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Big deficits mean big cash contributions to corporate pensions

By DAVID MILSTEAD

Canada's corporate pensions were in the best shape in years at the end of 2013. Not as much in 2014. Probably worse this year.

It's not good news for pension recipients, but it's also not good news for investors in some of the biggest names on the Toronto Stock Exchange. Companies that maintain defined benefit pension plans for broad swaths of their work force will find themselves contributing millions of dollars – sometimes tens or hundreds of millions – more over the next few years than they might have expected just over a year ago. That cuts into cash flow that would otherwise be available for capital investment or dividend payments to shareholders.

The analysts at **Veritas** ***Investment Research*** looked at pension plans at members of the TSX 60 to gauge the situation. Their conclusion: The total deficit of the companies ***Veritas*** studied grew from $6-billion at the end of 2013 to $15-billion at the end of 2014, with the possibility of the gap growing to $22-billion at the end of this year. That could mean these companies' annual cash contributions increase, on average, by more than 30 per cent this year, as well as in 2016, ***Veritas*** estimates.

"After five years of pain, 2013 offered the hope that DB plan deficits would be an issue of the past," writes ***Veritas*** analyst ***Dimitry Khmelnitsky***. "Unfortunately," he says, "deficits are again set to balloon."

The companies are not the culprit. If anyone, it's the Bank of Canada, which shocked the world with its January interest-rate cut. Here's why: Pension liabilities, which are payments promised to company retirees over the course of many years in the future, must be valued in present-day dollars. The math requires an interest rate to discount those future payments; in Canada companies use a long-term corporate-bond rate.

As the rate goes higher, the present value of liabilities is lower. Unfortunately, the opposite is true: As the rate gets lower, the liabilities get higher. And rates … well, they've gotten lower since 2013, contrary to many folks' expectations.

That's made a big impact: ***Veritas*** estimates that a decrease of 0.25 percentage points in the discount rate (i.e., the rate at which they must discount future payments to retirees) at BCE Inc., for example, adds $540-million to its pension deficit. Canadian Pacific Railway Ltd., Imperial Oil Ltd., Telus Corp., Power Corp. of Canada and Thomson Reuters Corp. all see their deficits jump by $200-million or more by that 0.25-percentage-point decrease.

Telus, which was essentially break-even at the end of 2013, swung to a $426-million deficit, according to its annual report. BCE's $1.35-billion deficit grew to just over $2-billion, ***Veritas*** believes, based on BCE disclosures. It also believes deficits at Imperial Oil will double, and Thomson Reuters could see its $260-million 2013 deficit nearly triple. (Companies that have already reported are typically, but not always, showing deficits larger than what ***Veritas*** forecast in its Feb. 3 report.)

These numbers are largely manageable for Canada's big pension plan sponsors. For perspective, ***Veritas*** compares the plan deficit to the companies' market capitalization. All but one of the companies

have pension deficits that are single-digit percentages of their market value, with most at just 2 per cent or less. (Bombardier Inc., whose pension issues I chronicled last month, is the exception, with an estimated pension deficit equal to 23 per cent of market cap.)

Or, another perspective on the relative health of Canadian pensions: The Mercer Pension Health Index, which estimates the health of a hypothetical Canadian defined benefit pension plan, fell from 106 per cent at the end of 2013 to 95 per cent at the end of 2014. By contrast, the aggregate funding level at corporate pensions at the member companies of the S&P 1500, the 1,500 largest U.S. companies, fell from 88 per cent at the end of 2013 to 79 per cent at Dec. 31, 2014, Mercer estimates.

What does this mean for actual cash going out the door? That's actually even harder to estimate, ***Veritas*** says. The increase will be gradual, as companies are allowed to "smooth" their deficits over three years to minimize the short-term shocks that one year's pension changes may bring. Some companies have made voluntary extra payments in the past that can be applied against future contributions. Companies can use letters of credit instead of cash in certain circumstances. And some companies have plans in foreign countries where funding requirements are not as strict as in Canada. (Bombardier is a beneficiary of this last situation, which mitigates its pension funding stats.)

All that said, ***Veritas*** believes companies should expect to expend more cash on their pensions over the coming years, a view shared by Manuel Monteiro, a partner at consulting firm Mercer, who said in December plan sponsors "can expect to make higher pension contributions."

Veritas expects Bombardier's cash contributions to increase by $88-million, or 22 per cent; Power Corp.'s to grow by $156-million, or 117 per cent; and Thomson Reuters' contribution increased 265 per cent to $256-million from $70-million in 2014. ***Veritas*** expected BCE to make $602-million in cash contributions in 2015, up from $240-million last year. But BCE said Feb. 5 it made $406-million in cash contributions in 2014, plus a special $350-million payment in December to shore up the pension plans in the recently acquired Bell Aliant. Even after that, BCE expects to put $400-million in cash into the plans this year. (BCE owns 15 per cent of The Globe and Mail.)

Thomson Reuters is one company that illustrates the forecasting difficulty: It made a $500-million voluntary contribution in 2013, and the company's chief financial officer, Stephane Bello, said Feb. 11 that the increase in cash pension contributions, cash taxes, and cash interest expense in 2015 would all told sum up to $30-million to $50-million.

Other companies may report lower cash contributions – at least in 2015. If rates stay low the remainder of this year, funding numbers may be worse at the end of 2015. And the sad news about Canadian corporate pensions will continue.

Low interest, high deficit

Companies that sponsor large defined-benefit pension plans are getting dinged by low interest rates. Because of the way a plan's liabilities are calculated, a decrease in rates increases a plan's deficit. In the right-hand column, below, analysts at ***Veritas Investment Research*** have estimated how much each company's deficit could grow if interest rates drop by 0.25 percentage points.