Equities

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U.S. Autos & Auto Parts

GM & F: Exploring Pension Lump Sum Payouts, Potential Positive

- Industry Overview

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- **What's New?** — With year-end reporting having shed light on the state of automaker pension plans, we shift our focus to exploring the potential for automakers to pursue further pension "de-risking" this year, specifically through lump sum payouts. De-risking has gained relevance this year after market volatilities, low rates and certain rule changes prompted companies to consider alternative options beyond traditional asset funding. Indeed, both U.S. automakers have recently hinted at considering "other actions" to de-risk their plans. Based on discussions with industry experts, including Citi's Head of Pension Solutions and former PBGC Director, Charles E.F. Millard, this report examines the ins and outs of pension lump sum payouts.

- **Why Pension Lump Sums?** — Unlike traditional company plan contributions, offering lump sum options to existing retirees can allow companies to actually extinguish the liability itself, thereby reducing future volatility risk. Consider that while GM's U.S. underfunding isn't at decade highs (thanks to strong 2011 asset returns), its gross benefit obligation of $109 billion is. Lump sums can potentially address this.

- **Why Now?** — In 2012, the Pension Protection Act (PPA) amends the discount rate calculation used to determine lump-sum payments, replacing a blended Treasury + corporate bond rate with a yield curve comprised of investment grade corporate bonds. The effect should be a more favorable discount rate than in prior years. That said, we do not believe companies would necessarily attempt to "game" the discount rate (vs. GAAP) if maximizing take rates was the desired outcome (offers need to be attractive).

- **Steps to Implementation** —The automaker and the UAW would serve as the key parties to determining the offer terms, and based on our understanding, PBGC and ERISA would not play a major regulatory role so long as the funding status of the plan remains above a prescribed 80% threshold. To begin, a company would likely draft a Board resolution and file an amendment to its pension plan in order to allow the offering. After reaching an agreement with the UAW on details of the offers, retirees would be offered a voluntary "opt-in" to receive lump-sum payouts. Predicting the exact details and take rates is quite difficult. But unlike the 2007 OPEB/VEBA deals, the existence of a backstop by the PBGC (plus the fact that OEM balance sheets are healthier) likely means that only retirees who want/need the buyouts would accept.

- **Stock Implications** — It is difficult to accurately predict the probability or impact of lump sum offers. However, we would view any sizable lump sum payout as a meaningful positive, and probably more for GM than Ford due to demographics. When analyzing every fundamental metric today vs. the past 10-years, the one metric that actually screens worse today is the size of pension benefit obligations (not the underfunding). We believe this has contributed to lower OEM trading multiples and investor anxieties over pension risk. De-risking could therefore be welcomed by investors.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Figure 1. Lump-Sum Pension Presentation

Pensions in Focus: Exploring Lump-Sum Payout Options

Citi U.S. Autos

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27 February 2012

Source: Citi Investment Research and Analysis

Figure 2. Lump-Sum Pension Presentation

Pension Focus: The Lump-Sum Purchase Option

The discussion of a lump-sum payout option surfaced in a letter between GM and the UAW after 2011 labor contract negotiations. Quantifying this is far from simple, but ultimately lump-sum payouts could help de-risk U.S. plans.

- **What's New?**
  - Recently GM & Ford have each discussed exploring further "options" to de-risk their U.S. pension plans
  - YE'11 underfunding amounts were less severe than expected, but gross liabilities rose to record levels
  - Lump-sum payout options gained relevance after a letter in a supplement to the 2011 GM-UAW labor agreement suggested that the U.S. pension plan could be amended in order for GM to better manage its pension risk
- **What is a Lump-Sum Payout Option?**
  - A voluntary offer to a retiree by the former employer to obtain a lump-sum payment/distribution in exchange for the rights to the pension annuity payments
- **Why Would a Company Offer It?**
  - An incentive for higher cost retirees (and others) to exit the plan thereby reducing plan cost, risk and volatility
  - Takes out actual liability rather than just fund an asset pool that's also subject to volatility
- **Why Would a Retiree Accept It?**
  - Need/Desire for upfront cash
  - Age/Poor state of health
- **How Does this Differ from 2007 OPEB/VEBA Deals?**
  - Pension buyouts not borne out of OEM distress (PBGC backs pension payments to retirees)
  - Less opportunity to "game" the discount rate, and offers are purely voluntary

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Source: Citi Investment Research and Analysis

Figure 3. Lump-Sum Pension Presentation

Pension Focus: The Lump-Sum Purchase Option

Many options exist for de-risking a pension plan; this remains a primary investor concern

- **Options for De-Risking a Pension Plan:**
  - Fund underfunded liabilities (contribute cash, issue debt/equity)
  - Reduce equity exposure, interest rate exposure (shift assets into bonds, interest rate derivatives, etc.)
  - Freeze/terminate plan; switch to defined contribution plan
  - **Lump-sum purchases**
- **Investor/Stakeholder Interests:** –
  - Funding is transfer of wealth from shareholders to employees/retirees
  - U.S. plan underfunding viewed as debt-like (U.S. law mandates funding); an underfunded plan affects:
    - Balance sheet
    - Liquidity
    - Credit ratings
    - Equity value
- **GM Has Aggressively Moved to De-Risk Plans:**
  - Capped the U.S. populations of hourly and salaried defined benefit plans.
  - Initiated a lump-sum option in salaried pension plan upon retirement
    - Will limit the longevity of the U.S. salary plan and reduce asset and liability risk.
  - Realigned asset allocation to reduce funded status volatility, and more closely match the corresponding obligation.
    - Investment targets: 14% equity, 66% fixed income (vs. 29% & 41% at 12/31/10, respectively)

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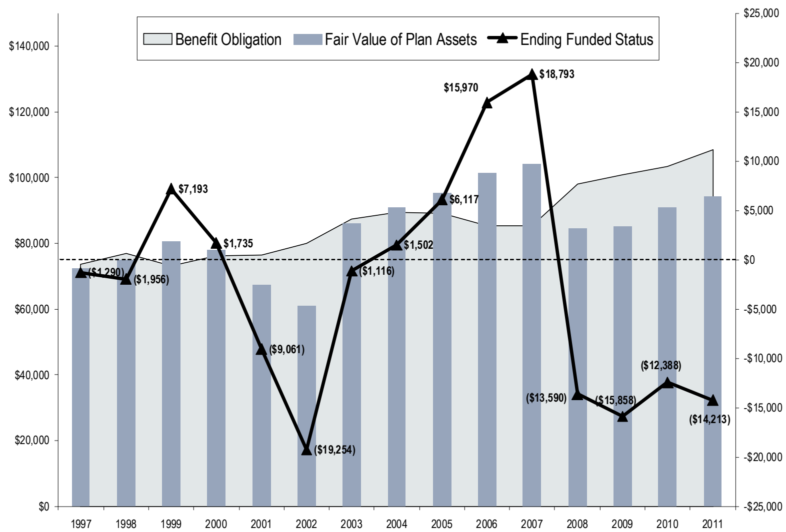
Source: Citi Investment Research and Analysis

Figure 4. Lump-Sum Pension Presentation

Pension Focus: The Lump-Sum Purchase Option

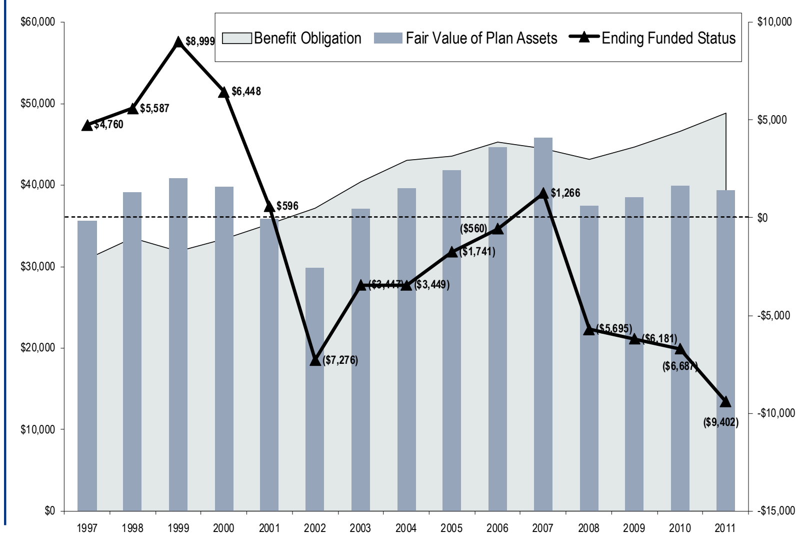
The size of pension benefit obligations and recent market volatility have magnified the need for de-risked plans; U.S. plans have decreased in funded status at GM and Ford (assets as a % of liability).

GM U.S. Pension Asset, Liability and Funded Status History



Source: Company reports, CIRA

Ford U.S. Pension Asset, Liability and Funded Status History



Source: Company reports, CIRA

- Although YE 2011 underfunding wasn't as severe as feared, benefit obligations continued to rise. Higher benefit obligations = higher inherent risk in the pension plan
- Companies are as much focused on de-risking as they are on contributing

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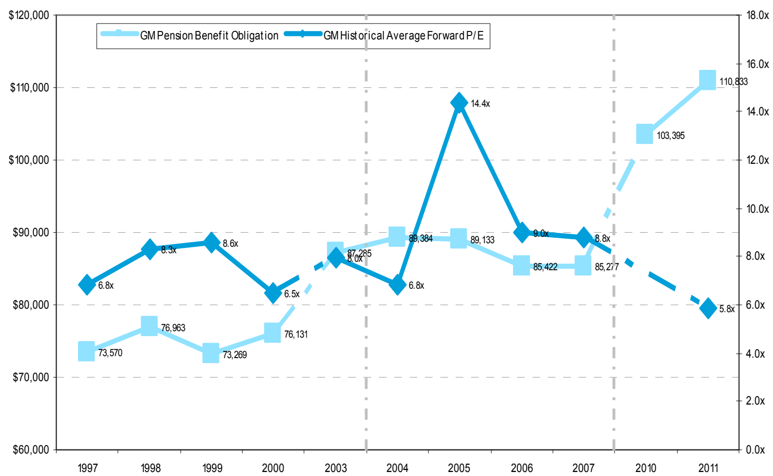
Source: Citi Investment Research and Analysis

Figure 5. Lump-Sum Pension Presentation

Pension Focus: The Lump-Sum Purchase Option

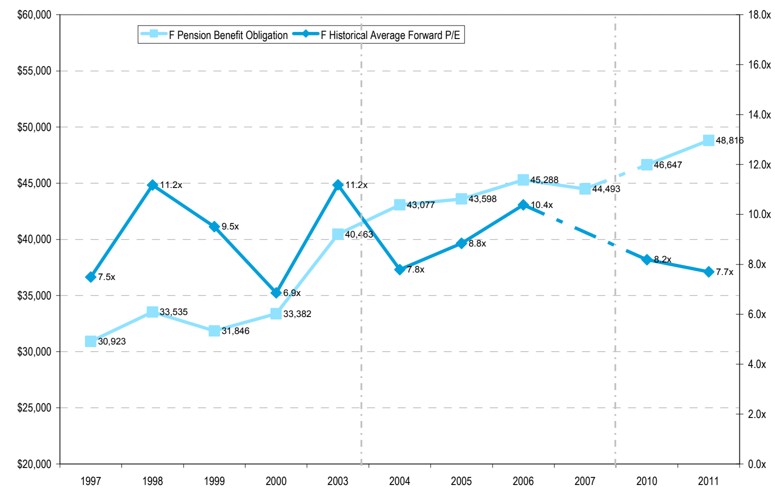
Virtually all fundamental metrics for Auto OEMs are significantly better today, except for one: U.S. Pension Benefit Obligations. While many factors affect valuation multiples, we believe pension obligations are one of them

GM Historical Forward P/E vs. U.S. Pension Liability



Source: Company reports, FactSet, CIRA

Ford Historical Forward P/E vs. U.S. Pension Liability



Source: Company reports, FactSet, CIRA

- Most investors would agree that virtually all Detroit 3 fundamental metrics – market share, pricing, margins, FinCo reliance, working capital management, liquidity, product cycle cadence – are significantly better today than they've been over the past decade. Pension Benefit Obligations remain the one exception.
- While many factors affect valuation multiples, we believe that pension obligations are one of them, as shown above.

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Source: Citi Investment Research and Analysis

Figure 6. Lump-Sum Pension Presentation

Pension Focus: The Lump-Sum Purchase Option

There are certain guidelines for enacting a pension lump sum, but the key parties would likely be the auto company, the UAW, and the retirees. Logistically, pension lump sums do not appear very onerous.

- **Who are the Key Players?**
  - Key parties include the employers (in this case GM or Ford) & the UAW, working on behalf of retirees
  - To implement, the OEM would likely need to draft a Board resolution and file an amendment to its pension plan that would allow the offering
  - Approval by ERISA, PBGC and Department of Labor aren't technically required, though they may issue an opinion on the offering's merits, according to our understanding of current rules.

- **What are the Roadblocks to Offering Lump-Sum Payouts?**
  - *The Plan's funded status*
    - Under the Pension Protection Act of 2006 (PPA), there are limitations to a lump-sum offering if a plan's funded-status drops below 80% funded; this includes subtracting pre-funding balances, commonly known as prepayments
    - If the plan falls under the 80% threshold, a company may only be able to pay a lump sum up to the amount PBGC would guarantee
  - *Demographics*
    - It may difficult to target specific groups within the plan for lump-sum payouts
    - Ideally, a company might target recent retirees, which would reduce the duration of the plan and make it less interest rate sensitive
    - Retirees in poor health (i.e. not reaching full life expectancy) would likely opt-in, increasing plan (and payout) costs
  - *Proper value to assign lump-sum payouts*
    - This primarily concerns arriving at a tenable discount rate for the lump-sum payout (more detail on the following slides)
    - <u>Companies unlikely in it to "game" the discount rate. If the goal is to maximize take rates, retirees would likely need to be presented with an "attractive" offer and one blessed by the UAW.</u>

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Source: Citi Investment Research and Analysis

Figure 7. Lump-Sum Pension Presentation

Pension Focus: The Lump-Sum Purchase Option

Arriving at a proper discount rate for the lump-sum option is not necessarily straightforward, although the discount rate assigned could end up similar or perhaps even lower than that governing normal pension obligations (i.e. U.S. GAAP)

Basic Mechanics for Establishing Discount Rate:

- IRC §417(e) sets forth applicable upper bound of interest rates for calculating a lump sum payment (i.e. the minimum size of payments)
- Interest rates used in the PV calculation must be derived from a three-segment "yield curve" of investment grade corporate bonds to determine the minimum lump-sum value of an annuity (see below and on next slide for further detail)
- Factor in the weighted average age of the pension plan's population. The weighting is based on each worker's specific benefit package
  - Plan demographics can be found in IRS Form 5500 under ERISA, Schedule SB; this relates to Single-employer defined benefit plan actuarial information

Minimum Present Value Segment Rates for Accounting Valuation, as of 1/30/12

For Plan Years Beginning in:	1st Segment	2nd Segment	3rd Segment
2011	2.25%	4.16%	4.79%
2012	2.07%	4.45%	5.24%

Source: IRS

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Source: Citi Investment Research and Analysis

Figure 8. Lump-Sum Pension Presentation

Pension Focus: The Lump-Sum Purchase Option

Interest rates used in the PV annuity calculation are derived from a three-segment "yield curve" of investment grade corporate bonds; in general, older participants will experience smaller reductions in lump-sums

A Closer Look at Discount Rate Components:

- IRC §417(e) prescribes the interest rate and mortality tables that must be used to determine the minimum PV of an annuity, and therefore the minimum value of a lump-sum distribution.
  - The Pension Protection Act (PPA) amended IRC §417(e) to replace the 30-year T-bond interest rate with a corporate bond interest rate as the rate used (not required, but sponsors prohibited from paying lump sums that are less than the amounts that would result from using the corporate bond yield curve and mortality table).
- Interest rates used in the PV calculation must be derived from a three-segment "yield curve" of investment grade corporate bonds to determine the minimum lump-sum value of an annuity
  - The corporate bond interest rate that plans use to determine the minimum lump sum value of an annuity will be based on the date at which the annuity otherwise would be payable to the participant
    - The PV of the portion of the annuity that is payable within 5 years will be valued using a short-term corporate interest rate, (i.e., the first segment of the yield curve). The portion of the annuity that is payable in 6 to 20 years will be valued using a medium-term interest rate (the second segment), and the portion of the annuity that is payable in more than 20 years will be valued using a long-term interest rate (the third segment)
- As a result, the minimum value of a lump-sum will be calculated using up to three different interest rates.
- In general, older plan participants will experience smaller reductions in their lump sums than younger participants because part of their annuities will be converted to a lump sum using short-term interest rates, which usually are lower than long-term interest rates.

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Source: Citi Investment Research and Analysis

Figure 9. Lump-Sum Pension Presentation

Pension Focus: The Lump-Sum Purchase Option

The upside and downside cases for offering a lump-sum payout

Positives

- ▲ Shrink plan in relation to size of operating company
- ▲ Smaller plan becomes less capital market sensitive
- ▲ Remove headline "pension overhang" issues
- ▲ New PPA guidelines allow for a more favorable discount rate, lowering the potential size of payments
- ▲ No tax implications to pensioners who roll payout over into IRA, making acceptance attractive

Negatives

- ▼ Funded ratio of the plan would likely drop
- ▼ Depress earnings (loss from expected return on plan assets outpaces lower interest costs)
- ▼ If retiree duration increases, plan becomes more interest rate sensitive
- ▼ Probable need to offer more attractive payouts, which increase cost of the plan
- ▼ Demographics of payout "acceptors" likely unfavorable

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Source: Citi Investment Research and Analysis

Companies Mentioned: Ford Motor Co (F.N; US$12.25; 1H); General Motors Company (GM.N; US$26.14; 1H)

Ford Motor Co

Company description

The Ford Motor Company (F) is a global company with two core businesses, Automotive and Financial Services. Automotive consists of the design, development, manufacture, sale, and service of cars, trucks and service parts. Financial Services consists of the operations of Ford Motor Credit Company (FMCC), a provider of vehicle-related financing, leasing, and insurance.

Investment strategy

We rate Ford (F) shares Buy/High Risk (1H) on a valuation-based risk/reward framework. The shares came under pressure in 2011 and the risk/reward appears imbalanced. Ford shares are likely to benefit from Japan-related pricing/share gain opportunities in the near to medium term and a strong product pipeline through 2012.

Valuation

We derive a $15 target price for the shares of F using an average of EV/EBITDAP and P/E valuation on our 2012E estimates.

We apply a 5.0x multiple to our 2012E EBITDAP of $10.4 billion to arrive at a $52 billion automotive enterprise value. We believe 5.0x is a reasonable multiple to reflect F's cyclicality partially offset by growth overseas and reduced legacy liabilities. Put differently, a 5x multiple on $10.4 billion of EBITDAP implies a 7% unleveraged FCF yield assuming $6 billion of capital expenditures and other uses (taxes, restructuring etc.) Taking our $52 billion enterprise value, we then add $8.7 billion in book value for the financial service business, as well as other assets (tax, JV value). Finally, we add excess cash balances above $8 billion, and this yields a total enterprise value of $83 billion. We then deduct Ford's gross debt and U.S. pension obligations (tax-effected) of $22 billion to arrive at a $61 billion equity value, or $15 per share.

For our P/E methodology, we apply a 10.0x multiple to our 2012E EPS forecast to yield a $15 stock value. A 10.0x multiple is somewhat higher than the historical trading range to reflect the stage of the recovery cycle, Ford's lower cash taxes vs. book taxes, as well as industry restructuring and resulting margin gains.

Risks

We rate F shares High Risk due to its relationships with organized labor unions, a distressed supply base, and commodity prices (primarily oil, steel, and resin).

Risks to F shares underperforming our target price including a weakening in the U.S. economy, slower progress in cost cutting initiatives, and weaker free cash performance. If any of these have greater or less impact than predicted, the shares could underperform or materially outperform our target price.

General Motors Company

Company description

Globally headquartered in Detroit, Michigan, General Motors Co. is a global automotive manufacturing company, with operations and sales in over 120 countries. GM assembles passenger cars, crossover vehicles (CUVs), light trucks (pick-up trucks), sport utility vehicles (SUVs), hybrids, vans and other vehicles in 71 assembly facilities globally and has an additional 88 global manufacturing centers worldwide. GM sells and services its vehicles through a global network of over 21,000 independent dealers.

Investment strategy

We rate GM shares Buy/High Risk (1H). GM fits well within our auto stock selection framework and bullish sector view, which is anchored by our sector "re-birth" theme and positive outlook for global demand. Unlike the auto supplier stocks, OEM investing requires forming conviction on that specific OEM's ability to outperform by way of profitable market share gains and superior regional exposure. We believe GM offers both at a low valuation. In particular, the North America product cycle and brand revitalization stories appear underappreciated based on our proprietary survey work, recent dealer checks and detailed product cycle analysis. We estimate that GM's 2012-14 product cycle may yield $3-4 billion in net pricing benefits. History suggests that OEM stocks are best owned heading into their product cycles, and we expect GM's upcoming cycle to prove no different. Combined with favorable industry dynamics (SAAR recovery, renewed price discipline, transition to global platforms) and GM's #1 presence in emerging markets, GM may be the most compelling 1-3 year auto turnaround story in our universe.

Valuation

We value GM shares at $36, which is based on 4.0x our 2012E EBITDAP of $9.2 billion. On a straight P/E basis, our target equates to 2012E-13E multiples of 10.5x and 7.5x. The relative multiples are somewhat higher than the 1990s averages to account for the earlier part of the SAAR recovery cycle, GM's above-average exposure to emerging markets, the upward shift in industry profitability, and, in our view, brighter market share recovery prospects ahead of the product cycle.

Risks

We rate General Motors shares High Risk based on the company's volatile earnings history and a number of qualitative factors. Risks to the stock not achieving our target price include a slower-than-expected auto sales recovery or double-dip recession scenario, market share/pricing erosion, adverse product mix shifts, worse-than-expected product launch execution, global regulatory/political risks and worse-than-expected cost execution, particularly in Europe.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Ford Motor Co (F)

Ratings and Target Price History
Fundamental Research

Analyst: Itay Michaeli

	Date	Rating	Target Price	Closing Price
1	7-Apr-09	3S	*2.00	3.49
2	24-Jul-09	3S	*4.00	6.78
3	16-Oct-09	3S	*4.40	7.42
4	20-Nov-09	3S	*6.50	8.64
5	1-Feb-10	3S	*7.50	11.12
6	28-Apr-10	*3H	*10.00	13.25
7	30-Jun-10	*2H	10.00	10.08
8	27-Jul-10	2H	*14.00	13.03
9	31-Oct-10	2H	*15.00	14.13
10	17-Dec-10	2H	*17.00	16.80
11	6-Jan-11	2H	*19.00	18.22
12	30-Jan-11	2H	*17.00	16.27
13	27-Apr-11	2H	*18.00	15.58
14	16-May-11	*1H	18.00	15.13
15	3-Oct-11	1H	*16.00	9.37
16	8-Oct-11	Stock rating system changed		
17	20-Nov-11	1H	*15.00	10.10

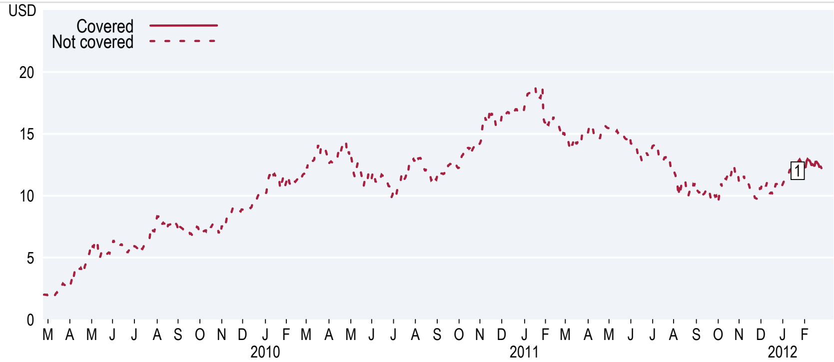
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Ford Motor Co (F)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Itay Michaeli



	Date	Rating	Target Price	Closing Price
1	23-Jan-12	*ADD MP	-	12.66

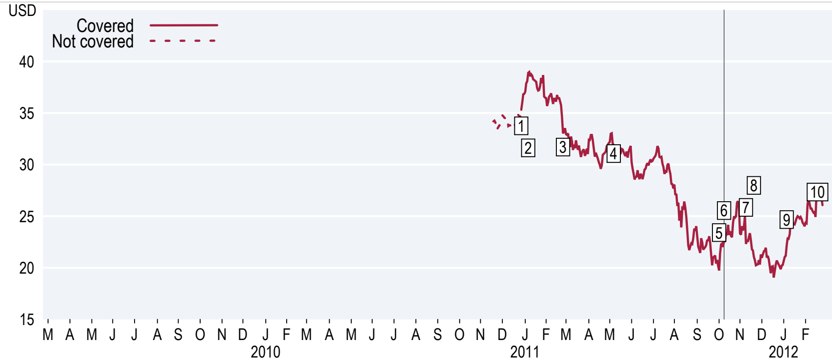
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

General Motors Company (GM)

Ratings and Target Price History
Fundamental Research

Analyst: Itay Michaeli
Covered since December 28 2010



	Date	Rating	Target Price	Closing Price
1	28-Dec-10	*1H	*45.00	35.32
2	6-Jan-11	1H	*47.00	38.90
3	24-Feb-11	1H	*50.00	33.02
4	6-May-11	1H	*48.00	31.91
5	3-Oct-11	1H	*43.00	19.73
6	8-Oct-11	Stock rating system changed		
7	9-Nov-11	1H	*37.00	22.31
8	20-Nov-11	1H	*35.00	21.68
9	5-Jan-12	1H	*34.00	22.17
10	17-Feb-12	1H	*36.00	27.34

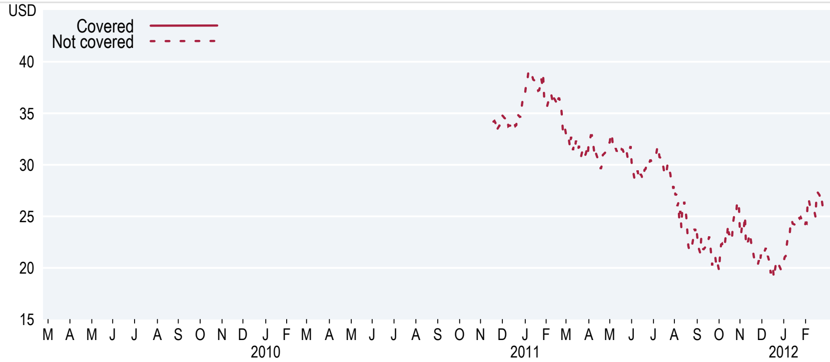
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

General Motors Company (GM)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Itay Michaeli
Covered since December 28 2010



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Citi Investment Research & Analysis Ratings Distribution

Data current as of 31 Dec 2011	*12 Month Rating* Buy	Hold	Sell	*Relative Rating* Buy	Hold	Sell
Citi Investment Research & Analysis Global Fundamental Coverage	57%	34%	9%	10%	79%	10%
% of companies in each rating category that are investment banking clients	45%	41%	40%	49%	43%	41%

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CIRA's stock recommendations include an investment rating and an optional risk rating to highlight high risk stocks.
Risk rating takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.
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