BEHIND THE NUMBERS
Quality of Earnings Analysis
March 12, 2021

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Unum Group (UNM) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are raising our earnings quality rating to 3+ (Minor Concern).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

When we looked at Unum initially in 2020, we had three major concerns: Its holding company structure limited its ability to move cash around, its closed block business was consuming considerable cash flow and that competed with the dividend, and its investment portfolio had exposure to key industries being hit hardest by COVID would could reduce reserve capital.

Flash forward a year; we see that Unum was able to transfer a large part of its closed block into a reinsurance deal. This should reduce the amount of cash flow needed to support that area and it provided more cash to the holding company. The portfolio values have recovered and the number of potential downgraded investments has fallen. The holding company is more liquid at this point.

What is strong?

- Unum made a deal to reinsure part of the Closed Block. That should reduce the cash demands on the parent company to those subsidiaries going forward, which makes the dividend more secure. Also, the deal released capital and will result in $650 million going to the parent company with $400 million already in place at the end of 4Q.

- The investment book started 2020 with a $32.4 billion corporate bond portfolio with 15% in energy and 7% in transportation. That was hit hard in COVID, but has recovered well throughout 2020 and closed the year at $32.2 billion. Some of these securities were likely transferred with the reinsurance deal described below. Even the mortgages Unum owned with 23% exposure to office space and 24% retail – did not have problems in 2020.

What is weak?

- Long Term Care continues to be a cash drain. This part of the Closed Block is still at Unum and the company had to shore up the situation with another $466 million in cash for 2020. Unum is guiding to higher payments for 2021. After boosting reserves by $2.0 billion to this business in recent years, Unum added $152 million more in 2020.

- The amount of excess capital available to the parent company from the subsidiaries is down to $974 million. That should be more than enough, but it still highlights that there are restrictions on moving capital around the various Unum companies and the parent company still has debt to service, dividends to pay, and other subs that require cash.

What to watch?

- NAIC (National Association of Insurance Commissioners) has proposed that reinsurers' special purpose vehicles maintain the same capital requirements as traditional insurers. Nothing has changed in the rules yet and Unum still sees this outcome as unlikely. The deal to move the closed block of LT disability out of Unum's reinsurers reduces this potential risk. However, there is still the captive reinsurance for LT Care. If Unum needs to boost capital in that unit under a rule change it could lead to more cash infusions there.

- ASC 944 is a new accounting change to update accounting and disclosure for long-duration insurance contracts. It takes effect January 1, 2023 and Unum does expect this to have a material impact on financial results:

> ***"This update significantly amends the accounting and disclosure requirements for long-duration insurance contracts.*** *These changes include a requirement to review, and if necessary, update cash flow assumptions used to measure the liability for future policy benefits for traditional and limited-payment contracts at least annually, with changes recognized in earnings. In addition,* ***an entity will be required to update the discount rate assumption at each reporting date using a yield that is reflective of an upper-medium grade fixed-income instrument, with changes recognized in other comprehensive income.*** *These changes result in the elimination of the provision for risk of adverse deviation and premium deficiency (or loss recognition) testing.* ***The update also requires that an entity measure all market risk benefits associated with deposit contracts at fair value, with changes recognized in earnings*** *except for the portion attributable to a change in the instrument-specific credit risk, which is to be recognized in other comprehensive income. This update also simplifies the amortization of deferred acquisition costs by requiring amortization on a constant level basis over the expected term of the related contracts. Deferred acquisition costs are required to be written off for unexpected contract terminations but are no longer subject to an impairment test. Significant additional disclosures will also be required, which include disaggregated rollforwards of certain liability balances and the disclosure of qualitative and quantitative information about expected cash flows, estimates, and assumptions. The application of this guidance will vary based upon the specific requirements of the update but will generally result in either a modified retrospective or full retrospective approach with changes applied as of the beginning of the earliest period presented. Early adoption is permitted."*

Supporting Detail

Closed Block Transaction Should Help Overall Picture

Our biggest issue with Unum was its holding company structure did not allow capital to flow easily from unit to unit. The parent company's largest source of income is dividends from various subsidiaries and the biggest use of cash was supporting capital at other subsidiaries involving the closed blocks of long-term care and individual disability. Losses at these two units continually consumed huge amounts of new capital:

Unum Parent	**2020**	**2019**	**2018**	**2017**
Dividends from Subs	**$975**	**$1,069**	**$1,135**	**$830**
Other Income	$52	$64	$67	$67
Total Revenue	$1,026	$1,153	$1,202	$897
Interest Exp.	$187	$173	$161	$154
Other Exp.	$51	$53	$53	$37
Parent Income	$803	$921	$989	$590
Undistrib. Sub Income	-$10	$179	-$466	$404
Net Income	$793	$1,100	$523	$994
Cash from Ops.	**$964**	**$1,000**	**$1,052**	**$741**
Cap. Exp	$82	$86	$73	$83
Cash to Subs	**$966**	**$389**	**$531**	**$80**
Dividends Paid	$232	$229	$216	$196
Stock Repo.	$0	$400	$356	$402
Cash/Securities	$530	$765	$460	$649
LT Debt	$3,346	$3,247	$2,831	$2,738
Pension Obligation	$678	$624	$594	$683

The keys here are the primary sources of cash are dividends from the other insurance subsidiaries, cash outflow to other subsidiaries dealing with the closed block have been sizeable cash drains, and Unum has not been covering all its cash outflows which includes shareholder items such as dividends and stock repurchases. This led to Unum borrowing more money, which still has to be serviced by the same source of cash flow.

When we wrote our first EQ review of Unum last year, the amount available from subsidiaries to the parent company without regulatory approval was $1.035 billion. In the 2020 10-K the comparable note is:

> *During 2021, we intend to maintain a level of capital in our insurance subsidiaries above the applicable capital adequacy requirements and minimum solvency*

margins. ***<u>As a result of our consideration of overall capitalization needs, we may not utilize the entire amount of dividends available in 2021, which are based on applicable restrictions under current law. Approximately $974 million is available, without prior approval by regulatory authorities,</u>*** *during 2021 for the payment of dividends from Unum Group's traditional U.S. insurance subsidiaries, which excludes our captive reinsurers. Approximately £170 million is considered distributable from Unum Limited during 2021, subject to local solvency standards and regulatory approval."*

Here is what has changed in this picture:

- Moving the Disability to Global Atlantic is expected to free up $650 million in capital. $400 million of it is reflected in the 2020 cash balance in the table above. The rest should arrive in 1Q21.

- Long-term Care is still a money pit. Unum raised the reserves for LTC by $151.5 million in 2020. This follows increases of $750.8 million in 2018, $698.2 million in 2014, and $573.6 million in 2011.

- Of the cash to subs outlay in 2020, $466 million went to LTC. Unum expects capital contributions to LTC to exceed 2020 levels this year.

- Overall, Unum has dealt with one of the more significant cash drains by moving the closed block disability claims so cash to subs should go down in 2021. Now with the added cash and likely a lower payment from subs – Unum's cash flow appears in better shape.

While Unum added flexibility and brought some closure to this matter, Global Atlantic did not do this to be nice. The deal has Global issuing $6.1 billion in reinsurance to settle claims on the policies. However, Unum's subsidiaries involved transferred $7.1 billion of cash and securities to Global as part of the deal. Global was also paid a reinsurance premium of $816 million for 12-years. From our reading, it sounds as though some of the securities transferred were higher yielding than the total Unum portfolio as a whole. That resulted in gains on the securities being realized by Unum and taxes of $274 million.

So looking at the consolidated income, Unum should have a smaller investment portfolio to generate income going forward. The bond portfolio fell from $47.4.8 billion at the end of 2019 to $44.1 billion at the end of 2020. That should lower interest income earned by the subsidiaries by perhaps $100-$110 million. At the same time, Unum will amortize the reinsurance premium, which will result in a non-cash expense of about $68 million if done on a straight-line basis. The losses from disability business being removed should offset some of that. Overall, we believe this may be a small earnings headwind and could lower the amount subs can send to the parent.

However, we do not see the warning signs of last year to the same degree when Unum's parent company was issuing more debt to have liquidity, was headed for a negative cash flow situation, and the subs it depends on for cash flow were facing the possibility of having less excess capital available due to falling investment values.

EPR Properties (EPR) Earnings Quality Update
12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are upgrading our earnings quality rating of EPR to a 4+ (Acceptable).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

EPR posted FFOAA (Funds from Operation as Adjusted) of 18-cents missing forecasts by 5-cents. EPR boosted its tax valuation allowance by $6.9 million in 4Q, which was a 9-cent impact. That included write-offs of prior period receivables of $4.3 million and of straight-line rent from prior periods of $0.9 million which were not expected after 3Q write-offs of $33.5 million. Both of those reduced rental revenue in 4Q and are not added back to FFOAA. Those two items cost EPR 7-cents in FFOAA.

More properties have been changed to recognizing rent when cash is received, which hurts revenue and income as the gap between accruing revenue and receiving the cash has to close. That plus deferred rent on properties still recognized as income further hurts cash flow. Cash from operations has turned positive. In the 4Q, cash collections of contracted rent were 46% - improved from 43% in 3Q and 29% in 2Q. In January, the rate was 66%. The accounting has grown more conservative by recognizing more of the rent as revenue only when cash is received. At this point, 94% of non-theater properties are open and 60% of theatres are so the cash flow should improve in 1Q further and continue growing through 2021.

What is stronger?

- Liquidity remains very strong for EPR. At the end of 2020, it had retired some debt and held $1.025 billion in cash against $3.69 billion in debt. In 1Q, it paid down another $500 million from its credit facility. This leaves EPR with over $500 million in cash, $910 million available on the revolver, no debt payments due in 2021. Also, negative Free Cash Flow was only -$6.3 million in 4Q and -$11.7 million in 3Q. The preferred dividends are $6.0 million per quarter.

What is weaker?

- EPR's footprint is shrinking at this point. In December it sold 6 private schools, 4 early childhood centers, 4 experience properties, and 2 land parcels. It has taken back 7 AMC leases, sold one property, and expects to sell 5 more. These various asset sales have boosted liquidity, but they also lower future rent income. Plus, EPR has permanently lowered rent by about 5% - $24 million on remaining assets. Capital spending – which includes maintenance was running about $12 million per quarter for Qs 2-4 in 2020. There is a limitation on capital spending while the debt is under covenant relief that should prevent EPR from adding much in new income-generating assets for 2021. That is a far cry from the $300-$500 million spent annually on new real estate and developments in recent years.

- Prior to COVID and running on all cylinders, EPR was generating about $5.44-$6.10 in FFO. It was paying a dividend of $4.62. Before COVID – 2020 guidance was for FFO of $5.19-$5.39 – lower because it sold much of its school portfolio in 2019 and that would be offset with new properties costing $1.6-$1.8 billion. Instead, 2020, saw new investments of only $83 million, more property sales, and rent abatement. These various losses of rent income should result in a lower FFO even with a full recovery, and we would expect the dividend to be lower than historical levels for several more years as the company rebuilds and finances a pipeline of new investments.

- EPR moved more assets to an income-recognition method for when cash is received in 4Q. In most situations, EPR records rent income as scheduled and books a receivable. It then sees the receivable decline when cash is received. When they have doubts about collection, rent income is recognized only when cash is received. This has a double negative impact as existing receivables are written off against revenue and prior income is reversed in the revenue line also. During 2020, EPR wrote off $27.1 million of receivables due from tenants and another $38.0 million of receivables that had accrued as straight-line rent. Credit losses of $30.7 million included $25.5 million related to a mortgage note receivable and unfunded commitments, so $5.2 million should have hit receivables too.

	4Q20	3Q20	2Q20	1Q20	4Q19
Accts Rec.	$116.2	$129.7	$134.8	$72.5	$86.8

- It looks like Receivables are being paid down – but in reality, the write-offs of more than $70 million are the reason for the decline.
- This does set the table for better earnings/cash flow in the future
- The $116 million figure includes $76 million of deferred rent – which tenants should begin paying more as their theaters open
- The $65 million in write-offs were not entirely forgiven, they were reversed out of revenue and receivables and will only be recognized when cash arrives.
- Thus 2020, there was deferred rent, forgiven rent, and reversed rent impacting results. As 2021 and 2022 move forward, normal rent should come in, along with deferred rent, and some reversed rent too.

- The REIT metrics are overstating cash flow because of rent that is being accrued and not collected. Often, Cash from Operations is close to adjusted FFO and AFFO. Thus the accounting has not been overly aggressive at EPR in the past. All these metrics add back impairments, write-offs, credit losses, gains/losses. Adjusted EBITDA also adds back interest expense:

	4Q20	3Q20	2Q20	1Q20	2020	2019	2018
CFO	$5.8	$2.1	-$31.6	$89.0	$65.3	$439.5	$484.3
Adj. FFO	$13.1	-$11.7	$31.4	$75.9	$108.7	$423.2	$460.4
AFFO	$17.4	$2.7	$33.3	$90.1	$143.4	$422.7	$466.3
Adj. EBITDA	$68.6	$70.9	$77.2	$130.6	$347.4	$562.5	$546.0

What to watch

- EPR may resume a small dividend in 2021. The covenant waivers restrict dividends being paid unless EPR is required to pay a dividend to maintain its REIT status. Just looking at Interest, Depreciation, G&A, and operating expenses, EPR had $114 million in costs in the 4Q. There is another $8 million in operating expenses related to the closed Kartrite property, which is expected to open late in 2Q. So revenue over $120-$125 should produce income.

EPR expects to have $136 million of contractual revenue and recognize about $100 million in 1Q21. Adding Kartrite would add about $8 million per quarter. As more theaters open, the cash collection rate should increase too. There is also income on mortgage notes for $8 million more. Ultimately, contractual revenue could top $156 million per quarter.

- EPR can waive its covenant relief prior to the end of the year if it is meeting the covenants. It already meets several of the ratios and is close to the others:
  - Total Debt/Total Assets < 60%. – currently at 48%
  - Secured Debt/Total Assets < 40% -- currently essentially 0%
  - Income for debt service/Net Int. Exp > 1.5x – It has been 1.6x the last three quarters and should improve with rising rent collection.
  - Unencumbered Assets/Unsecured Debt > 150% -- It is at 197% now.
  - Property Income/Int. Exp > 175%. With property expense of about $60 million, property revenue over $360 million should do it – and EPR is forecasting $545-$624 million.
  - Adjusted EBITDA > 150% of Interest expense + preferred dividends + scheduled debt maturities. Interest and preferred dividends are $190 million so $300 million of EBITDA should do it. EBITDA was $69 million in 4Q and $71 million in 3Q. EPR will need more recovery to reach this target but are close.

- At this time the convertible preferred stocks are not being accounted for as dilutive because EPR's stock price is too low. This removes a small headwind for the Adjusted FFO and AFFO figures per share. The series C is convertible at $60.43 and series E at $51.80. The dilution impact is about 3.8 million shares and adds back the $3.9 million in dividends paid on these two classes of preferred stock. If EPR's stock continues to recover, the normal headwind of this dilution is about 1-2 cents per share each quarter.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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