Daiwa Securities

General Electric Company (GE)

Global Credit Research GCRE012

FICC Research Dept.

Credit Issues (2): Pensions

- $29bn of underfunded pension liabilities; part of the pension liability to be transferred when splitting the Healthcare unit
- $4bn of annual pension costs driven by actuarial losses; $18bn of unrecognized net actuarial loss to be amortized in the future
- $6bn of contributions in 2018 and no contributions expected in 2019; pension contributions should be manageable as they should be offset by $4bn annual savings from dividend cuts. Low returns on plan assets, falling mortality rates remain major risk factors.

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Daiwa Securities Co. Ltd.

This is the second report in our series on GE credit issues. In our first report we looked into GE's borrowings structure and GE's policy regarding leverage. We could confirm that GE has no liquidity issues in the short term due to its cash holdings and its rich credit facilities. However there is a concentration of debt maturities in 2020 that requires refinancing and/or raising cash by selling assets. The continuity of GE's commitment to strengthening its balance sheet after the management change last year is credit positive. For more details on GE's borrowings please refer to our previous report: "General Electric Company- Credit Issue 1: Concentration of debt maturities in 2020" released on December 14th, 2018.

Besides the above borrowings, GE's debt consists also of a large underfunded pension liability, which is the focus of our current report. GE sponsors a number of pension plans, including two principal pension plans as well as other affiliate pension plans.
The principal pension plans are the GE Pension Plan and the GE Supplementary Pension Plan. In the end of FY17, The GE Pension Plan is a defined benefit plan that covers approximately 240,000 retirees and beneficiaries, approximately 150,000 vested former employees and approximately 49,000 active employees. This plan is closed to new participants. The GE Supplementary Pension Plan is an unfunded plan that provides supplementary benefits to higher-level, longer-service employees. The GE Supplementary Pension Plan annuity benefit is closed to new participants and has been replaced by an installment benefit.
Other pension plans include 51 US and non-US pension plans with assets or obligations greater than $50m. These other pension plans cover approximately 63,000 retirees and beneficiaries, approximately 76,000 vested former employees and approximately 40,000 active employees.

In the end of FY17, the total projected benefit obligations (PBO), including both principal pension plans and other pension plans, amounted to approximately $100bn. GE had approximately $72bn of assets to meet these obligations that results in approximately $29bn of underfunded pension liability. Principal pension plans account for 86% of the underfunded amount. GE plans a transfer of approximately $18bn of debt and pensions obligations to Healthcare unit as GE intends to separate the Healthcare segment in the future. Lawrence Culp, who was appointed Chairman and CEO of GE in October, 2018 did not mention the timing or the form of the split and he might take some time to make his own evaluations. For more details on the funded status please refer to Chart 1.

In FY17, GE reported $4bn of pension costs, including $3.2bn of net actuarial loss amortization. For more details on pension costs please refer to Chart 2. As December, 2017, GE had $18bn of net actuarial losses that need to be amortized in the future. GE lowered the long-term expected return rate on GE Pension Plan for cost recognition in 2018 to 6.75% from 7.5% assumed in 2017.

GE made $6bn of contributions to GE Pension Plan in 2018 compared to $1.4bn in 2017, contributions funded by intercompany loans from GE Capital. GE does not plan to make any contributions in 2019.

We expect GE to make further contributions to its pension plans in the future given the large underfunded liability, the high amount of unrecognized net actuarial losses and a lower long-term expected return rate on the plan assets. However we think the contributions should be manageable and should be mostly offset by approximately $4bn of retained cash due to dividends cut. GE announced on October 30, 2018 that it would reduce the quarterly dividend from $0.12 cents to $0.01 cent per share beginning with the Board's dividend declaration in December 2018. We could also see pension liability shrinking over time if the market interest rates increase. Higher interest rates would increase the discount rates used in the actuarial models that would result in a lower present value of the projected benefit obligation (PBO). The discount rate for principal pension plans at end of FY17 was 3.64%. (Discount rates used to measure pension obligations and pension costs are different for the same year. The discount rate used to measure the pension obligations at the end of the year is used to measure pension cost in the following year). A 25bps increase in discount rate would decrease the pension benefit obligation at year-end by about $2.4bn according to GE estimates.

The main risk factors that could increase the pension debt are low returns on assets, falling mortality rates, lower market interest rates. GE evaluates discount rate and expected return on assets annually and mortality rates on a periodical basis. A 50bps decrease in the expected return on assets would increase pension cost in the following year by $0.3bn according to GE estimates.

Chart 1: Funded status of the pension plans

	Principal pension plans		Other pension plans	
December 31 (in millions)	2017	2016	2017	2016
Projected benefit obligations	$ 74,985	$ 71,501	$ 25,303	$ 22,543
Fair value of plan assets	50,361	45,893	21,224	17,091
Underfunded	$ 24,624	$ 25,608	$ 4,079	$ 5,452

Source: Company materials

Chart 2: Costs of pension plans

	Total			Principal pension plans			Other pension plans		
(In millions)	2017	2016	2015	2017	2016	2015	2017	2016	2015
Service cost for benefits earned	$ 1,629	$ 1,699	$ 1,840	$ 1,055	$ 1,237	$ 1,424	$ 574	$ 462	$ 416
Prior service cost (credit) amortization	285	304	205	290	303	205	(5)	1	—
Expected return on plan assets	(4,639)	(4,370)	(4,183)	(3,390)	(3,336)	(3,302)	(1,249)	(1,034)	(881)
Interest cost on benefit obligations	3,462	3,609	3,333	2,856	2,939	2,778	606	670	555
Net actuarial loss amortization	3,241	2,705	3,577	2,812	2,449	3,288	429	256	289
Curtailment loss (gain)	43	50	99	64	31	105	(21)	19	(6)
Pension cost	$ 4,021	$ 3,997	$ 4,871	$ 3,687	$ 3,623	$ 4,498	$ 334	$ 374	$ 373

Source: Company materials

Chart 3: GE assumptions for pension cost calculations

	Principal pension plans			Other pension plans (weighted average)		
December 31	2017	2016	2015	2017	2016	2015
Discount rate	4.11%	4.38%	4.02%	2.58%	3.33%	3.53%
Expected return on assets	7.50	7.50	7.50	6.75	6.36	6.95

Source: Company materials

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1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
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■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

Assumptions, Significance and Limitations of Credit Ratings

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[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.co.jp/web/)

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May 2018

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in materials presented along with this cover letter, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction.
In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name:Daiwa Securities Co. Ltd.
Financial instruments firm:chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type Ⅱ Financial Instruments Firms Association