Understanding Pension Risk and the Benefits of De-Risking

Glenn O’Brien
Managing Director, Prudential Retirement

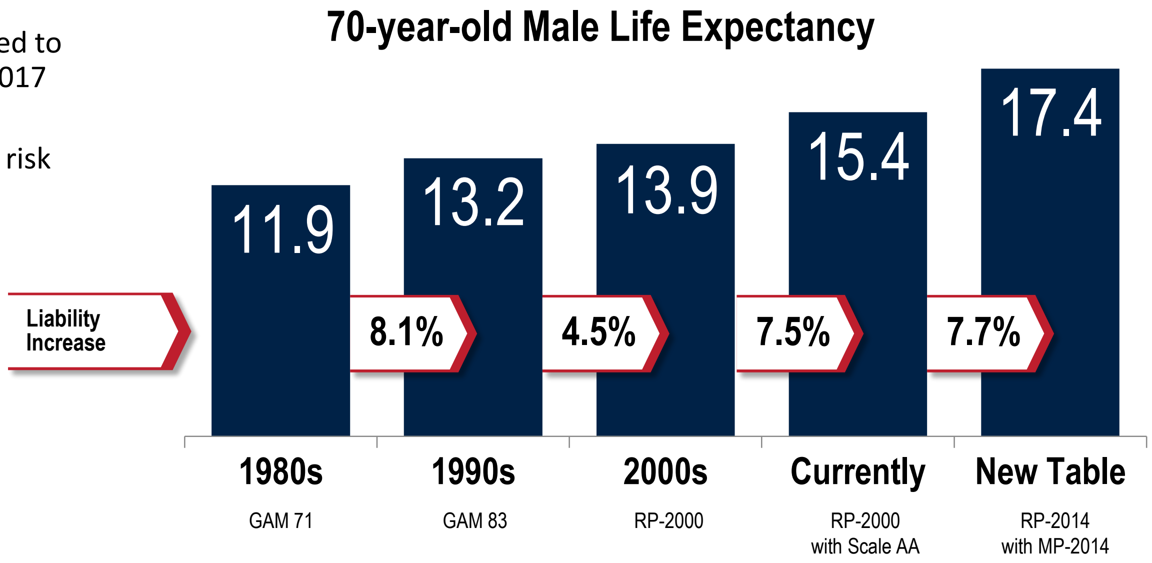
Rohit Mathur
Sr. Vice President, Prudential Retirement

Prudential
Bring Your Challenges®

Increasing Longevity Matters

U.S. pension plan sponsors face increasing liability due to mortality table updates.

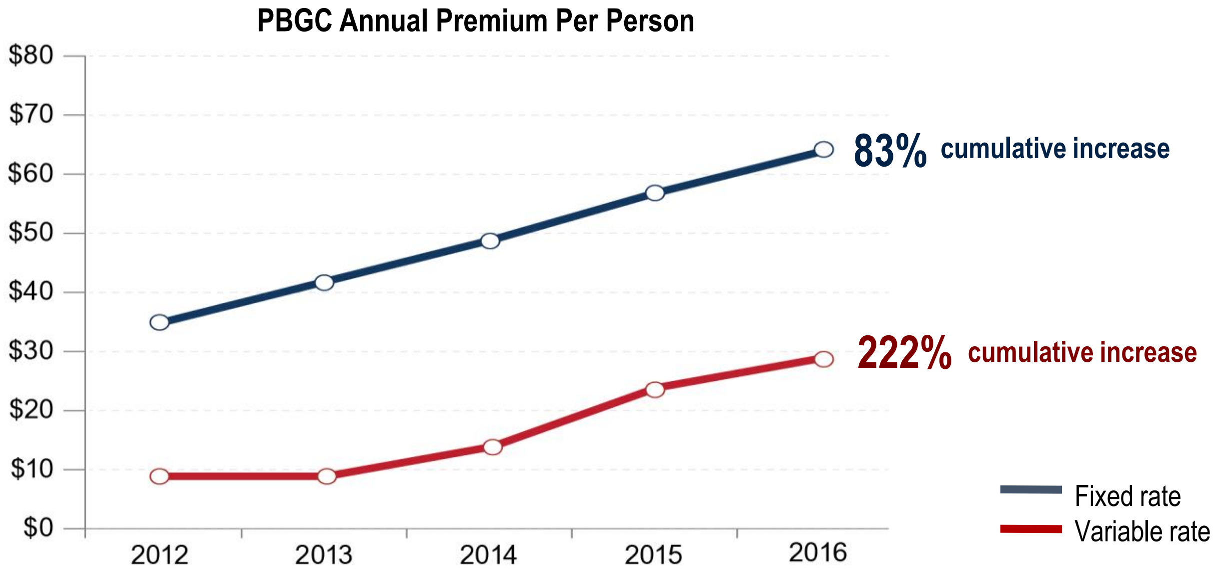
- New SOA mortality tables expected to be adopted as new standard by 2017
- Increased awareness of longevity risk among plan sponsors



Source: Prudential calculations. An update to the required table is expected to be finalized in 2014.

Regulatory Changes

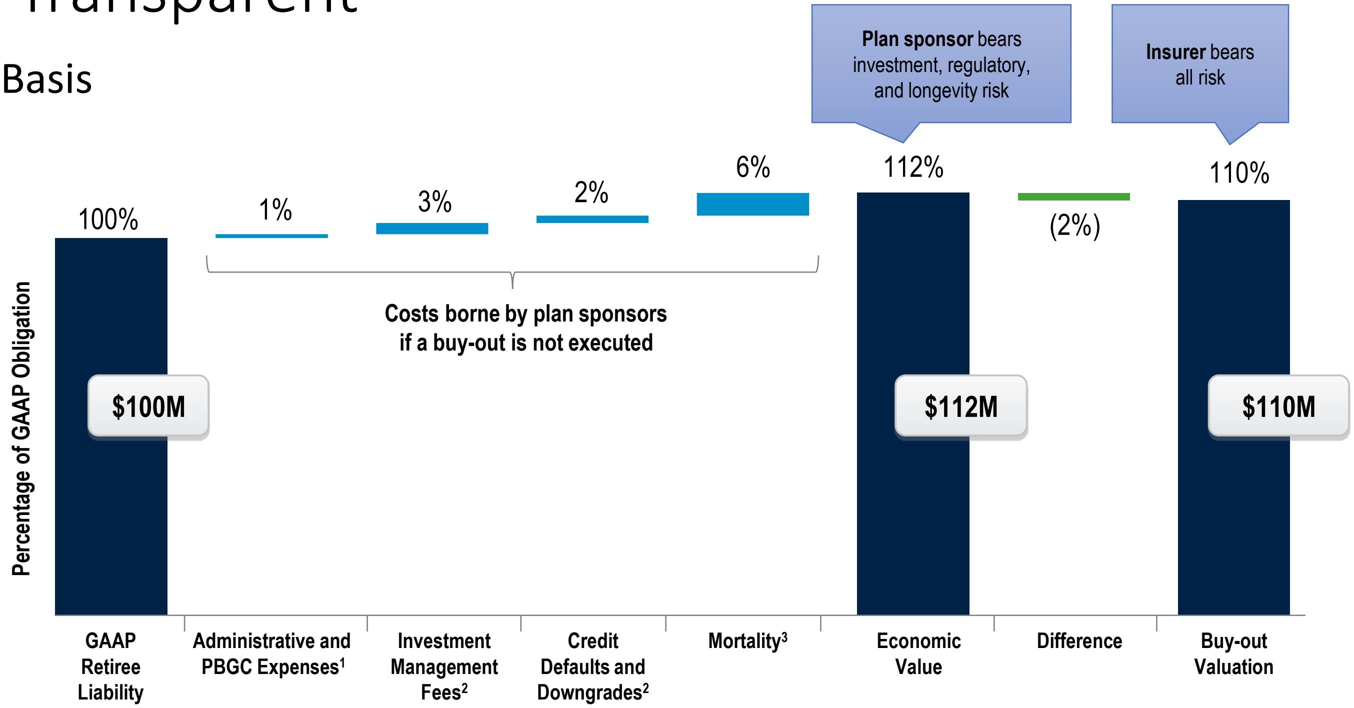
Two sharp increases in PBGC premiums in the last two years



Source: PBGC

Pricing is Transparent

Old Mortality Basis



[1] Costs not included in the GAAP retiree obligation include per person administrative expenses of $40 per year and PBGC expenses per person of $49 in 2014, $57 in 2015, $64 in 2016 and indexed after 2016.

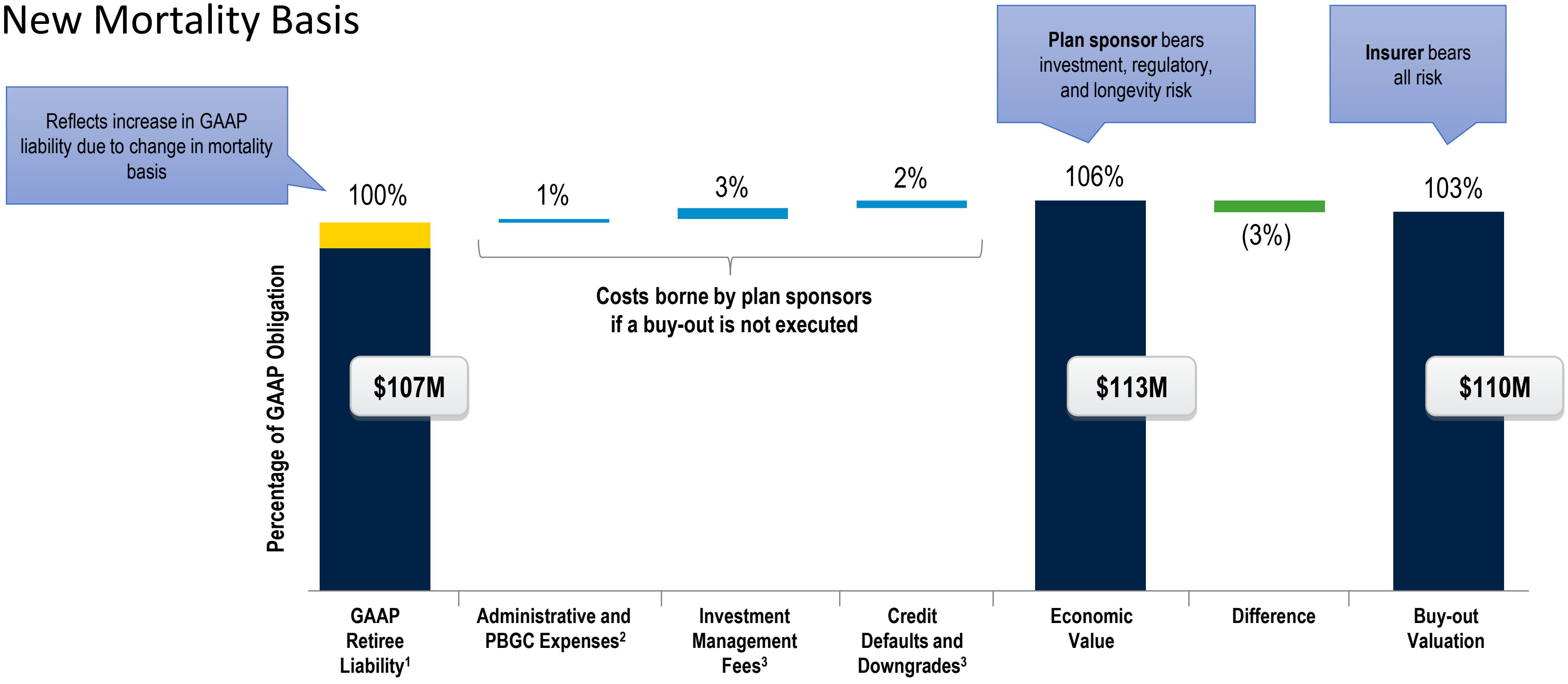
[2] GAAP obligations are discounted using rates unadjusted for investment management fees and the risk of credit defaults and migrations. These are estimated at 30 and 24 basis points per annum, respectively.

[3] This exhibit reflects a change in the mortality basis from the RP2000 Healthy Annuitant Table with Scale AA to a pricing mortality table.

Pricing is indicative and provided for discussion purposes only. Percentages represent present value of estimated future costs. Pricing is subject to change per market conditions and specific client demographic information.

Pricing is Transparent and More Economic Than We Thought

New Mortality Basis

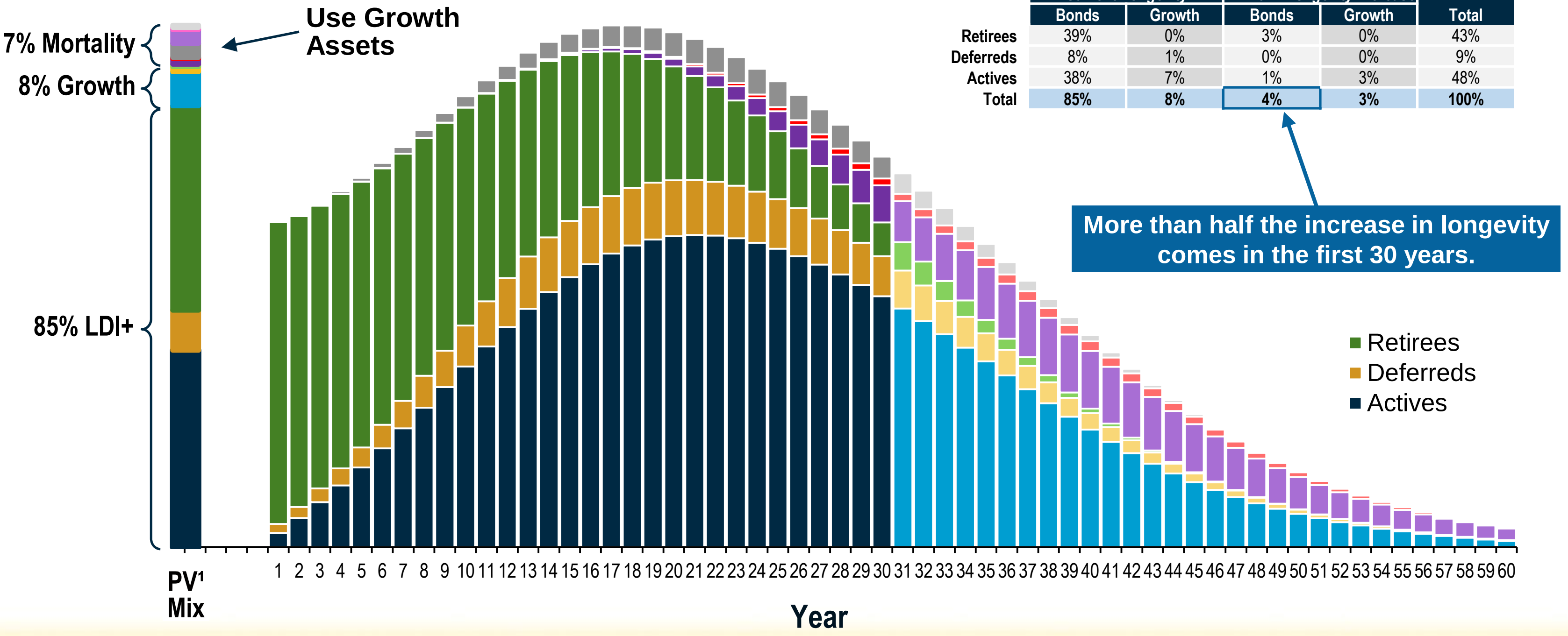


[1] GAAP liability reflects RP-2014 mortality table with MP-2014.

[2] Costs not included in the GAAP retiree obligation include per person administrative expenses of $40 per year and PBGC expenses per person of $49 in 2014, $57 in 2015, $64 in 2016 and indexed after 2016.

[3] GAAP obligations are discounted using rates unadjusted for investment management fees and the risk of credit defaults and migrations. These are estimated at 30 and 24 basis points per annum, respectively.

Projected Disbursements with RP-2014



	Current Longevity		RP-2014 Longevity Increase		
	Bonds	Growth	Bonds	Growth	Total
Retirees	39%	0%	3%	0%	43%
Deferreds	8%	1%	0%	0%	9%
Actives	38%	7%	1%	3%	48%
Total	85%	8%	4%	3%	100%

Source: Prudential Fixed Income as of May 30, 2014. For informational purposes only.
There can be no assurance that the projections will be achieved. [1] PV = Present Value.

Yes, it is debt, and paying off one's debt can be a good thing

The market demands a premium for pension risk.

1. Pension risk adds volatility to companies' stock prices
2. Pension risk increases a firm's beta
3. Pension risk increases a firm's cost of capital
4. Investors view pension liabilities as riskier than debt

Pensions weigh on the stock prices of pension-heavy companies.

Funding pension deficits and/or de-risking would create shareholder value by reducing cash flow and earnings volatility and lowering Weighted Average Cost of Capital (WACC), for many companies.

Source: Morgan Stanley, "How Corporate Pension Plans Impact Stock Prices," October 27, 2010.

Eventually Economics Matter

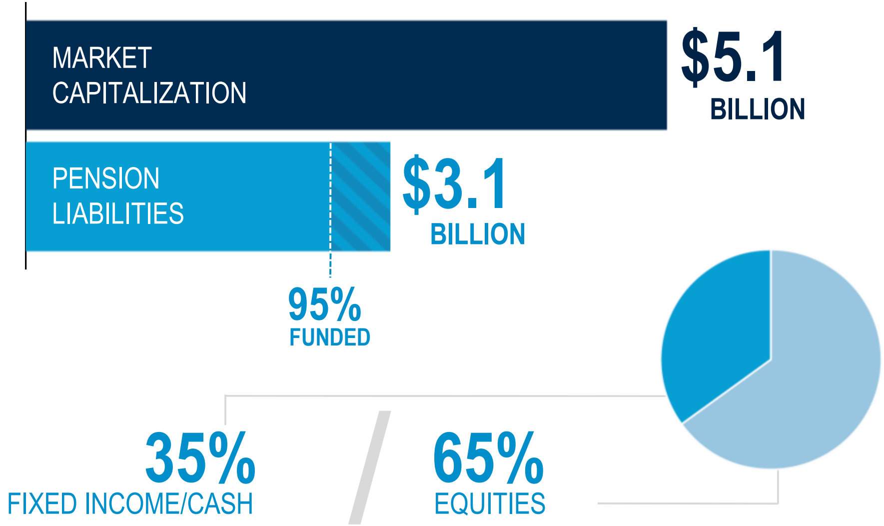
De-risking Impacts Corporate Cash Flow and Stock Price

Unfunded pension liabilities are a form of corporate debt.

That debt is effectively senior to shareholder equity.

The more risk there is in the pension plan, the more likely it is that there will be a significant increase in the unfunded pension liability and a corresponding reduction in the stock price.

To demonstrate this point, we have modeled a hypothetical company:



Source: Prudential. For illustrative purposes only.

Determining Impact of Pensions on Stock Price
Methodology

Discounted cash flow approach to corporate valuation

- Firm Value is calculated by discounting the free cash flow of the firm, excluding interest expense and pension contributions, by the Weighted Average Cost of Capital (WACC).
- Total Equity Value of the firm is calculated by deducting the value of the debt and pension obligation from the Firm Value.

Net Present Value of Pension Contributions

Methodology

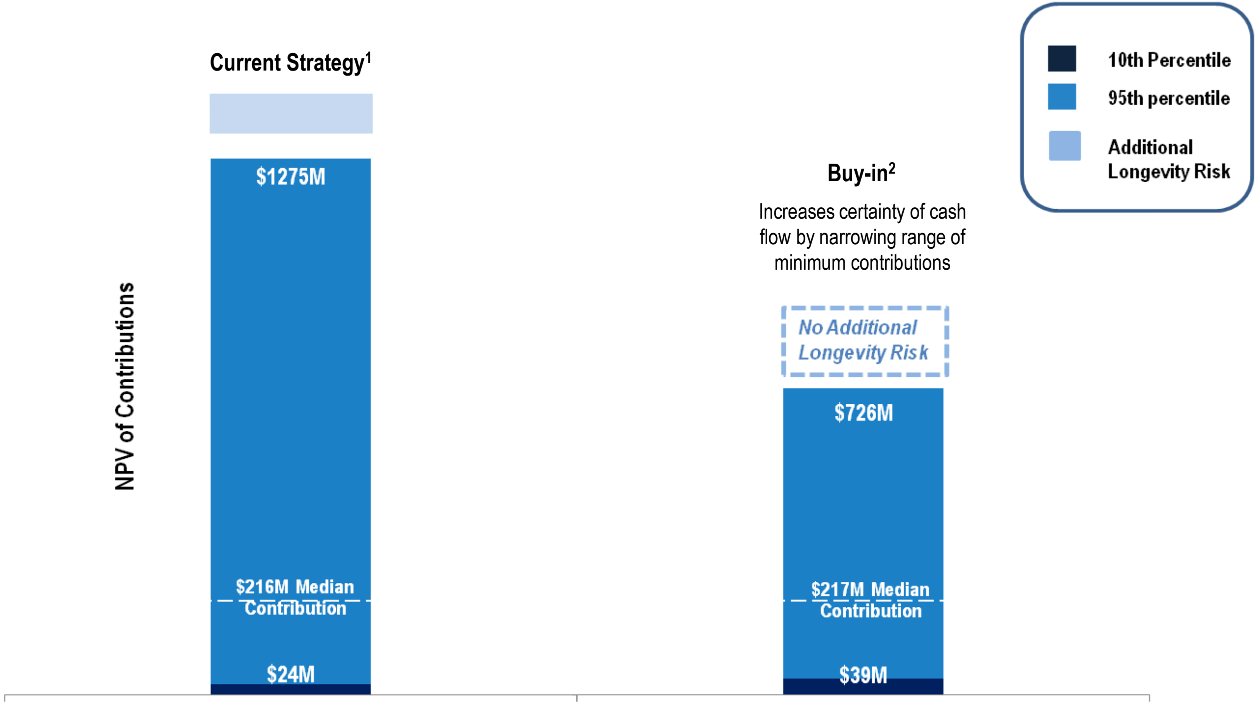
1,000 stochastic scenarios modeled using varying asset performance and interest rates

- Determined minimum contribution requirement and funded status for each scenario
- Calculated Net Present Value of U.S pension contributions for each scenario
  - For foreign plan assumed the underfunded amount as debt and held constant in all scenarios
- Scenarios modeled for current investment strategy and de-risking (buy-in) strategy

Outcomes

1. Cash volatility is reduced
2. Stock price range is narrowed and downside risk to stock price is reduced compared to upside give
3. WACC is reduced, as the pension beta is reduced
4. Lower WACC increases stock price

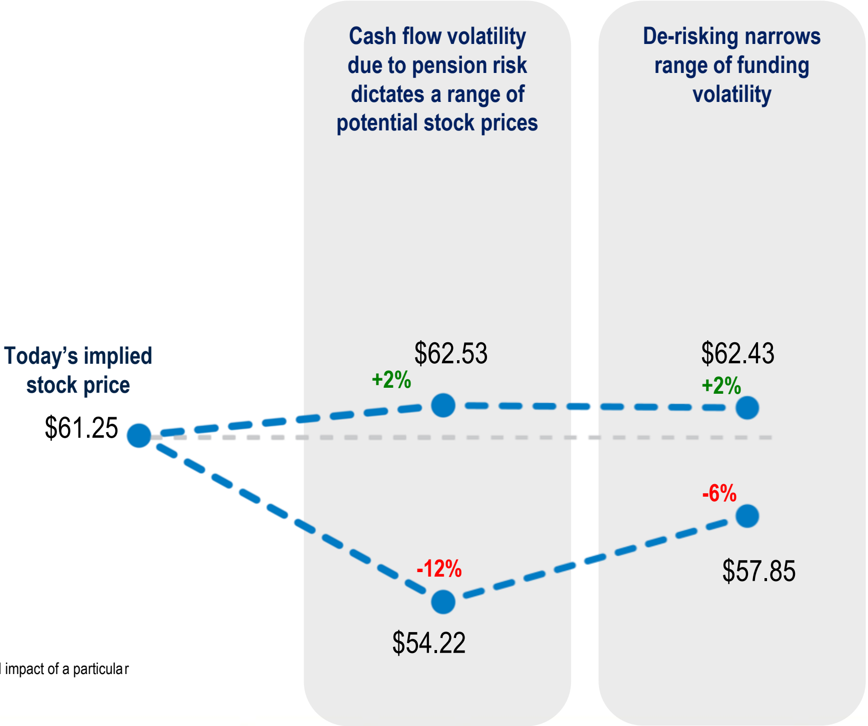
De-risking Reduces Cash Flow Volatility



Source: Prudential
[1] Equities (65%) and Fixed Income and Cash (35%)
[2] Buy-in for retirees remaining – remaining assets invested 65% Equities/35% Fixed Income
Note: These illustrations are based on Prudential models and there can be no assurance as to the actual impact of a particular transaction on a company's future stock price or cash flows.

De-risking Eliminates Downside Risk in Stock Price

Significant exposure to risk assets and interest rate risk creates funding volatility.



Note: These illustrations are based on Prudential models and there can be no assurance as to the actual impact of a particular transaction on a company's future stock price or cash flows.

Credit and Capital Structure Considerations

- Pension underfunding is viewed as a debt-like obligation
  - Tax-adjusted by Standard & Poor's, while Moody's does not explicitly factor in tax benefit of contribution
  - Pari passu to unsecured debt
- Rating methodologies and metrics do not explicitly consider a company's:
  - Asset allocation and asset / liability mismatch
  - Risk retained in case of a fully funded plan
- Impact of Buy-out
  - Generally, viewed as neutral
  - Today, qualitatively evaluate risk reduction from lower pension asset and liability volatility against cost of buy-out (impact on leverage and liquidity)
  - Analysts should explicitly (quantitatively) consider reduction in pension asset and liability volatility

Pension Impact on Credit Profile

De-risking reduces downside risk in rating profile

Category	Weight	Current
Financial Policy[2]	15%	**Baa1**
Financial Strength[3]	35%	**A3**
Overall Credit Rating		**Baa3**

Notes: Based on Moody's Global Manufacturing Methodology, Dec. 17, 2010 and Moody's Global Standard Adjustments in the Analysis of Financial Statements for non-financial corporations Dec. 21, 2010
1 . Downside scenario reflects leverage ratios calculated under 95th percentile of required plan contributions
2. Moody's analysis of financial policy includes Debt / Book Capitalization (5%) and Debt / EBITA (10%)
3. Moody's analysis of financial strength includes EBITA / Interest Expense (15%), FFO / Debt (10%), RCF / Net Debt (5%), FCF / Debt (5%)
Source: Prudential Analysis, Capital IQ
These illustrations are based on Prudential models and there can be no assurance as to the actual impact of a particular transaction on a company's future rating or cash flows.

Recent Transactions: Performance Relative to S&P500

Visteon	-0.7%	**July 16, 2014:** Annuity contract for about a third of the $1bn pension obligation
NCR	+0.6%	**November 19, 2013:** U.K. pension annuitization
SPX	+1.0%	**November 13, 2013:** Annuities for retirees and lump sums to deferred vested; General account
verizon	+2.6%	**October 17, 2012:** Annuities for management retirees; Earning release also impacted announcement day returns
NCR	+6.4%	**July 31, 2012:** Lump sums to certain deferred vested; $100M NPV benefits disclosed
GM	+1.6%	**June 1, 2012:** Annuities and lump sums to retirees
Ford	-2.5%	**April 27, 2012:** Lump sums to U.S. salaried and term vested participants; Earning release also impacted announcement day returns
Honeywell	+3.4%	**November 15, 2012:** Accelerated funding; asset de-risking strategy MTM pension accounting

Source: Capital IQ, Prudential Analysis

Market Reaction

"…the move helps significantly **reduce economic volatility, improves valuation transparency** and enables GM to **focus more on making cars rather than managing a pension fund.**"

— Morgan Stanley

Source: "General Motors: Pension Down, Credibility Up." Morgan Stanley. June 1, 2012. Used with permission.

"As GM continues to fund and de-risk its pension, investors should develop increased confidence that **incremental cash flows will accrue to them, and not the pension.** As this happens, **GM's multiple should expand.**"

— Credit Suisse

Source: "Doing the Right Thing…GM Further De-risks Pension; Positive for Equityholders."
Credit Suisse, Equity Research. June 4, 2012. Used with permission.

"...these moves have long-term **positive effects on the companies' credit profiles.** Future cash contributions will be lower and the companies will be less exposed to pension plan liability and asset volatility…In the long term, **GM should benefit from the reduction in exposure to volatility of its plan's projected benefit obligation** (PBO) caused by interest rate changes, the risk of volatility in plan asset values, and longevity risks tied to plan participants."

Source: U.S. Corporate Pensions 2013 Overview. Fitch Ratings, August 15, 2013.

Analyst reactions illustrate the impact of the transaction on perceptions, are not meant to imply endorsement of specific analysts' views, and do not necessarily represent the views of all analysts.

0267036-00001-00