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BTN Thursday Thoughts

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April 19, 2018

Lockheed Martin – Are the Pension Issues Finally Ending?

For many years, several of the defense contractors have looked cheap and well capitalized – until investors saw the pension plans. In the case of LMT, the pension obligations were typically larger than all the funded debt at the company:

($ in bills)	2017	2016	2015	2014	2013	2012	2011	2010
Funded Debt	$14.30	$14.30	$15.30	$6.10	$6.20	$6.30	$6.50	$5.00
Underfunded Pension	$15.60	$13.60	$11.60	$11.20	$9.20	$15.10	$13.30	$10.40
EBITDA	$7.10	$6.80	$5.70	$6.60	$5.50	$5.40	$5.00	$5.10
Free Cash Flow *	$5.30	$4.10	$4.20	$3.00	$3.70	$0.60	$3.30	$2.70
Debt/EBITDA	4.2x	4.1x	4.7x	2.6x	2.8x	4.0x	4.0x	3.0x

*Free Cash Flow excludes acquisitions. In 2017, FCF was helped by a $3.4 billion reduction in deferred tax liabilities. In 2012, a cash contribution to the pension plan that exceeded pension expense by $1.9 billion lowered Free Cash Flow.

It wasn't until LMT bought Sikorsky that funded debt topped the unfunded pension obligations. The Debt and Pension Obligations-to-EBITDA has been essentially 3-4x for years now. **What the bulls always argued was the company would not need to pay for the pensions, they could bill the government for the shortfall under CAS** (Government Cost Accounting Standards), therefore it should not be viewed as a future cash obligation. (We will describe this more below – but essentially, costs associated with a government program can be reimbursed including future pension obligations and adjustment costs). **The bears argued that LMT would need to fund its pension under FASB rules, which required it to cure shortfalls within 7-years and the government looked at this type of adjustment funding over a much longer time-frame.**

Here is what was happening over the last several years with LMT's pension:

($ in bills)	2017	2016	2015	2014	2013	2012	2011	2010
Discount Rate	3.63%	4.13%	4.38%	4.00%	4.75%	4.00%	4.75%	5.50%
Exp Rate of Return	7.50%	7.50%	8.00%	8.00%	8.00%	8.00%	8.00%	8.50%
Pension Cost	$1.40	$1.00	$1.10	$1.10	$1.90	$1.90	$1.80	$1.40
Funding by LMT	-	-	-	$2.00	$2.30	$3.60	$2.30	$2.20

The company was clearly paying a sizeable amount of cash into the pension every year from 2010-14. It was fighting against the falling discount rate, which was pushing up the total liability number and thus higher funding was not curing the shortfall until the discount rate increased in 2013. Net Accrued Losses have also been impacting the situation as actuarial assumptions on the discount rate, investment losses, and changes in longevity have modified. LMT saw this hit equity for a $12.6 billion in cumulative loss in recent years. Thus, shareholder equity has fallen from a recent peak of $4.9 billion in 2013 to -$0.6 billion in 2017.

In 2018, LMT is going to make a $5.0 billion contribution to its pension plan, which will bring the total to a little over $17.4 billion paid in since 2010. The many government rule changes have definitely helped, and we will discuss the Harmonization of the CAS and FAS (Financial Accounting Standards) rules below. We would side with the bears that LMT did have to fund the pension ahead of the government reimbursing the company.

There are three different standards that come into play regarding LMT's pension.

FAS – (Financial Accounting Standards) is what most people are familiar with in working with GAAP. Simply stated, a company recognized pension benefits as earned by employees with estimates for longevity, people who will leave early, and pay increases. These assumptions compute a service cost for the year. Another cost is interest expense computed by multiplying the discount rate by the total Pension Benefit Obligation. Those two costs are netted against an estimated return earned on Funded Assets in the Pension Plan (Estimated Rate of Return * Asset). The result is pension cost under FAS that may also be adjusted for changes in assumptions and actual net losses on pension assets. That is pension cost under GAAP and it reduces net income, but as a non-cash expense, is added back to cash flow.

CAS – (Government Cost Accounting Standards) is how the company can bill the government for pension costs. CAS uses similar assumptions to calculate service cost based on current wages, longevity, etc. CAS also allows a company to bill additional expense to cover prior shortfalls between CAS forecasts and reality. This happens over time and is paid in arrears by the government. So, for example, let's assume that estimated wage growth was too low in prior years or that the discount rate used for CAS was too high. In either case, reality would show that not enough money was collected under CAS and the company could bill for not only current service cost, but also for past adjustments. The big difference in how CAS is accounted for is it shows up as revenues on the income statement. To the extent the receivables are paid in a timely manner, they come through as cash. So, whereas FAS resulted in a non-cash expense on the income statement and is added back on the cash flow statement – CAS represents cash revenues and is only adjusted on the cash flow statement if a portion was still listed as a receivable.

PAA – (Pension Adjustment Act under ERISA) this came into play in 2008 dealing with curing shortfalls in pension funding (the difference between Obligations and Assets). This law requires companies to cure shortfalls in funding over 7-years. Thus, many companies including LMT had to boost cash funding into pensions. It works more on actual assets and actual returns verses the calculated obligations. Thus, under FAS or CAS – computing expense involves an assumed rate of return multiplied by assets in the pension. LMT is currently using 7.5% and we have never seen a company that assumes a negative rate of return. However, if the fund does lose money, it is possible the funding shortfall increases and that creates a higher cash payment requirement into the fund.

The basic problems that LMT ran into in conforming to all these different sets of rules were CAS is the ultimate source of cash flow, but CAS used more lenient assumptions to minimize cash payments and stretch them out. Meanwhile FAS/GAAP and ERISA were computing higher expenses, higher underfunding levels, and faster cash funding schedules. Historically, CAS used a discount rate that was much closer to the Expected Rate of Return on Assets. The higher the discount rate, the lower the Present Value of the future obligation becomes.

Everyone is aware that interest rates overall were declining after 2008 fairly rapidly. Thus, LMT was billing the government under CAS based on high and fairly stable discount rates and not showing very large funding shortfalls to recoup shortfalls based on unrealistic assumptions. At the same time, FAS was requiring falling discount rates that were already much lower that was driving up the PV of the future obligation and ERISA was there to mandate it cure the shortfalls in 7-years. In the table above, you can see the falling discount rates used by LMT and the hefty cash payments it was making into the pension plan between 2010-14.

What Has Changed?

For FAS expense, the government realized that with the FED cutting interest rates, it was driving down the discount rates for pension plans. In 2012, the MAP-21 Act was passed that allowed companies to use a 25-year average of yields on high quality bonds as the discount rate. With rates falling rapidly after 2008, this helped considerably. As seen above, the discount rate was declining until 2012 (it was 5.875% in 2009 and 4.000% in 2012), before suddenly rising 75bp in 2013. That was the result of the new rule. It was supposed to expire by the end of 2016. However, it was extended until 2021 and will phase out in 2024.

Even as each year a higher rate is pulled out of the average and replaced by a lower rate, the discount rate stopped moving down as rapidly. This overall increase in the discount rate also cut the size of the pension-funding deficit and the funding levels began to fall too. The company's goal is to keep it above 80%.

	2017	2016	2015	2014	2013	2012	2011	2010
ERISA Funded Status	83%	86%	90%	92%	90%	90%	>80%	>80%

The heavy funding before the MAP-21 change helped LMT essentially go to zero cash funding in years 2015-17. The $5 billion contribution in 2018 should boost this ratio again.

CAS- Harmonization is the other change that came about in 2013. This was designed to make payments under CAS more closely match some of the FAS rules. The basic changes were:

1. To have CAS use the yield on high-grade bonds also for the discount rate. This effectively lowered the discount rate under CAS accounting that before more closely followed the rate of return assumptions. Thus, PBO went up and assets were flat, so there was a larger short-fall in funding under CAS that could be billed to the government

2. To change the CAS amortization period of experienced gains and losses from 15 years to 10 years. As a result, the companies could bill and be paid more quickly.

3. To allow CAS to be billed for projected increases in benefits if they are written into a collective bargaining agreement. This allowed increases to be passed along more quickly also.

These rules were transitioned into effect over 5-years – 0% in year 1, 25% in year 2, 50% in year 3, 75% in year 4, and 100% in year 5. They are now in full effect. So, the trend has been to allow higher CAS-related income for the companies. Here is what LMT has been reporting:

$ in mm	2017	2016	2015	2014	2013	2012	2011	2010
CAS	$2,248	$1,921	$1,527	$1,520	$1,466	$1,111	$899	$988
FAS	$1,372	$1,019	$1,127	$1,144	$1,948	$1,941	$1,821	$1,442
CAS/FAS Spread	$876	$902	$400	$376	-$482	-$830	-$922	-$454

Remember, CAS is income and FAS is expense. LMT is forecasting $1 billion in income from the CAS/FAS spread in 2018. That will be helped largely by the funding more of the pension assets in 2018 and having the expected rate of return on the assets reduce pension expense under FAS.

Also remember, from a cash flow standpoint, CAS is largely cash revenues and FAS is a non-cash expense. Cash funding to the pension plan represents a use of cash. In this area also, LMT has benefitted considerably of late. This assumes all the CAS income is paid in a particular year and part does not remain a receivable. So, treat this as a proxy:

$ in mm	2017	2016	2015	2014	2013	2012	2011	2010
CAS	$2,248	$1,921	$1,527	$1,520	$1,466	$1,111	$899	$988
Pension funding	$46	$23	$5	$2,000	$2,250	$3,837	$2,285	$2,240
CAS/contrib Spread	$2,202	$1,898	$1,522	-$480	-$784	-$2,726	-$1,386	-$1,252

LMT went from seeing pensions consume over $2 billion in cash per year to generating over $2 billion in cash per year with the CAS Harmonization rules. LMT is forecasting that after a $5 billion payment in 2018, it will not have a material cash payment to the pension plan in 2019 or 2020.

LMT froze its pension for non-union people and is transitioning new-hires away from defined benefit plans

> ***"Many of our employees are covered by qualified defined benefit pension plans*** *and we provide certain health care and life insurance benefits to eligible retirees (collectively, postretirement benefit plans). We also sponsor nonqualified defined benefit pension plans to provide for benefits in excess of qualified plan limits.* ***Non-union employees***

> ***hired after December 2005 do not participate in our qualified defined benefit pension plans,*** *but are eligible to participate in a qualified defined contribution plan in addition to our other retirement savings plans.* ***They also have the ability to participate in our retiree medical plans, but we do not subsidize the cost of their participation in those plans*** *as we do with employees hired before January 1, 2006.* ***Over the last few years, we have negotiated similar changes with various labor organizations such that new union represented employees do not participate in our defined benefit pension plans.***
>
> ***In June 2014, we amended certain of our qualified and nonqualified defined benefit pension plans for non-union employees; comprising the majority of our benefit obligations; to freeze future retirement benefits.*** *The calculation of retirement benefits under the affected defined benefit pension plans is determined by a formula that takes into account the participants' years of credited service and average compensation. The freeze will take effect in two stages.* ***On January 1, 2016, the pay-based component of the formula used to determine retirement benefits was frozen so that future pay increases, annual incentive bonuses or other amounts earned for or related to periods after December 31, 2015 are not used to calculate retirement benefits. On January 1, 2020, the service-based component of the formula used to determine retirement benefits will also be frozen so that participants will no longer earn further credited service for any period after December 31, 2019.*** *When the freeze is complete, the majority of our salaried employees will have transitioned to an enhanced defined contribution retirement savings plan. As part of the November 6, 2015 acquisition of Sikorsky, we established a new defined benefit pension plan for Sikorsky's union workforce that provides benefits for their prospective service with us. The Sikorsky salaried employees participate in a defined contribution plan. We did not assume any legacy pension liability from UTC."*

This should have the impact of reducing the service cost component of pension expense that builds Pension Obligations over time. It should also create more transition expenses. Overall, this should reduce pension expense under FAS and CAS. LMT will continue to fund remaining shortfalls with cash as needed. Also, most of the time – defined contribution plans like 401-k's get some matching, profit sharing components paid by the employer. LMT will need to pay for some of those in cash.

How Will Pensions Impact the Future?

The transition to CAH Harmonization is over. Having it phase in 25% per year was a great tailwind to grow earnings and cash flow in recent years. We would expect the rate of change to for CAS/FAS income to peak and perhaps start to decline in 2019. **This may be important because the swing in CAS/FAS income has been $1.8 billion** from being a -$922 million drag in 2011 to an $876 million source of income in 2017. Total operating income – with the acquisition of Sikorsky in 2015 – has grown from just over $4 billion to $5.9 billion over that same time. The CAS/FAS income has played a huge role in income gains for LMT. It's unlikely to disappear and operating profit did rise in 2017 by $372 million with CAS/FAS declining by $26 million. But, if this becomes a smaller figure overall after 2018 – earnings growth could suffer at LMT.

In addition, higher interest rates should lower CAS Income as well as FAS expense and shrink the underfunded part of the pension in both cases. LMT estimates that a 0.25% change in the discount rates changes the pension obligation by $1.5 billion and the FAS pension cost by $115 million. Rising interest rates should also cost LMT more cash interest expense on the debt they use to finance the $5 billion contribution to the pension plan in 2018. Given that FAS is non-cash, CAS is cash income, and Interest Expense is a cash cost – this should lead to lower cash flow from this area post 2018.

Also, don't forget there are multiple sets of books being used here. LMT's financial statements use FAS, which is GAAP accounting to assess the pension plan's status. They also use ERISA rules to determine how much if any cash contributions are required. However, CAS is paying adjustments to catch-up on the pension shortfall and it is paying based on the shortfall under CAS accounting. CAS assumptions have traditionally favored making CAS shortfalls smaller than FAS and use longer-term time horizons than ERISA. Thus, forecasts that CAS is about to pay in another $9-$10 billion based on FAS underfunding levels after the $5 billion contribution, may be overstating what CAS is still going to fund. Therefore, CAS income could decline faster than FAS expense too and make the CAS/FAS income figure fall rapidly.

We noted above that LMT is moving employees to contribution plans and it will likely have to pay matching contributions. It is doing that already – only it is using common stock to pay for it at this point:

> *"We maintain a number of defined contribution plans, most with 401(k) features, that cover substantially all of our employees. Under the provisions of our 401(k) plans, we match most employees' eligible contributions at rates specified in the plan documents. Our contributions were $613 million in 2017, $617 million in 2016 and $393 million in 2015, the majority of which were funded using our common stock. Our defined contribution plans held approximately 35.5 million and 36.9 million shares of our common stock as of December 31, 2017 and 2016."*

One of the bigger issues that could impact LMT as this pension catch-up and transition slows is this has been a huge source of cash flow for the company. LMT has also conditioned investors to expect rising dividends and sizeable stock repurchases. There is little margin here to continue all that unless CAS cash flow keeps rising. Just look at the last few years:

$ in mm	2017	2016	2015
Net CAS Cash	$2,202	$1,898	$1,522
Total Cash Ops	$6,476	$5,189	$5,101
% of CFO from net CAS	34%	37%	30%
Capital Spend	$1,177	$1,063	$939
Free Cash Flow	$5,299	$4,126	$4,162
Dividend	$2,163	$2,048	$1,932
Dividend % FCF	41%	50%	46%
Stock Repurchase	$2,001	$2,096	$3,071
Cash after Div/Repo	$1,135	-$18	-$841

These are years where CAS has provided growing cash with minimal pension contributions being made by LMT. In every other year since 2010, except 2017, LMT has essentially spent all its free cash flow on dividends and repurchases. What happens as CAS-provided cash flow declines? It's unlikely to disappear – so we are not saying one-third of cash flow is going to vanish. However, a drop of $1 billion may not be unreasonable. Before the Harmonization catch-up, CAS was bringing in $900 million to $1.1 billion per year. And during that time, LMT was making annual contributions of over $2 billion to the pension plan. That's unlikely to happen again too. So, LMT has gone from an abnormally bad situation to an abnormally good situation since 2010. A normal year in 2019 or 2020 could see the pension cash flow situation drop from over $2 billion to about $1 billion.

The potential problem is LMT has added some new cash needs. It will have borrowed $5 billion that it has to pay interest on and eventually, likely repay. It will still have some pension funding contributions to make in the future. It is now incurring $600 million in 401-k costs per year and that is likely to grow as more people are moved toward that situation. If they issue stock to cover that, they will need to buy back even more stock for the repurchase plan to work as planned. Yet, the dividend and the repurchases already consume nearly all of Free Cash Flow before factoring in anything new that requires cash or a reduction in CAS post 2018.

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