



Rethinking Pension Valuation  
Economic Reality of Pension Liabilities

May 15, 2006

ThyssenKrupp



# Agenda

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CFO & Executive Board Member of ThyssenKrupp AG

- Pensions at ThyssenKrupp: Status Quo and Development
- Analysts' View
- Funding of Pensions
- Pensions – CFO's Perspective
- Appendix



# ThyssenKrupp Pension Liabilities

## Germany

Mainly internally funded

Pension	Oct 1, 2004	Sep 30, 2005
Liabilities	€6,133 million	€6,392 million

Financed by accruals  
(covered by fixed assets)

⇒ Internal funding

## Outside Germany

Mainly externally funded

Pension	Oct 1, 2004	Sep 30, 2005
Liabilities	€752 million	€875 million

Financed by fund assets

⇒ External funding

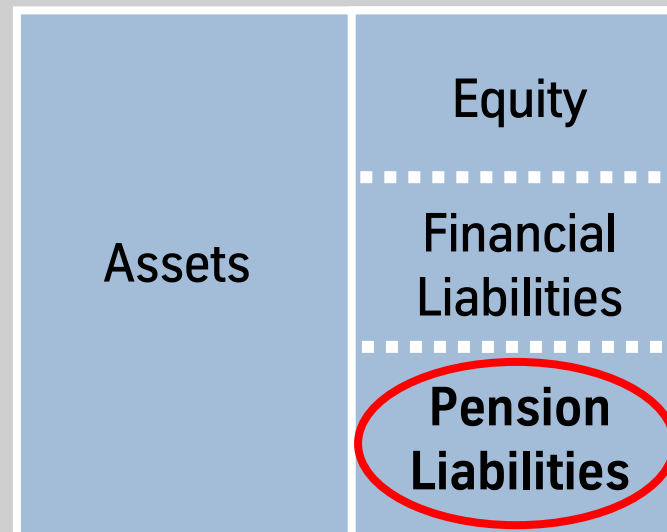
⇒ Two different systems

The presentation will focus on German accrued pensions (mainly internally funded).



## Characteristics of Internally Funded Pension Liabilities

- Internally funded pensions are **funded by assets**
- Pension liability in the balance sheet to be seen as a reminder of **annual cash outflows**
- **Neither redemption nor repayment in one go**



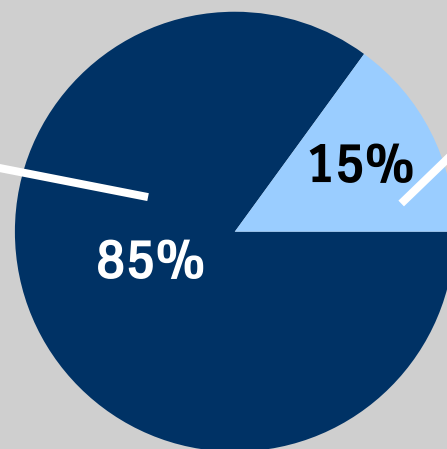
⇒ **Strong distinction of pension liabilities from financial liabilities**

## ThyssenKrupp Pension Scheme – Status Quo

### Very mature pension scheme

**Active pensioners**  
(ave. age 72 years)

⇒ Decrease in number over time with mortality rates



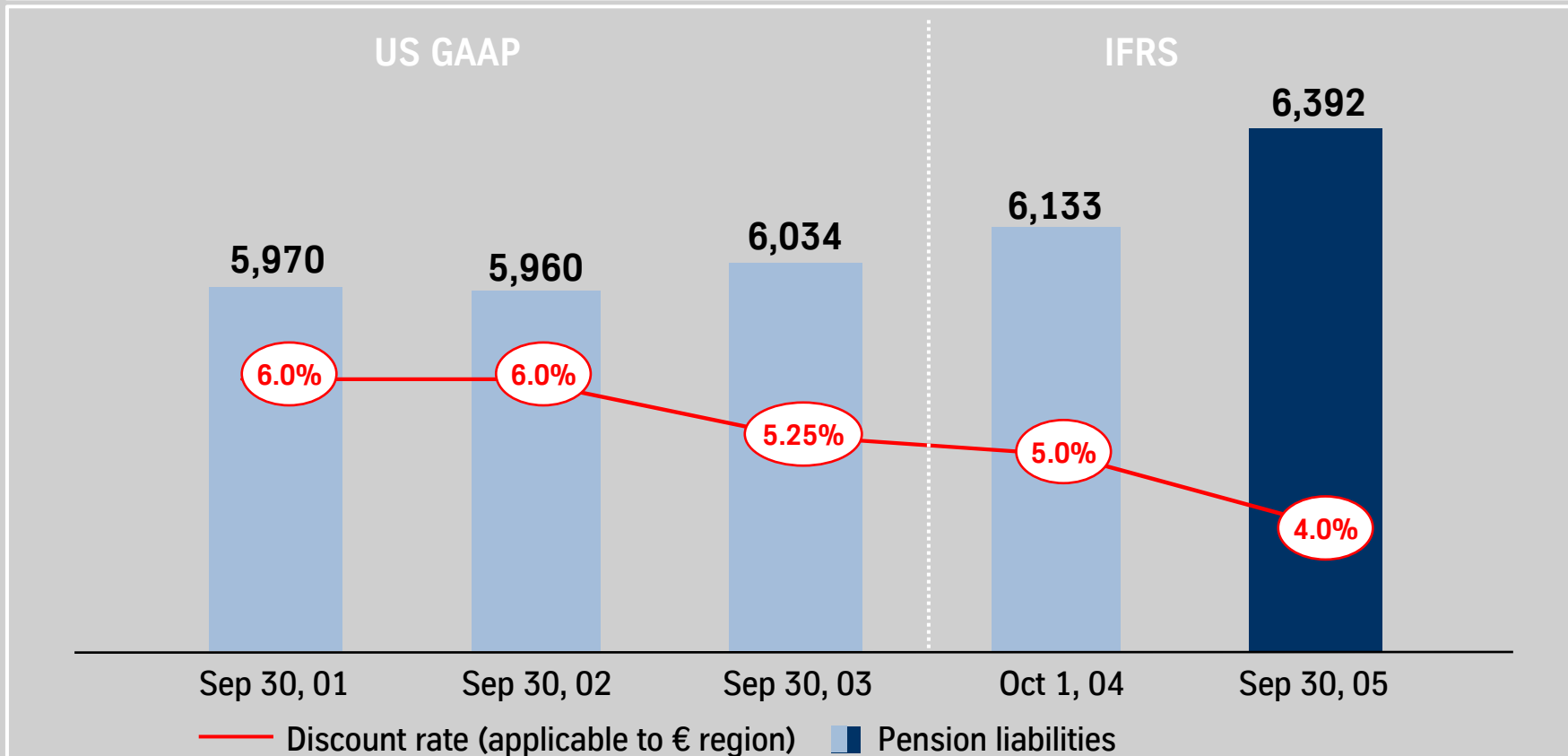
**Future beneficiaries**  
(ave. age 55 years)

⇒ Pension payments around peak and decline over time

# Development of Accrued Pensions Over Recent Years

Germany (mainly internally funded pensions)\*

million €



⇒ **Reduction in discount rate results in corresponding increase in pension liabilities**

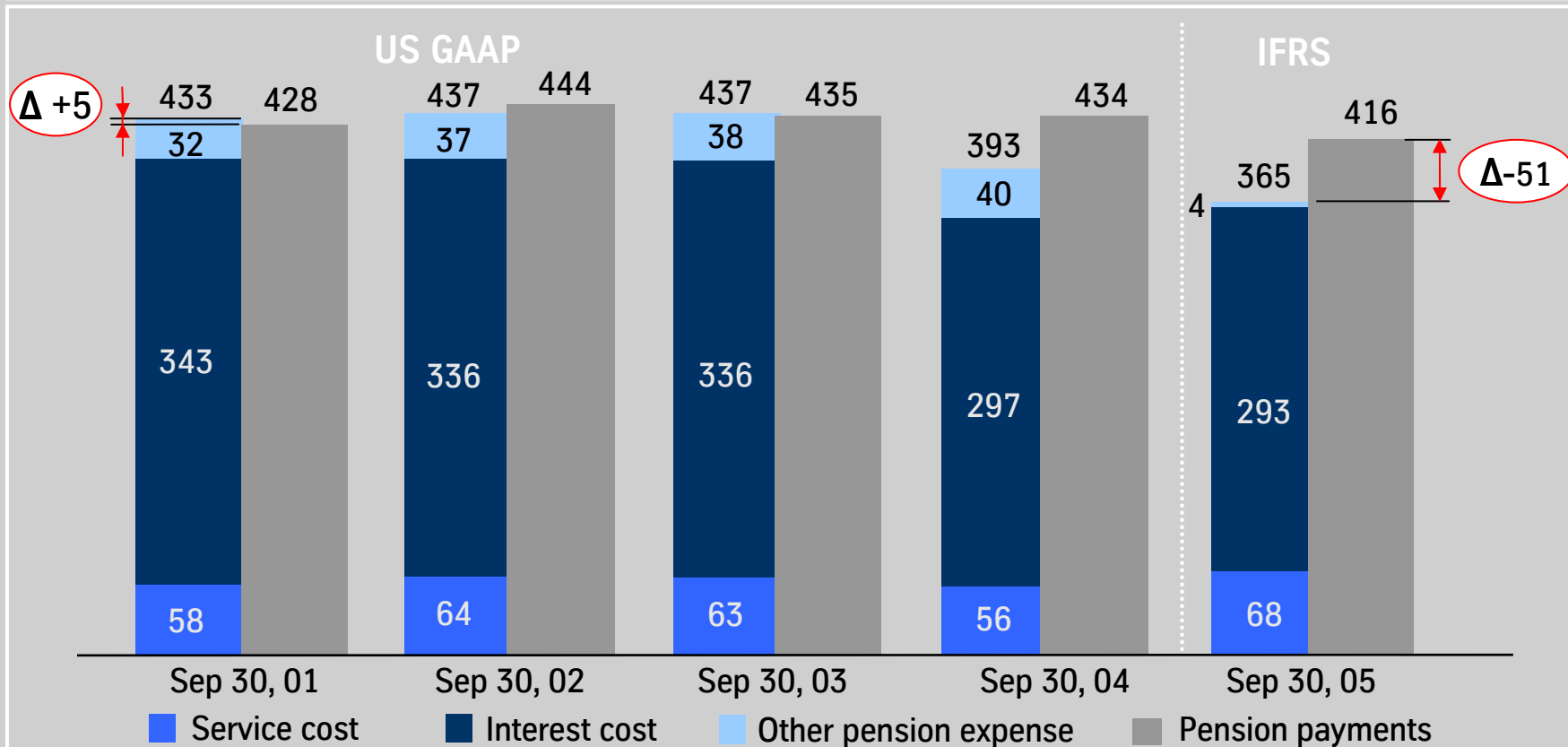
\* 2001-2003: Internally funded pensions; Decrease in pension liabilities partially compensated by changes in the consolidated Group and in 2004 by adaptation of life expectancies



# Development of Pension Expense and Payments Over Last Years

German pension expense and pension payments\*

million €



⇒ A tight gap or a negative delta between payments and expenses implicates a mature pension scheme

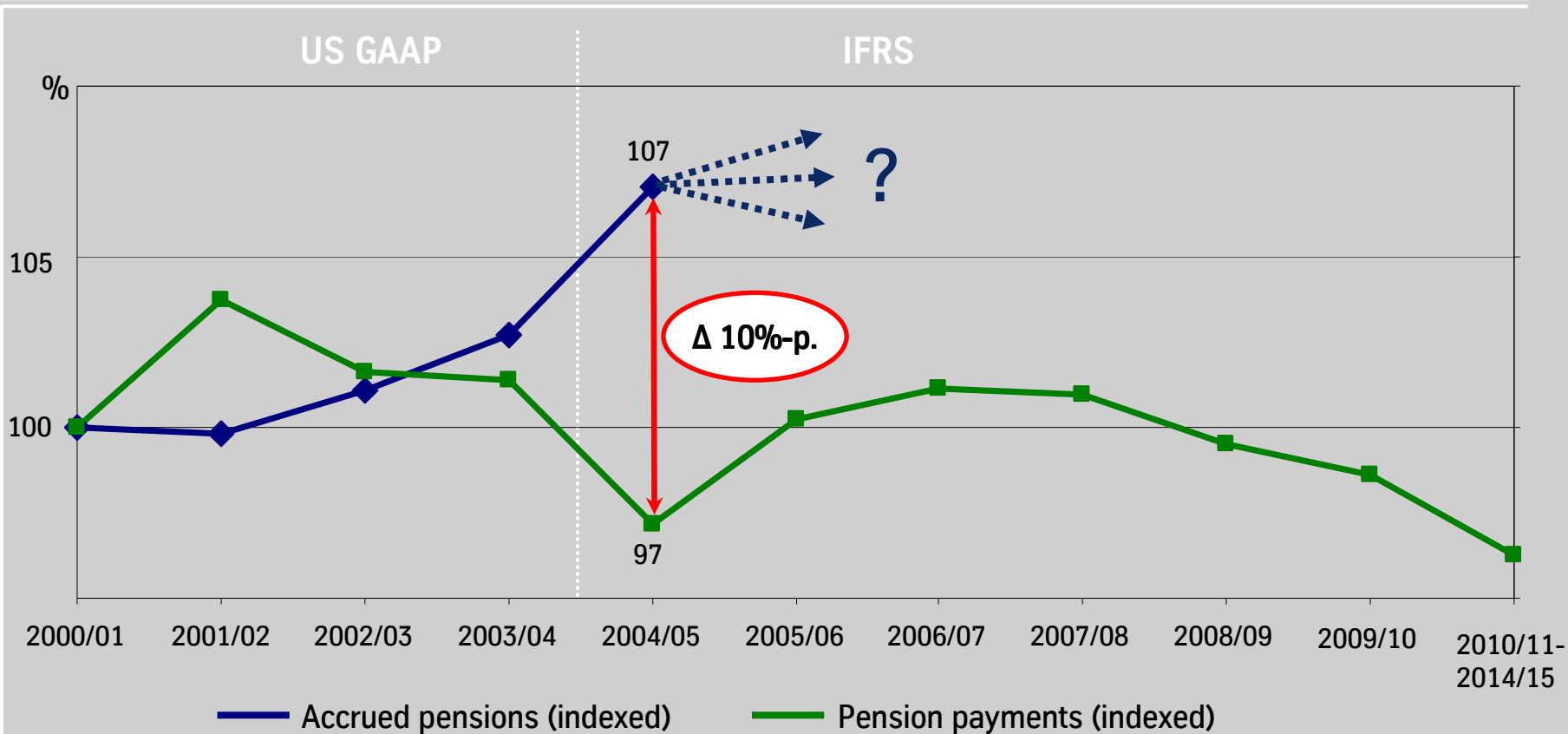
\* 2001-2004: Internally funded pensions



# Widening of Gap Between Accrued Pensions and Payments

German pensions and pension payments (index)\*

in %



➔ Increase of pensions only a matter of accounting and not economically driven

\* 2001-2004: Internally funded pensions



## Discount Rate

- Neither an indicator of operating nor of economic performance
- Not immediately determined by the company environment
- Underlying volatility driven by external factors

### Conclusion:

⇒ Discount rate mainly reflects a pure accounting view

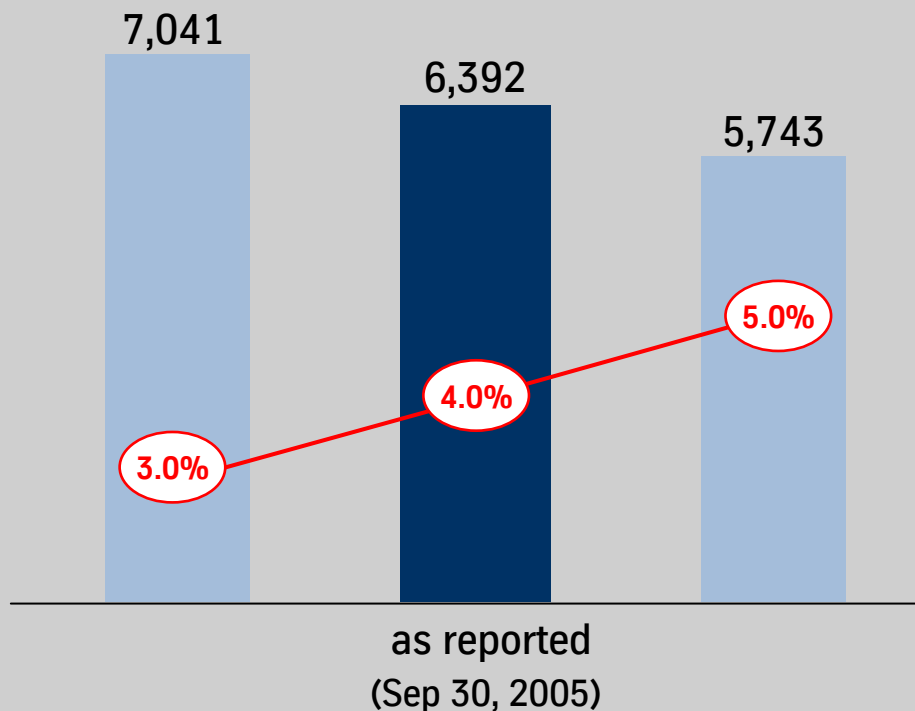
⇒ Valuation of pensions based on discount rate not economically reasonable



# Sensitivity Analysis

German pension liabilities (mainly internally funded pensions)

million €



⇒ A 1%-p. difference in the discount rate results c.p. in approx. €650 million swing in the German pension obligation

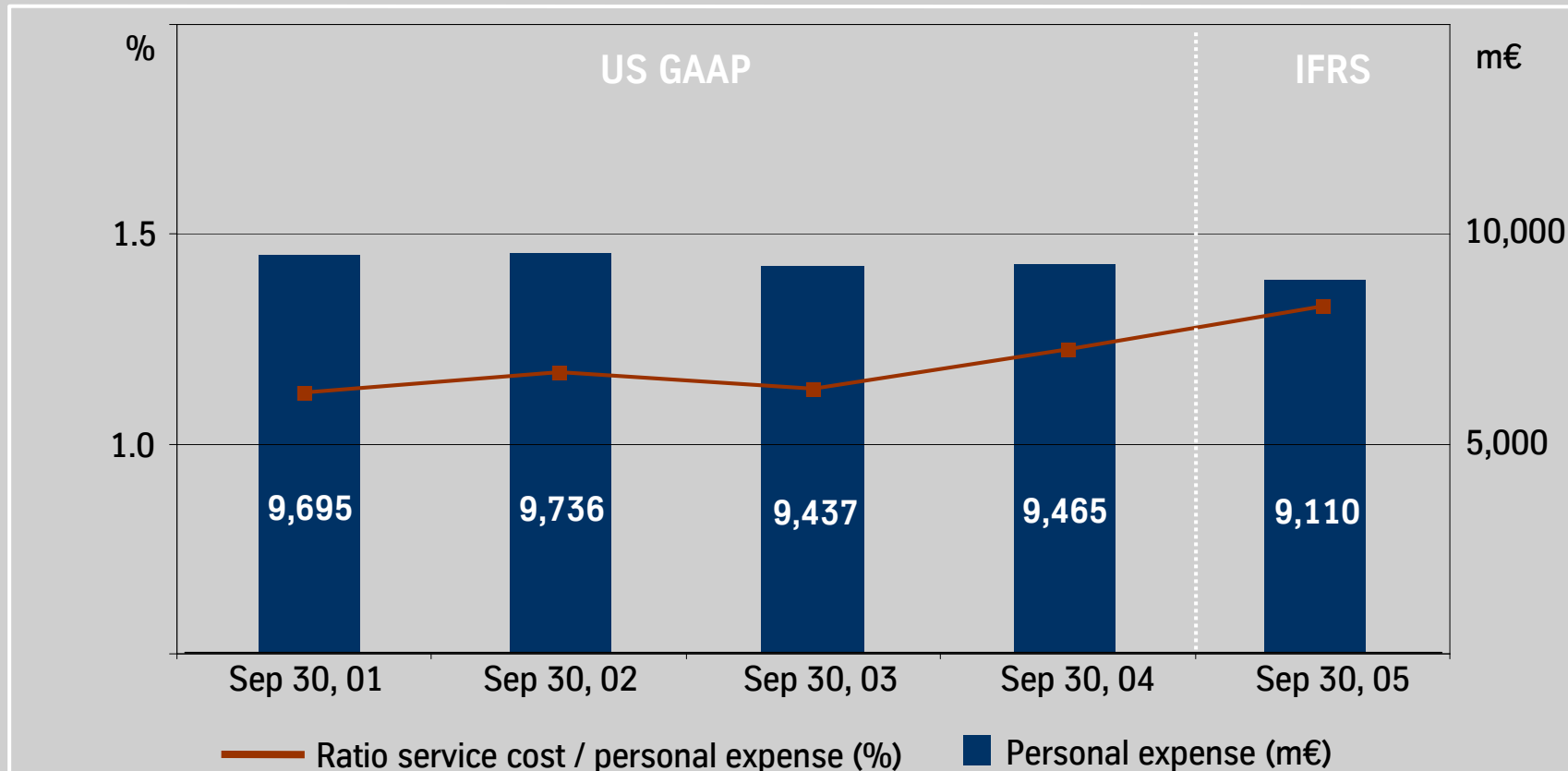
## Further Development of Accrued Pensions

- **Valuation of pension liabilities depends on factors which cannot be determined in advance, in particular**
    - Development of discount rate
  
  - **Payments to pensioners will decrease over the course of the coming years, because**
    - 85% of the annual payments go to existing pensioners, who decrease in number over time with mortality rates
- ⇒ Pension payments around peak and decline over time



# A Proxy to Future Cash Outflow

## Development of service cost proportional to personal expense (Group)

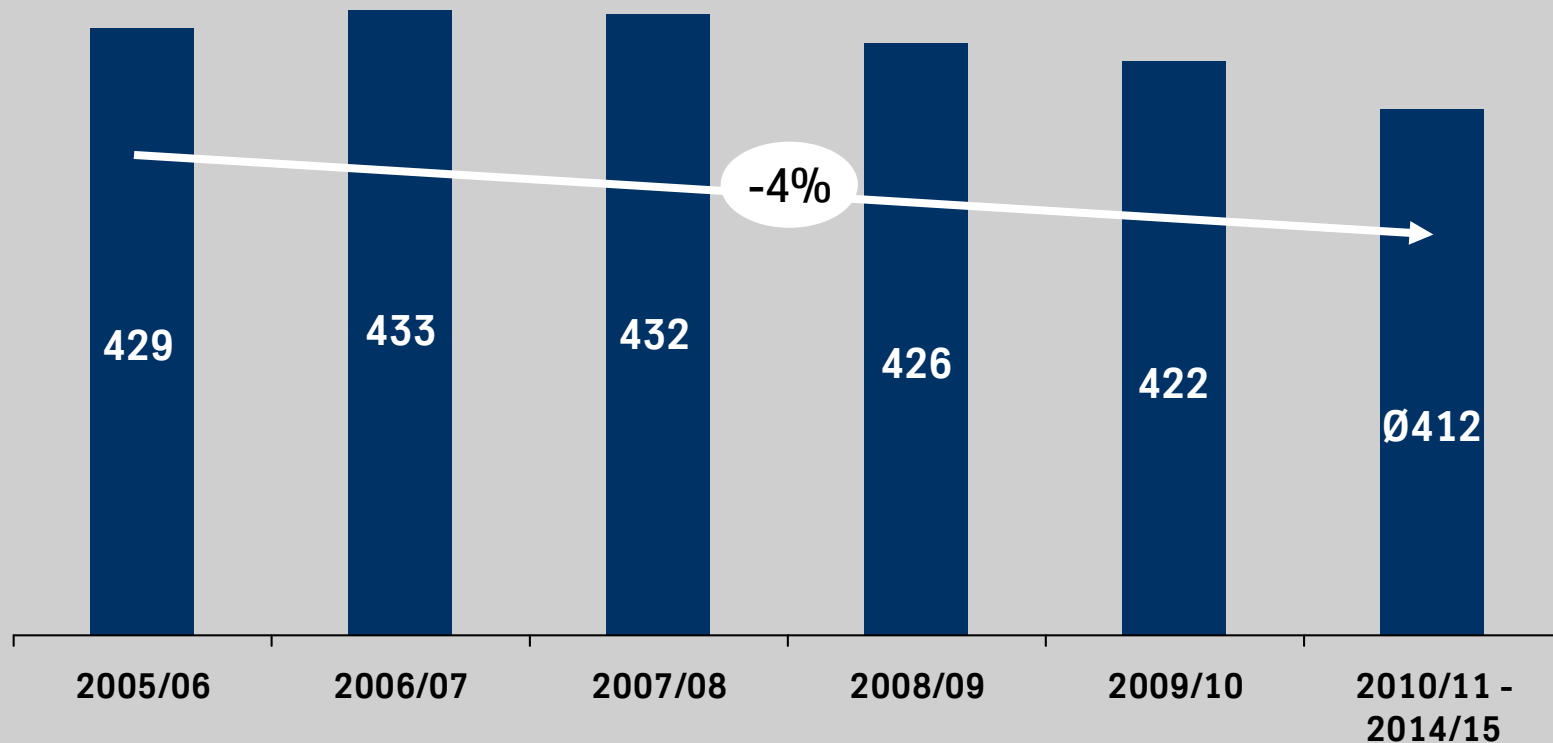


⇒ Ratio of service cost to personal expense oscillates around 1.0% to 1.5%

# Pension Payments Forecast

Germany (mainly internally funded pensions)

million €



⇒ Pension payments around peak and decline over time

# Analysts' View (I)

## Analyst I

	low	high
Carbon steel	6,915	7,991
Stainless steel	2,220	2,511
Automotive	3,057	3,240
Elevator	3,501	3,932
Technologies	2,963	3,370
Services	2,440	2,380
Corporate	-606	-912
<b>Firm value</b>	<b>20,491</b>	<b>22,513</b>
Net financial debt	328	328
<b>Pension debt</b>	<b>8,840</b>	<b>8,840</b>
Minorities	390	390
Financial assets	610	610
<b>Equity value</b>	<b>11,543</b>	<b>13,566</b>
no. of shares	514.89	514.89
Fair value	22.42	26.35
10% conglomerate discount	2.24	2.63
15% conglomerate discount	3.36	3.95
<b>Value per share</b>	<b>20.18</b>	<b>23.71</b>
<b>Value per share</b>	<b>19.06</b>	<b>22.39</b>



## Analysts' View (II)

### Analyst II

- Pension expense completely covered by group cash flow
- Discount rate of 4% does not represent an economic long-term interest rate
- Anomalous to treat one cash flow as a liability discounted at 4% and the others at WACC

⇒ Economic reality and valuation implications completely different



# Analysts' View (III)

## Analyst II

	2006E					
€m	Sales	EBITDA	EV/Sales (%)	EV/EBITDA	EV	
Steel	9,755	1,808		4.0	7,231	
Stainless	5,459	445		8.0	3,562	
Automotive	8,024	522		5.0	2,608	
Technologies	6,226	405		6.5	2,631	
Elevator	3,924	432		9.0	3,885	
Services	13,058	496	25		3,265	
Real Estate (notional)					400	
<b>Pension cost in interest</b>		<b>(350)</b>		<b>8.0</b>	<b>(2,800)</b>	
Corporate	(2,360)	(160)		6.0	(960)	
<b>Enterprise Value</b>					<b>19,820</b>	
Net cash (Debt) (2006E)					458	
<b>Unfunded US pension and healthcare* / Other liabilities</b>					<b>(3,000)</b>	
MI buyout at book value					(481)	
Non-core assets					1,075	
Market Value					17,872	
Conglomerate discount (%)					10	
Market cap					16,085	
<b>Price per share (€)</b>					<b>31</b>	
* Unfunded part of US Funded Pensions and healthcare <b>€1,500 m</b>						



## Funding of Pensions: Lacking Rationale for ThyssenKrupp (I)

- Funding of future pension cash outflows with government bonds:
  - ThyssenKrupp with very mature scheme (85% pensioners)
  - Investment horizon to service claims extremely short
  - ⇒ Investment appropriate to risk should thus mainly comprise low-risk, fixed-interest bonds (current **bond yields at 4.0%**)
  
- ThyssenKrupp itself generates returns in excess of this across the cycle
  - ⇒ **Target ROCE: 14.0%**
  
- **Return on liquidity: 2.5%**



## Funding of Pensions: Lacking Rationale for ThyssenKrupp (II)

**Why fund pensions at 4.0% if internally we can achieve ROCE of 14.0%?**

**CTAs\***

- ⇒ ... are fashionable, but do not create value!
- ⇒ ... make only sense if one has surplus liquidity.

\* Contractual Trust Arrangement



## Pensions – CFO's Perspective

### ⇒ Pension liabilities do not reflect the impact on the company properly

- No redemption nor repayment:  
Pension liabilities in the balance sheet as a reminder of annual cash outflows
- Development of accrued pensions mainly driven by discount rate representing a pure accounting view

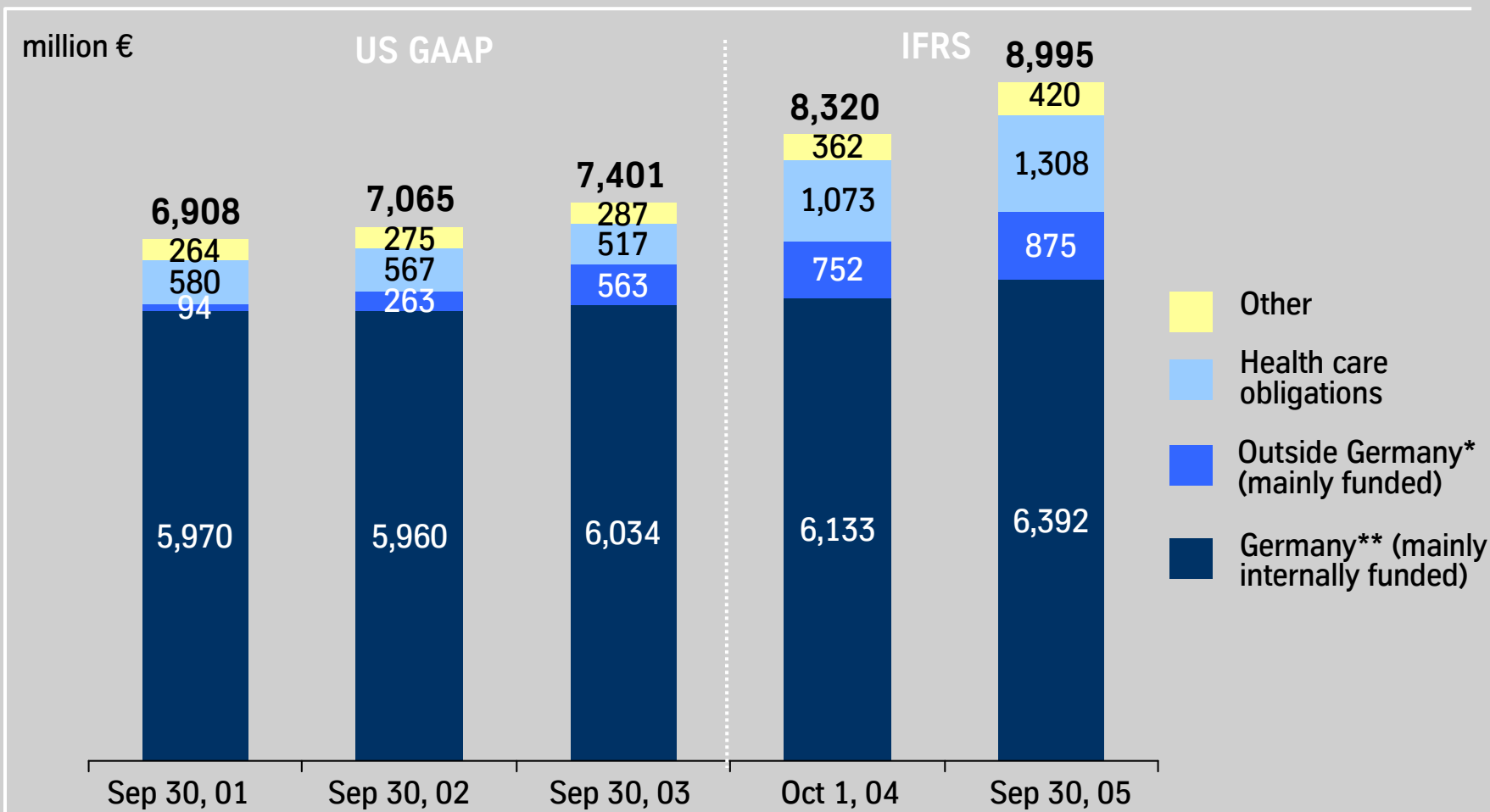
### ⇒ Economic driven valuation of pensions reasonable

- Focus on development of pension expense / payments rather than pension liabilities in order to reflect the annual economic impact on ThyssenKrupp

# Appendix



# Accrued Pension and Similar Obligations (I)



\* 2001-2003: Funded pensions

\*\* 2001-2003: Internally funded pensions



## Accrued Pension and Similar Obligations (II)

	Oct 1, 2004	Sep 30, 2005
Accrual-backed German pension plans	€6,133 m	€6,392 m
Pension plans outside Germany	€752 m	€875 m
<b>Accrued pension obligations</b>	<b>€6,885 m</b>	<b>€7,267 m</b>
Accrued health care obligations	€1,073 m	€1,308 m
Other pension-related obligations	€362 m	€420 m
<b>Total</b>	<b>€8,320 m</b>	<b>€8,995 m</b>



## Accrued Pensions by Segment

by segment	Oct 1, 2004		Sep 30, 2005	
	€ million	%	€ million	%
Steel	1,138	17	1,313	18
Stainless	206	3	244	3
Special Materials	95	1	-	-
Automotive	849	12	904	12
Technologies	904	13	1,139	16
Elevator	128	2	152	2
Services	438	6	483	7
Corporate	3,127	46	3,032	42
<b>Total</b>	<b>6,885</b>	<b>100</b>	<b>7,267</b>	<b>100</b>



# Impact by IFRS Conversion (I)

IAS 19

- **Opening Balance Sheet**
  - **Application of the Fresh Start method:**
    - ⇒ Direct recognition in equity of all unrecognized actuarial gains/losses according to IFRS effective October 1, 2004
    - ⇒ Negative effect on Equity in opening balance sheet
  - **Reduced discount rate (5.0% instead of 5.5%)\*** due to change of measurement date to September 30, 2004 instead of June 30, 2004
- **Starting with balance sheet date September 30, 2005**
  - **Recognition of all actuarial gains/losses directly in Equity (no corridor approach)**
    - ⇒ Increase/decrease in EBT because unrecognized actuarial losses/gains are not amortized as under US GAAP
    - ⇒ Better transparency through complete presentation of obligations in balance sheet
    - ⇒ Increased volatility of Equity

\* Applicable to €-region



## Impact by IFRS Conversion (II)

IAS 19

- **General changes in pension accounting**
  - **Reclassification of pension interest cost/expected return on plan assets to financial income/expense**
  - **Measurement date on September 30 of each fiscal year (instead of June 30)**
  - **Additional provisions due to expected voluntary early retirement agreements under IFRS, which were not recorded under US GAAP (“Anspruchs-Altersteilzeit”)**
  - **No additional minimum pension liability**



# Impact by IFRS Conversion (III)

IAS 19

million €		2004	2005
<b>Pension and similar obligations*</b>			
US GAAP	(Sep 30)	7,189	7,954
<b>Adjustments</b>		<b>1,095</b>	<b>938</b>
<b>thereof:</b>			
<b>Pension obligations</b>		484	159
<b>Postretirement obligations other than pensions</b>		540	716
<b>Voluntary early retirement agreement</b>		71	63
IFRS	(Oct 1, 04 / Sep 30, 05)	8,284	8,892
<b>Impact on EBT</b>	(2004/05)	–	<b>59</b>

\* Figures refer to continuing operations as reported on February 1st, 2006



# Impact by IFRS Conversion (IV)

IAS 19

## Pension cost – 2004/2005

- **Reclassification of pension interest cost/expected return on plan assets to financial income/expense**
- **No amortization of unrecognized actuarial gains/losses**

million €	2004/2005						Δ IFRS/ US GAAP
	Germany	US GAAP outside Germany	Total	Germany	IFRS outside Germany	Total	
Service cost	65	54	119	68	53	121	2
<b>Interest cost</b>	307	116	423	293	125	418	-5
<b>Expected return on plan assets</b>	(5)	(121)	(126)	(5)	(115)	(120)	6
Amortization of transition obligations	6		6				-6
Recognition of past service cost	2	7	9	2	1	3	-6
<b>Amortization of actuarial loss</b>	3	22	25				-25
Settlement and curtailment loss	14	1	15	7	(4)	3	-12
<b>Net periodic pension cost</b>	<b>392</b>	<b>79</b>	<b>471</b>	<b>365</b>	<b>60</b>	<b>425</b>	<b>-46</b>



# Impact by IFRS Conversion (V)

IAS 19

## Healthcare cost – 2004/2005

- **Reclassification** of interest to **financial income/expense**
- No amortization of unrecognized actuarial gains/losses

million €	2004/2005		
	US GAAP USA/Canada	IFRS USA/Canada	Δ IFRS/ US GAAP
Service cost	16	21	5
<b>Interest cost</b>	53	<b>60</b>	7
Recognition of past service cost	(6)		6
Expected return on reimbursement rights		(4)	-4
<b>Amortization of actuarial loss</b>	27		<b>-27</b>
Curtailment gain		(1)	-1
<b>Net periodic postretirement benefit cost</b>	<b>90</b>	<b>76</b>	<b>-14</b>



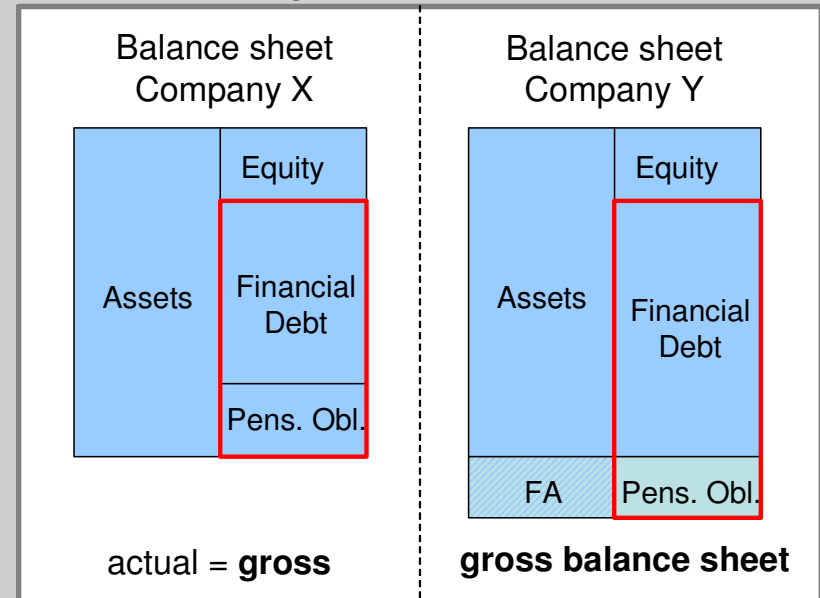
# Objective Comparison of Pensions

A Scientific Investigation\* by Gerke/Pellens (Universities Erlangen-Nuremberg/Bochum)

- Secure equal treatment of pension obligations
- Notional balance sheet extension as way of resolving unequal treatment
- Increase transparency for company comparisons with regard to ratings

Companies with internally funded pension obligations

Companies with externally funded pension obligations



⇒ Comparison with regard to asset and capital structure

\* For complete presentation please see [http://www.prof-gerke.de/\\_Forschung/\\_Gutachten/\\_gutachten.html](http://www.prof-gerke.de/_Forschung/_Gutachten/_gutachten.html)



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In this presentation all figures are prepared in accordance with IFRS. As in the notes to the annual report, all figures include discontinued operations unless otherwise stated.

**Due to the conversion process figures included here should be seen as provisional as the IASB may still enact provisions that could be applied retroactively. The audit of the restated figures will be in conjunction with the audit of the full financial statements under IFRS for the fiscal year ending September 30, 2006.**

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