

Issue Commentary

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08 AUGUST 2011

Executive Summary

While pension asset balances generally rebounded in 2010, many firms continue to face significant funding shortfalls. Unfortunately, the arcane rules of pension accounting and the discretion allowed in the choice of actuarial assumptions can result in companies understating the magnitude of their pension shortfalls. We systematically analyzed 2010 fiscal year-end pension disclosures for hundreds of U.S. firms with material pension-plan obligations.

The six firms reviewed in this *Issue Commentary* disclosed pension-accounting assumptions that are out of line with the rest of the publicly traded universe. As a result, the balance sheet may not provide an accurate portrayal of their financial position, while their future earnings and cash-flow streams may be at risk for unexpected declines.

Other things equal, we expect these firms to underperform the market. Consistent with this expectation, the firms named in our 2010 pension-accounting commentary underperformed the market by an average of 5% over the next six months and 12% over the next 12 months.

Alcoa Inc. (AA)

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AA's massive \$12.3 billion PBO may be understated by approximately 24.5% because of the use of a discount rate that ranks in the 89th percentile of all companies in this study. Our estimate of the company's adjusted funding deficit equates to 43.4% of current market capitalization and 15.0% of total assets.

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Delta Air Lines. (DAL)

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Our estimate of DAL's adjusted funding deficit equates to 233.8% of its current market capitalization. The company also appears to be recognizing an unusually low proportion of the net actuarial losses that have been deferred in AOCI.

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General Dynamic Corp. (GD)

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Cumulative plan asset returns for the last two years are still \$826 million short of recouping the substantial \$2.36 billion loss (-31.7% return) experienced during 2008. We estimate that GD's sustainable pension expense may be more than two times the expense recorded in 2010.

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Timken Co. (TKR)

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TKR uses a return-on-plan-assets assumption of 8.75%, which ranks in the 94th percentile of all companies examined in this study. After adjusting as-reported figures for what we view is a sustainable plan-asset-return assumption, we estimate that the company's periodic expense may be twice that recorded in 2010.

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Textron Inc. (TXT)

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Our estimated adjusted pension funding shortfall of \$2.86 billion is equivalent to 55.4% of the company's current market capitalization and 18.7% of the company's total assets at the end of 2010.

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Unisys Corp. (UIS)

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UIS reported net pension income in 2010, despite having \$2.86 billion in net actuarial losses stored in AOCI. Additionally the company's pension-funding shortfall equates to 365.4% of current market capitalization and 98.7% of total assets at the end of 2010. In our opinion, UIS will likely have to divert substantial operating cash flows toward funding its obligations at the detriment of reinvesting for future growth.

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Pension Issue Commentary: Two Years of Recovery Have Yet to Offset Losses Recorded in 2008

INTRODUCTION

CY2008 was a difficult year for companies offering defined-benefit plans to their employees. According to a survey of U.S. firms, the median rate of return on plan assets during CY2008 was a dismal -23.8%.¹ Diversification was no protection either, as nearly every type of investment commonly held by pensions lost significant value, including stocks, bonds, and real estate.

During 2009, the median return on plan assets was 19.1%, not nearly enough to offset the losses recorded in the prior year.² During 2010, the median return on plan assets was 12.4%.

Two years ago we published an *Issue Commentary* (07/07/09) that involved a systematic review of pension concerns at hundreds of firms with a particular focus on nine companies whose pension accounting seemed especially problematic to us. A similar analysis was published a year later (07/15/10), focusing on an additional seven firms with large deficits and potentially problematic pension-accounting assumptions. In this *Issue Commentary*, we review the status of our highlighted firms from the previous two years and identify six new companies whose pensions raise significant concerns.

We continue to focus on the variation in the key assumptions used to estimate a firm's pension liability for financial-reporting purposes. These can distort the underlying economic reality, particularly as plan assets have yet to return to their beginning-of-2008 balances. In this regard, our goal in this *Issue Commentary* is to identify a subset of U.S. firms that we believe may face obligations that are substantially greater than the liability reported on their balance sheets.³

In identifying firms for analysis, we apply a systematic approach to remove as much discretion as possible in estimating the economic value of each firm's pension obligation. These estimates are used to identify firms that may face relatively larger shortfalls and greater exposure to future increases in pension expense and related cash contributions.

The selection process yielded six new companies that we believe may have the greatest disparity between the economic value of their pension obligation and the net liability (including amounts stored in "accumulated other comprehensive income" or AOCI) reported on their balance sheet. We focus on this latter group because its firms may face a greater risk of share mispricing due to a failure of the market to discount the full economic value of their pension obligations.

¹ We only include firms with fiscal years matching the calendar year to ensure comparability.

² On an absolute basis, most of the 2008 losses were recovered in 2009, but most firms remain well behind their cumulative expected returns.

³ We do not attempt to identify firms that may have violated generally accepted accounting principles (GAAP) in computing pension expense, pension assets, or pension liabilities. Our sole focus is determining whether the reported obligation and pension expense (or income) appears consistent with a standardized estimate of the underlying economic obligation. Moreover, our methodology places all firms on equal footing. As a result, the firms selected for analysis tend to be those that have set their expected return on plan assets and/or discount rate on plan liabilities at levels well above that of the median sample firm.





The remainder of the report is organized as follows: The next two sections provide a brief introduction to pension accounting under U.S. GAAP and discuss two valuation assumptions that may be used to reduce a firm’s pension liability relative to economic reality. The third section describes the statistical methodology used. The fourth and final section focuses on six new firms that we believe may be mispriced by the market as a result of a mismatch between the pension liability reported in the financial statements and our estimate of the true economic value of the obligation.

A Brief Primer on Pension Accounting

The following discussion reprises an overview of salient features of pension accounting under U.S. GAAP, as originally published in our 07/07/09 *Issue Commentary*.

DEFINED-BENEFIT PLANS VS. DEFINED-CONTRIBUTION PLANS

There are two general types of pension plans commonly employed by U.S. firms: defined contribution and defined benefit. The primary difference between the two types of plans is how the company’s obligation is defined. In a defined-contribution plan (such as a 401K plan), the firm provides funds (or matches contributions) that employees invest themselves. Since the employees bear all future risks on the investment (including whether the resulting asset is sufficient for retirement), the company’s obligation is limited to the amount of *contributions* it has committed to provide. In contrast, in a defined-benefit plan, the firm invests money itself to provide for future payments it has promised to employees when they retire. Thus, the company’s obligation is the actual (but uncertain) stream of future payments it must ultimately provide to employees when they retire.

Given their relatively less complicated nature, the accounting for defined-contribution plans is simple. The contributions are expensed as incurred (i.e., as employees earn the contributions), and the company faces no liability beyond any contributions currently payable to the plan. The accounting for defined-benefit plans is much more complicated, however, as the company must estimate the present value of its future obligation, the cash contributions required to fund the obligation, and the economic cost of providing the pension benefit.

ACCOUNTING FOR DEFINED-BENEFIT PLANS

The accounting rules for defined-benefit pensions under U.S. GAAP are specified in ASC 715 Compensation–Retirement Benefits (formerly Statements of Financial Accounting Standards (SFAS) 87 and 158). The accounting for pensions is convoluted, due in large part to a desire to shield net income from large year-to-year changes in pension asset values, but also as a result of the use of actuarial assumptions in making predictions that in turn directly affect financial-statement presentation.

There are two basic components that must be valued in determining the net asset or liability associated with a firm’s defined-benefit plan. The first component, the





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projected benefit obligation (PBO), is an estimate of the present value of all future benefits that the company is obligated to provide to past and present employees as a consequence of services *already* provided by those employees.⁴ The second component, plan assets, consists of all funds contributed to the plan plus (minus) any gains (losses) on related investments.

The accounting for plan assets is, in principle, straightforward since the assets are fair valued. However, the PBO is difficult to measure, as it involves payouts decades into the future, with a high degree of uncertainty regarding how much will actually be owed (due to uncertain life expectancy, retirement salary levels, etc.). On top of this uncertainty, there is ambiguity about how to discount the expected future cash outlays to determine their present value. Though the final payments are not entirely known, in theory the obligations are fixed by criteria established in the plan.

The Financial Accounting Standards Board (FASB) does not specify how firms should select an appropriate discount rate. As a result there is significant variation across firms. Even firms that claim to use essentially the same methodology show substantial variation in their chosen discount rates.

In our research we have found that companies that use relatively higher discount rates (and thereby report relatively lower PBO values) state that they base their rate on some average of corporate bond yields. Economically this approach makes no sense because the default premiums embedded in corporate bond yields merely reflect the likelihood that *other* companies will fail to honor their *bond* obligations. The premiums have no effect on how much the reporting firm is obligated to pay its pensioners. Indeed, the use of a risk-adjusted discount rate would only be appropriate if management were concerned about the firm's ability to satisfy the pension obligation.⁵

INCOME-STATEMENT AND BALANCE-SHEET PRESENTATIONS

The computation of pension expense is complex because of a variety of smoothing effects meant to limit the year-to-year variability in pension expense. The most prominent smoothing effect is the use of an expected return rather than the actual return to calculate income on plan assets (which is netted against pension expense). Thus, a fund that loses \$1 billion on \$3 billion in investments during 2008 could still have reported a net pension gain of, say, \$240 million if it expects the plan's investments to earn 8% over the long term. In theory, fluctuations between actual and expected returns should even out over time. But this will occur only if the company has consistently used a realistic, long-term expected rate of return.

⁴ In theory, this amount reflects what the company would owe if the existing plan were curtailed and the present value of all benefits were paid out to employees today.

⁵ Needless to say, this distinction can be very important. For example, during 2008 many firms raised their pension discount rates in a year when the risk-free interest rate actually fell. This trend substantially reversed itself in 2009, with many companies slashing unsupportable discount-rate assumptions. The reduction of discount rates continued further in 2010.





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Unfortunately, the FASB offers little guidance in the selection of an appropriate expected return on plan assets. Not surprisingly, public companies also vary considerably in the expected rates of return they use. For those firms that chose an unattainably high expected return, economic reality generally catches up with them over time. Ultimately, these firms are likely to be forced to make sizable contributions to offset their growing pension deficit. Their pension losses must also be recognized against net income over time, which can lead to periodic earnings shortfalls.

Losses on pension assets flow through pension expense (and net income) in two ways. First, when pension assets decline in value, the amount of accounting-based “pension income” (i.e., not the real amount of investment income) will decline because the expected *rate* of return is multiplied against a smaller base of assets. Second, if actual pension income deviates too far from what has been recognized in income previously, the “excess loss” is gradually amortized as additional pension expense under what the FASB refers to as the “corridor approach.”⁶

For balance-sheet reporting purposes, plan assets are netted against the PBO to determine the funding status of the plan. If the PBO is larger, there is a funding deficit, which is reflected as a net liability on the balance sheet. If the plan assets are larger, there is a funding surplus, which is reported as a net asset on the balance sheet.⁷ In addition, the “excess loss” resulting from application of the corridor approach may be stored in other accumulated comprehensive income (i.e., it is reported as a reduction of stockholders’ equity).

STATISTICAL EVIDENCE ON THE FACTORS THAT DETERMINE PENSION-ACCOUNTING ASSUMPTIONS

In our 2009 *Issue Commentary* (07/07/09), we tested two hypotheses about how companies select the discount rate and the expected rate of return used in accounting for their pension plans. Our analysis demonstrated that firms with higher “true” pension deficits (per our estimate) were more likely to select high discount rates, leading to a downward bias in as-reported pension liabilities. Also, firms with especially poor actual returns were more likely to increase their expected returns going forward. Both findings were statistically and economically significant. These findings are also consistent with the hypothesis that, on average, firms with pension-funding problems or poor investment returns strategically choose more lenient assumptions, presumably to obscure the magnitude of their shortfalls. The results of these tests also underlie our decision

⁶ For example, if a firm lost 28% of its plan assets in 2008 (the median loss reported for our sample of publicly traded domestic firms for CY2008), pension income for 2009 would only be 72% of the amount reported in 2008 (assuming the expected rate remains the same). Furthermore, if the company fails the test required under the corridor approach, additional losses may be amortized to pension expense each quarter. Either one of these mechanisms (or worse yet, both of these mechanisms) could cause a nasty earnings surprise for many firms in 2009 and beyond.

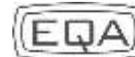
⁷ This is only true in recent years (since SFAS 158 was promulgated in 2006) and is still not necessarily the case for firms using international financial reporting standards (IFRS). For various reasons, before SFAS 158, the balance-sheet numbers could be different from the funding deficit/surplus reported in the footnotes. Even now, the real economic deficit could deviate substantially from the balance-sheet liability if the PBO is mismeasured as a result of the many assumptions involved.





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to focus on firms with relatively larger pension deficiencies and unusual pension accounting assumptions.

Research Methodology

GOALS OF THE ANALYSIS

Our goal is to eliminate differences in pension accounting caused by firms' accounting assumptions, as there is little reason to expect that the assumptions should vary across companies. With a consistent methodology for pension analysis we aim to estimate the following:

- How large the real economic deficits in companies' pensions are. This affects the likely cash-flow consequences in future years.
- How much of the real deficits are not shown on the balance sheet as liabilities. This is the amount that investors may be unaware of.
- How much the sustainable long-term pension expense is likely to be, relative to the as-reported expense for 2010. This is clearly relevant to firm valuation.
- How much as-reported pension expense is likely to be reported in 2011 and beyond. This could cause significant earnings surprises.

STEP 1: SELECTION OF COMPARABLE FIRMS

First, we need to establish a set of firms to compare. Our goal is to have as large a set as possible while having complete detailed pension data and fully comparable companies.

We began by eliminating all companies below \$800 million in market capitalization from our study. We further removed all ADRs from consideration and only included companies that closed their fiscal year between 11/15/10 and 03/15/11.

In a distinction from our previous reports, we focus on both active and inactive defined-benefit plans. Furthermore, we have excluded companies with plans that have a reported PBO that is less than 10% of market capitalization in order to concentrate on plans that are material relative to the company's valuation.

Our primary source of pension plan data was Capital IQ. However, for companies that maintained multiple plans with multiple assumptions, had plans in multiple geographies with multiple assumptions, or had disclosed discount-rate and expected return-rate assumptions as a range, data was hand-collected from 10K statements.

Finally, discount and expected-return-rate assumptions were averaged (if companies maintained multiple plans) using the PBO and plan assets, respectively, as weights. For companies that provided a range of assumed rates,





we used the median.

STEP 2: ESTIMATING THE ECONOMIC VALUE OF THE PBO

There are a number of critical assumptions that go into the calculation of the PBO. However, while assumptions about underlying variables, such as salary growth, are important, we are not in a position to assess these assumptions in a large scale, cross-sectional comparison. The only assumption we can assess is the discount rate.

Since the discount rate is used to adjust for the time value of money in valuing future cash obligations, it should, in principle, be roughly the same for all firms. Moreover, because the amount of the obligation is fixed by specific plan parameters, one could argue that the appropriate discount rate is the long-term risk-free rate.⁸ Accordingly, in our analysis we impose a uniform rate of 4.25%, which is an average of the last month of rates on 30-year Treasury Bonds. Since the median pension assumes a higher rate of 5.40%, our estimate of the true economic PBO is generally much higher than the figure reported by sample firms. The key point, however, is that we use a method that puts all companies on an equal basis and does not reward firms for choosing an abnormally high discount rate.⁹ Note also that the use of an alternative discount rate (such as the median sample rate) it is unlikely to have an appreciable effect on the selection of firms for review. (It would, however, affect the dollar magnitude of estimated funding deficits.)

Since we do not know the year-by-year cash-flow projections that are being discounted to derive the PBO, we adjust for the difference in discount rates indirectly. Specifically, we assume a uniform pattern of future obligations starting at the current level of cash outflows, which is based on the company-provided disclosure of estimated cash payments over the next five years. We further assume that the obligation continues to grow for 15 years, flattens out for the next 10 years, then gradually declines to zero over the next 50 years. We use Microsoft Excel's GOALSEEK function to find the appropriate growth rate—applied to Years 6 through 20—that forces the sum of the entire 80 years of discounted cash flows to equal the company's total PBO. Additionally, the rate of decline used in the final 50 years is equal to $1 - (\text{year\#} - 30)/50$, where year# ranges from 31 to 80. This adjusted PBO allows a largely discretion-neutral metric for comparing firms. In addition, this procedure ensures that the exact pattern of cash flows we assume has a minimal effect on our final estimates.

STEP 3: SUSTAINABLE LONG-TERM PENSION BENEFIT EXPENSE

While the PBO assumptions (discount rate) are major drivers of balance-sheet presentation, the discount rate has only a modest impact on the income

⁸ Contrariwise, one could also argue that the discount rate should be higher for firms that may be unable to fully honor their pension obligations.

⁹ As an alternative, we could have chosen the median rate for our sample firms. However, that would not have affected the selection of firms for presentation in our report. It would only affect the dollar amount of the estimated economic PBO.





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statement in the short term. On the other hand, the expected return on plan assets has a direct impact on the pension-expense calculation.

In this report we focus primarily on potential longer-term earnings effects of pension assumptions that may be misaligned with economic reality. To assess the longer-run earnings effects, we construct a measure of sustainable pension expense using a set of uniform assumptions for all companies. This includes the discount rate as discussed above, as well as the expected return, which we set at 6.0% for the typical pension asset allocation.¹⁰

Of note, our uniform expected return assumption is much lower than the median assumed rate of return for sample firms, which was 8.0% for 2010. Thus, other things equal, our estimate of income earned on plan assets (pension expense) will tend to be lower (higher), on average, than as-reported values. However, our method of estimating interest costs (i.e., the cost of financing the pension obligation) will tend to offset the potential understatement of pension income. Specifically, we compute interest costs based on our adjusted PBO multiplied by our discount-rate assumption (which, as noted earlier, is lower than the median as-reported discount rate). Additionally, it is important to note that our goal is to identify relative outliers, or those firms that appear likely to have understated their pension expense or liability relative to the median firm.

SELECTION OF FIRMS THAT MAY BE MISPRICED BECAUSE OF A FAILURE OF THE MARKET TO REFLECT THEIR TRUE ECONOMIC PENSION OBLIGATION

Using the data developed in the prior section, we examine firms that have especially large pension deficiencies, abnormally high assumptions (and unusual increases in them), and are likely to see material increases in their pension expense and cash outflows in the years to come. These are firms that we believe investors should be wary of, as the pension obligations could consume a significant of future cash flows, especially if financial markets continue to be weak in the next few years. For many of these companies, their deficits are so vast that even a strong bull market might not be enough to cover the shortfall.

While there may be a perception that, after the 2008 crash, all companies had fairly significant pension problems, this is not entirely true. First, not all firms have large defined-benefit plans, and those with defined-contribution plans are fine (though their employees may not be). Those with small defined-benefit plans or less-optimistic assumptions are also unlikely to be facing severe deficiencies—certainly nothing of the magnitude as the companies highlighted below. Likewise, the asset-value recovery in 2009 and 2010 might seem to have solved

¹⁰ In our studies we have noted that management’s formation of the assumed rate of return for plan assets is based on the weighted-average expected return by asset class of the plan portfolio, which often references historical or annualized 10-year returns to support the return assumption utilized in the calculation of the periodic pension benefit expense. That said, the five-year (three-year) average annual rate of return on plan assets has been 6.2% (2.1%) for all companies examined in this study. A recent study (February 2011) by Towers Watson (link: <http://www.towerswatson.com/assets/pdf/3761/Global-Pensions-Asset-Study-2011.pdf>) indicates that U.S. pension assets have grown at a 4.2% 10-year (12/31/00–12/31/10) CAGR.





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much of the pension problems that arose in 2008, but in fact, this recovery was insufficient in magnitude to have mended the gaping deficiencies at several companies, including the firms we focus on in this *Issue Commentary*.

Our analysis consists of two parts. The first part of the analysis provides a summary update of our current view on the companies we had a Negative view of as featured in our last *Issue Commentary* (07/15/10). The second part of the analysis introduces six new companies with outlier pension-accounting assumptions that we believe are likely to imply overvaluation of the firms and may lead to significant financial problems in coming years.

Revisiting 11 Firms Covered in 2009 and 2010

COMPANIES REVIEWED IN 2010

Our July 2010 analysis of pension disclosures (see *Issue Commentary* 07/15/10) featured seven new companies (based on disclosures in 2009 annual reports). The list of firms included AMR Corp. (AMR), Eastman Kodak Co. (EK), The Goodyear Tire & Rubber Co. (GT), ITT Corp. (ITT), Lockheed Martin Corp. (LMT), Macy's Inc. (M), and The New York Times Co. (NYT).

Of the companies featured in the July 2010 publication, we are reiterating our negative view on AMR, ITT, and LMT. AMR's estimated pension deficit (i.e., "adjusted funding deficit" in Table 1, next page) remains highly material at 36.2% of total assets as of 12/31/10, and it continues to use an unusual discount rate (5.80%, 93rd percentile) and assumed return on plan assets (8.50%, 79th percentile). Similarly, ITT's adjusted funding deficit was equal to 22.7% of total assets at year end, while its discount rate (5.70%) was in the 87th percentile and assumed rate of return on plan assets (8.88%) was in the 99th percentile. We have similar concerns with respect to LMT, with an adjusted funding deficit equal to 54.1% of total assets at year end and an assumed rate of return on plan assets of 8.50% (79th percentile).

Our view on GT, M, and NYT is now neutral, primarily as a result of a significant reduction in their discount rates. In fact, each of these companies reported a discount rate below the median for 2010.

We have elected to drop EK from coverage because its market capitalization has fallen below our \$800 million minimum threshold. EK's shares have fallen 51.6% since our July 2010 publication.

COMPANIES REVIEWED IN 2009 (WITH VIEWS REITERATED IN 2010)

In connection with last year's analysis, we also reiterated our negative view on four firms that were featured in our July 2009 analysis of pension disclosures (i.e., based on disclosures in their 2008 annual reports). The four firms were AES Corp. (AES), Pactiv (acquired in 2010), Marsh & McLennan Companies Inc. (MMC), and United Parcel Service (UPS).

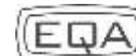
We continue to have a negative view with respect to pension-accounting





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assumptions reported by AES and UPS. AES' adjusted funding deficit was estimated at 23.5% of total assets at 12/31/10. In addition, the firm continues to report the highest rate of return assumption (10.84%) and the highest discount rate assumption (9.41%) in the entire sample of firms. UPS's adjusted funding deficit was 30.0% of total assets at year end, its discount rate (5.96%) was in the 99th percentile, and its rate of return assumption (8.70%) was in the 93rd percentile.

In contrast to the above firms, we have moved to a neutral opinion of the assumptions utilized by MMC, as the company slashed its discount rate assumption to 5.59% from 6.02% during 2010.

Finally, Pactiv was acquired by Reynolds Group Holdings Limited on 08/17/10. As a result, we have dropped the firm from coverage.

Table 1. Summary Review of Formerly Featured Companies

	Current View	Discount Rate	Percentile Rank	Assumed Rate of Return	Percentile Rank	Adjusted Funding Deficit/ Year-End Total Assets
AES	NEGATIVE	9.41%	100 th	10.84%	100 th	23.5%
MMC	NEUTRAL	5.59%	70 th	8.18%	68 th	24.0%
PTV	(1)	(1)	(1)	(1)	(1)	(1)
UPS	NEGATIVE	5.96%	99 th	8.70%	93 rd	30.0%
AMR	NEGATIVE	5.80%	94 th	8.50%	79 th	36.2%
EK	(2)	(2)	(2)	(2)	(2)	(2)
GT	NEUTRAL	5.31%	28 th	7.81%	41 st	25.1%
ITT	NEGATIVE	5.70%	87 th	8.88%	99 th	22.7%
LMT	NEGATIVE	5.50%	53 rd	8.50%	79 th	54.1%
M	NEUTRAL	5.40%	37 th	8.75%	94 th	7.4%
NYT	NEUTRAL	5.60%	71 st	8.75%	94 th	37.2%

Notes:

(1) Pactiv (PTV) was acquired on 08/17/10.

(2) Eastman Kodak (EK) has fallen below our \$800 million minimum market capitalization threshold.

Table 2. Summary Review of Currently Featured Companies and Summary Statistics

Ticker	Current View	Discount Rate	Percentile Rank	Assumed Rate of Return	Percentile Rank	Adjusted Funding Deficit/ Year-End Total Assets
AA	NEGATIVE	5.75%	89 th	8.75%	94 th	15.0%
DAL	NEGATIVE	5.69%	83 rd	8.82%	99 th	31.9%
GD	NEGATIVE	5.73%	88 th	8.43%	79 th	17.4%
TKR	NEGATIVE	5.87%	97 th	8.75%	94 th	26.8%
TXT	NEGATIVE	5.71%	87 th	8.26%	76 th	18.7%
UIS	NEGATIVE	5.56%	68 th	8.01%	63 rd	98.7%
	Study Mean:	5.42%	-	7.68%	-	9.6%
	Study Median:	5.40%	-	8.00%	-	7.0%





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Alcoa Inc. (NYSE:AA)
390 Park Ave.
New York, NY 10022
(212) 863-2674
www.alcoa.com

INDUSTRY	Aluminum
PRICE	\$12.79 (08/05/11)
MARKET CAP	13.61 billion
ENT. VALUE	21.74 billion
P-E RATIO	14.63
EV/REVENUE	0.93
DEBT/EBITDA	2.38
SHORT INTEREST	5.8%
DAYS TO COVER	2.8

VIEW **NEG**

Company description: Alcoa Inc. (NYSE:AA) engages in the production and management of aluminum, fabricated aluminum, and alumina.

Relatively high discount-rate assumption may understate true economic value of funding deficit: As of 12/31/10, AA’s reported PBO was \$12.3 billion. However, the company utilized a 5.75% discount rate. While down from the 6.15% reported in 2009, the firm’s discount rate still ranks in the 89th percentile of all companies we surveyed. After adjusting for what we view as a more-realistic discount rate, we believe the economic value of AA’s PBO may be closer to \$15.4 billion, or 24.5% higher than reported.

Adjusted funding deficit represents a material portion of total assets, market capitalization: Plan assets totaled \$9.45 billion at the end of 2010, giving the firm a \$2.89 billion shortfall by as-reported figures. The company’s current funding shortfall primarily resulted from a \$2.06 billion loss (or -19.3% return) on plan assets during 2008. Cumulative returns since 2008 have totaled \$1.89 billion, or \$171 million short of the prior recorded loss.

After adjusting the PBO to reflect the uniform discount rate applied throughout our analysis, we estimate AA has an adjusted pension funding deficit of \$5.91 billion, equivalent to 43.4% of the company’s current market capitalization and 15.0% of total assets at the end of 2010.

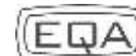
Sustainable pension expense may be materially higher than expense recognized in 2010: During 2010, AA recognized a pension expense of \$233 million. Our estimated sustainable pension expense for AA is \$498 million—113.8% higher than the reported figure. Our sustainable pension expense is based on a \$652 million interest expense, reflecting the lower uniform discount rate applied throughout this analysis, minus \$567 million to reflect our view of a sustainable return on plan assets. Additionally, we add the expected amortization of net actuarial losses (\$244 million) as well the expected amortization of prior service cost (\$17 million) to our estimate. With \$4.22 billion in net actuarial losses recorded in other comprehensive income, we believe the company’s amortization of prior-period losses will remain significant going forward.





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Delta Air Lines Inc.
(NYSE:DAL)
1030 Delta Blvd.
Atlanta, GA 30332
(404) 715-2600
www.delta.com

INDUSTRY	Airlines
PRICE	\$6.97 (08/05/11)
MARKET CAP	5.90 billion
ENT. VALUE	16.80 billion
P-E RATIO	22.34
EV/REVENUE	0.50
DEBT/EBITDA	3.05
SHORT INTEREST	2.3%
DAYS TO COVER	1.4
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Company description: Delta Air Lines Inc. (DAL) provides scheduled air transportation for passengers and cargo in the United States and internationally.

PBO may be understated due to unusually high discount-rate assumption: At the end of 2010 DAL's reported PBO totaled \$17.5 billion when measured utilizing the company's discount-rate assumption of 5.69%. DAL's discount rate ranks in the 83rd percentile of all companies in our survey. After adjusting for the uniform discount rate applied to all companies in this study, we estimate that the company's PBO may be closer to \$22.0 billion—25.9% higher than the as-presented PBO.

Adjusted pension funding deficit is two times the firm's market capitalization: At the end of 2010 DAL had \$8.2 billion in plan assets, resulting in a reported \$9.3 billion funding shortfall. The company's funding shortfall primarily resulted from a \$1.1 billion loss (-22.3% return) in 2008 for DAL-only assets and an additional \$2.0 billion loss (-31.1% return) in 2008 suffered at Northwestern Airlines (acquired on 10/29/08). While the combined plan assets have generated \$2.2 billion in cumulative gains since 2008, the returns are \$876 million short of offsetting prior losses.

Of greater concern, after adjusting DAL's PBO to reflect the lower uniform discount rate applied throughout this study, the company's adjusted funding deficit balloons to \$13.8 billion. This is equivalent to 233.8% of the company's current market capitalization and 31.9% of total company assets at the end of 2010.

Sustainable pension expense appears notably higher after adjusting for outsized return assumption: DAL's current weighted-average expected long-term rate of return on plan assets is 8.82%, ranking in the 99th percentile of all companies surveyed. In our view, the use of a high discount-rate assumption combined with a high expected-return assumption may be distorting the reported cost of the company's pension plans.

During 2010 DAL recognized \$367 million in net period benefit cost associated with its pension plans. Our initial estimate of the company's sustainable expense is closer to \$496 million, or 35% higher than presented. Interest expense is estimated to be \$936 million, based on the adjusted PBO and our uniform discount-rate assumption, minus \$495 million in returns on plan assets based on our 6.0% sustainable-return-rate assumption. No service expense is added, as the company's plan is frozen. Additionally, we have added \$55 million for the actual amount of net actuarial losses transferred to the income statement (from AOCI) during 2011. However, as discussed next, we believe our initial estimate may be low, based on an unusually low level of expected actuarial losses to be recognized by the company relative to the amount of total losses stored in AOCI.

Unusually low level of actuarial losses expected to be transferred to income in 2011: DAL indicates that it will recognize \$55 million in actuarial losses in the company's periodic expense out of other comprehensive income during 2011.





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However, this amount represents just 1.7% of the total actuarial losses stored in AOCI (of \$3.3 billion). Thus, at the current rate of amortization, it would take almost 60 years to fully amortize the firm's actuarial loss. We also note that the rate of amortization reported by the firm ranks in the 10th percentile among all companies examined in this analysis. The low expected recognition of prior actuarial losses out of AOCI implies that both the company's as-presented and our calculated sustainable pension expense are both likely understated. Had DAL recognized the same amount of losses as the median of all companies examined in the current study (5.68% of AOCI), we estimate that it would have recognized an incremental \$132 million in periodic costs. Adding this to our sustainable expense calculation leads to an adjusted total of \$628 million—71.4% higher than the amount actually recognized in 2010.

General Dynamics Corp. (NYSE:GD)

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www.generaldynamics.com

Company description: General Dynamics Corp. (NYSE:GD) provides business aviation; combat vehicles; weapons systems and munitions; shipbuilding design and construction; and information systems, technologies, and services worldwide.

Note on GD's pension plan characteristics: GD provides the following disclosure related to its pension plan under the disclosure *Government Contract Considerations* as presented in the company's 2010 10K:

INDUSTRY	<i>Aerospace and Defense</i>
PRICE	\$64.44 (08/05/11)
MARKET CAP	23.31 billion
ENT. VALUE	24.34 billion
P-E RATIO	9.19
EV/REVENUE	0.75
DEBT/EBITDA	0.23
SHORT INTEREST	1.0%
DAYS TO COVER	1.7
VIEW	NEG

Our contractual arrangements with the U.S. government provide for the recovery of contributions to our pension and other post-retirement benefit plans covering employees working in our government contracting business. For non-funded plans, our government contracts allow us to recover claims paid. Following payment, these recoverable amounts are allocated to contracts and billed to the customer in accordance with the Cost Accounting Standards and specific contractual terms. For some of these plans, the cumulative pension and post-retirement benefit cost exceeds the amount currently allocable to contracts. To the extent recovery of the costs is conserved provable based on our backlog, we defer the excess in contracts in process on the Consolidated Balance Sheet until the cost is allocable to contracts. For other plans, the amount allocated to contracts and included in revenues has exceeded the plan's cumulative benefit costs. We have deferred recognition of these excess earnings to provide a better matching of revenues and expenses. These deferrals have been classified against the plan assets on the Consolidated Balance sheet.

Additional details regarding how the company is accounting for pension benefits associated with government contracts is not available. However, our concern is that GD's recognition of periodic costs for the company's pension plans may be understated if—as it appears from the above disclosure—the company is utilizing a secondary smoothing mechanism beyond the expense smoothing accounting that already takes place as part of the pension accounting process. That is, if the company is deferring costs against its future backlog, it may lead to lower future returns on the company's government contract work and/or a





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diversion of gains from those project towards funding the company's pension and other retirement obligations, at the expense of shareholder returns.

Large funding deficit created by material decline in pension assets in 2008:

At the end of 2010 GD's pension plan assets were \$6.25 billion—resulting in a funding shortfall of \$2.99 billion. The company's funding shortfall primarily resulted from a \$2.36 billion loss (-31.7% return) on plan assets in 2008. Cumulative returns since 2008 have totaled \$1.53 billion, leaving \$826 million in losses that have not been recouped.

After adjusting the company's PBO higher for our uniform discount rate assumption, we estimate that the company has a \$5.66 billion adjusted funding deficit—equivalent to 24.3% of its current market capitalization and 17.4% of total assets at the end of 2010.

Estimated sustainable pension expense more than double the as reported expense for 2010: During 2010 GD recognized \$166 million in periodic benefit costs on its pension plans. Our estimate of the company's sustainable pension expense is \$457 million or 175.1% higher than the expense reported in 2010. Interest expense is estimated to be \$506 million based on our adjusted PBO and uniform discount rate, minus \$375 million in expected returns based on our sustainable return assumption. Additionally, we carry-forward last year's \$211 million in service costs, deduct \$44 million for the expected amortization of prior service credits, and add \$159 million in amortization of net actuarial losses stored in AOCI. With \$3.78 billion in losses recorded in AOCI, we anticipate that the company will continue to report sizeable amortization expenses going forward.

Timken Co. (NYSE:TKR)

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Canton, OH 44706
(330) 438-3000
www.timken.com

Company description: Timken Co. (NYSE:TKR) develops, manufacturers, markets and sells anti-friction bearings and related products and steel products primarily in the United States and Europe.

Outsized discount rate assumption may be causing PBO to be understated: TKR's PBO totaled \$2.82 billion at the end of 2010. The majority (86%) of the company's PBO is associated with its U.S. plan, which was measured utilizing a 5.75% discount rate. The remainder of the company's PBO was measured using rates ranging from 4.75% to 9.00% (or 6.88% at the median). We calculate that the company's weighted average discount rate is approximately 5.87%, which ranks in the 97th percentile of all companies examined in our study. After adjusting for the uniform discount rate applied throughout this analysis, we estimate that the company's PBO may be closer to \$3.54 billion, or 25.8% higher than presented.

Returns have offset 2008 losses, but significant deficit remains: At the end of 2010 TKR's plan assets stood at \$2.42 billion, resulting in a reported funding shortfall of \$393 million. After experiencing a \$564 million loss (-22.2% return) on plan assets in 2008, plan assets have returned \$714 million in the ensuing period. While helping offset the former loss, we estimate that the company's adjusted pension deficit is closer to \$1.12 billion, or 29.8% of the company's

INDUSTRY	Industrial Machinery
PRICE	\$38.27 (08/05/11)
MARKET CAP	3.74 billion
ENT. VALUE	3.62 billion
P-E RATIO	9.59
EV/REVENUE	0.77
DEBT/EBITDA	0.00
SHORT INTEREST	0.9%
DAYS TO COVER	0.8
VIEW	NEG





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current market capitalization and 26.8% of the company's total assets at the end of 2010.

Pension expense may be understated due to outsized rate of return assumption: TKR recognized \$53 million in periodic expenses associated with the company's defined benefit pension plans. Our estimate of the company's sustainable pension expense is \$107 million, or 101.9% higher than the expense reported in 2010. The primary difference in our estimate versus the company's reported expense results from the company's abnormally high expected return on plan assets assumption of 8.75%, which ranks in the 94th percentile of all companies examined in our study.

For our estimate of sustainable pension expense, interest expense is estimated to be \$150 million based on a higher PBO and lower discount rate assumption, minus \$145 million in expected returns on plan assets utilizing the uniform lower sustainable return assumption applied throughout this analysis. We have also carried-forward the company's \$32.7 million in service expense, plus \$9.4 million in expected 2011 amortization of prior service cost, plus \$59.7 million in expected 2011 amortization of net actuarial losses out of AOCI. Since net actuarial losses stored in AOCI total \$967 million, we believe the company will be continue to report material levels of actuarial losses going forward.

Textron Inc. (NYSE:TXT)
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Providence, RI 02903
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Company description: Textron Inc. (NYSE:TXT) operates in the aircraft, defense, industrial, and finance businesses worldwide.

Adjusted PBO substantially higher than as-presented PBO: TXT's PBO stood at \$5.88 billion at the end of 2010, when measured utilizing the company's discount-rate assumption of 5.71%. TXT's discount-rate assumption ranks in the 87th percentile of all companies examined in our study, however. After adjusting for the lower uniform discount-rate assumption applied throughout this analysis, we estimate that the company's PBO may be closer to \$7.42 billion, or 26.2% higher than presented.

INDUSTRY	Aerospace & Defense
PRICE	\$18.59 (08/05/11)
MARKET CAP	5.16 billion
ENT. VALUE	9.59 billion
P-E RATIO	44.69
EV/REVENUE	0.89
DEBT/EBITDA	4.53
SHORT INTEREST	9.1%
DAYS TO COVER	5.0
VIEW	NEG

Recovery of plan-asset performance has not offset 2008 loss: At the end of 2010, TXT's pension plans were backed by \$4.56 billion in assets, resulting in a \$1.32 billion shortfall. The shortfall was due largely to a \$1.14 billion loss (-22.7% return) on plan assets recorded in 2008. Since this point the firm's pension assets have only returned \$1.00 billion, implying that \$138 million of the losses have yet to be offset by plan returns. After adjusting for a higher PBO utilizing the uniform discount rate applied throughout this analysis, we estimate that the company's adjusted funding shortfall is closer to \$2.86 billion, equivalent to 55.4% of the company's current market capitalization and 18.7% of total assets at the end of 2010.

Sustainable pension expense may be twice as large as the reported 2010 expense: During 2010 TXT recognized \$126 million in periodic benefit cost for its pension plans. Our estimated sustainable pension expense is closer to \$256 million, or 103.5% higher than the expense recognized. For our sustainable





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pension expense figure we estimate \$315 million in interest expense based on the higher PBO estimate multiplied by the uniform discount rate applied throughout this analysis, minus \$274 million to reflect what we view as a sustainable return on plan assets. Service costs of \$124 million in 2010 are carried forward as well as \$16 million in amortization of prior service costs and \$75 million in amortization of net actuarial losses. TXT has \$1.98 billion of net actuarial losses recorded in AOCI, indicating that the amortization of prior period losses is likely to remain material in the near to mid-term.

Unisys Corp.
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Company description: Unisys Corp. (NYSE:UIS) operates as an information technology company worldwide.

Material funding deficit may be a significant cash drain going forward: In combination, UIS's domestic and international PBO totaled \$7.31 billion at the end of 2010. On a weighted-average basis, the company utilized a 5.56% discount-rate assumption. We would note that this ranks only in the 68th percentile among all companies analyzed in our study and ranks as the lowest among the companies featured in this *Commentary*. That said, after recalculating the company's combined PBO to reflect the uniform discount rate applied throughout this analysis, we estimate that the company's adjusted PBO may be closer to \$8.95 billion, or 22.3% higher than presented. This is important to consider given the materiality of the company's funding deficit.

INDUSTRY	IT Consulting & Other Services
PRICE	\$18.90 (08/05/11)
MARKET CAP	815.84 million
ENT. VALUE	638.25 million
P-E RATIO	10.80
EV/REVENUE	0.17
DEBT/EBITDA	0.00
SHORT INTEREST	10.1%
DAYS TO COVER	8.3
VIEW	NEG

Adjusted funding deficit represents a substantial portion of market capitalization, total assets: UIS had \$5.97 billion in assets supporting its pension plans, resulting in a reported funding deficit of \$1.35 billion. In 2008 the company experienced a \$1.63 billion loss (-22.6% return) on plan assets. Since that point, plan assets have returned \$1.66 billion. However, after adjusting the return \$258 million lower to account for foreign exchange, plan returns are still \$224 million short of offsetting the losses experienced in 2008.

After adjusting for our higher estimated PBO, the company's adjusted funding deficit grows to \$2.98 billion, equivalent to 365.4% of its market capitalization and 98.7% of total assets at the end of 2010. Accordingly, our analysis suggests that the company's pension plans could require significant amounts of incremental funding.

UIS is reporting pension income on a significantly underfunded plan with significant losses still being stored in AOCI: Another reason for highlighting UIS in our current report is the fact that it reported a pension gain (not an expense) in income during 2010. Specifically, for 2010 UIS reported \$2.9 million of net pension income. In our view, this figure is unlikely to be representative of the true economic impact of its plan.

Our estimate of the company's sustainable pension expense is \$141 million. Our interest expense assumption is \$378 million based on our estimate of a higher PBO utilizing offset by the lower uniform discount rate applied throughout this analysis, minus \$358 million to reflect what we view as a sustainable rate of





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return on plan assets. Additionally, we carry forward the company's 2010 service expense of \$14.5 million (for international pensions) and utilize the company's assumed amortization of prior service costs of \$0.6 million and \$104 million of net actuarial losses to be recognized out of AOCI. With \$2.86 billion in net actuarial losses stored in AOCI, we anticipate the company will continue to recognize material net actuarial losses going forward.

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