Ashland's pension plans are underfunded, the chemicals company made higher-than-required contributions in years past, avoiding the need for cash funding now. Credit Suisse estimates the company will have pension-related costs of 79 cents a share next year, higher than Ashland's own guidance, stemming largely from the decline in its pension-plan assets. Ashland also told *Barron's* its plans are unlikely to be as underfunded as Credit Suisse estimates.

Chemical companies have been squeezed this year by dwindling end-market demand. Eastman Chemical recently said fourth-quarter earnings will be well below prior forecasts. Credit Suisse thinks Eastman's pension costs could triple in 2009 to 77 cents a share, though some of that risk might be reflected already in 2009 earnings estimates of $4.05 a share.

PPG Industries, which makes industrial coatings and chemicals, expects to make higher pension contributions and see higher costs in 2009, according to a recent SEC filing. But a spokesman for the Pittsburgh company emphasized it has plenty of cash on hand to fund the necessary amounts. Credit Suisse expects PPG's pension costs to more than double in 2009, to 83 cents per share.

THE PENSION FUNDS AT some of America's best-known companies are in better shape than one might expect, due to years of prudent management and abundant cash. Also, funding requirements tend to be lower overseas, where many have large operations. ExxonMobil (XOM) has more than enough cash to cover its estimated 2008 deficit of $11.7 billion, much of which is tied to non-U.S. plans. General Motors (GM) would be 96%-funded for 2008, given a projected $4 billion pension deficit in 2008, according to Credit Suisse. That's above the 94% funding threshold.

This year pension liabilities should decline modestly, because corporate bond rates used to discount future payouts are higher. But any drop probably will be offset by market losses and new funding requirements. In the early 2000s many investors were forced to take a crash course in pension accounting because of its negative impact on corporate earnings. It's time for a refresher.

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