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BEHIND THE NUMBERS
Quality of Earnings Analysis

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UnitedHealth Group Incorporated (UNH)
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 maintain our earnings quality rating on UHN of 5- (Strong)

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

Summary

UNH beat forecasts on adjusted EPS by 13-cents in 4Q20. We will need the 10-K to find some of the figures we are tracking to fully update 4Q results. UNH can probably beat guidance calling for 5%-8% EPS growth from $16.88 to $17.75-$18.25. As expected, the COVID earnings picked up in 1Q-3Q 2020 as patients deferred treatment, which held down medical costs and inflated earnings. Now that those treatments are back to normalized levels, UNH is expecting a $2 billion headwind for earnings as it compares to the 2020 quarters. At the same time, 2020 was penalized by the ACA tax that boosted its tax rate from 21% to 24%. That tax was repealed effective for January 1, 2021 – so that should lower the tax rate again. The tax issue should boost EPS by 69-cents in 2021 and the COVID headwind should reduce EPS by about $1.64 in EPS.

What is strong?

- The return toward normal operations was not as ugly on earnings as we anticipated. We believed premiums would be essentially flat with 1Q and 2Q, which happened. But we expected medical costs to balloon to the point where UNH may report flat earnings or even below the prior-year levels. It did not get that bad:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Med. Costs Payable	$21.9	$21.2	$19.2	$22.8	$21.7	$20.9
Quarterly Med Cost	$42.1	$41.6	$34.7	$41.0	$39.3	$39.0
DSP for Med. Costs	47.4	46.5	50.5	50.7	50.4	48.9
Premium Rev.	$50.6	$50.9	$49.4	$50.6	$47.6	$47.4
Medical Ratio	83.7%	81.7%	70.2%	81.0%	82.5%	82.4%
Premiums - Costs	$8.5	$9.3	$14.7	$9.6	$8.3	$8.4

This shows roughly flat premiums collected before, through, and after COVID. Quarterly medical costs dropped in 2Q20 allowing the net between revenue and cost to increase to $14.7 billion in 2Q vs. $8-$9 billion in other periods. We expected the deferred medical procedures to result in a higher increase in costs in 3Q and 4Q. It looks better than we anticipated. We thought the medical ratio of quarters medical cost to premium revenue could have jumped to the high 80% range. It looks like 3Q still benefited from deferred care. 1Q21 may see more headwind in this area. UNH noted that medical costs related to COVID were much higher in December which may carry over into January too. Every $0.1 billion that this source of earnings did not decline as deferred medical care was completed is about 8-cents in EPS. The beat was 13-cents in 4Q.

What is weak?

- Rebates are continuing to accrue but may still not be getting paid at past speed. This is a stat where we will need the 10-K to verify. UNH estimates the rebates and nets them against premium revenue – thus they are going through income as noncash earnings. However, the cash comes in on a lagging basis and is often tied to volume targets being reached – UNH simply cannot bill for the rebates as quickly as they go through earnings. The rebates go into “other A/R” on the balance sheet, which also includes Medicare D drug discounts. The “other A/R” account has been rising. It was $8.5-$10.0 billion before COVID. It was $13.2 billion after 3Q20. We do not know the 4Q figure yet. It is listed on the 4Q balance sheet as a catch-all of three working capital items. That catch-all was flat with 3Q20. Every $0.5 billion of increase in this area is just under 40-cents in EPS of non-cash earnings.

- UNH continues to repurchase stock with minimal impact on EPS growth. In 2018 and 2019, UNH spent $10 billion in cash to repurchase 41 million shares. But, during the same time, it issued 20 million shares via stock options. Thus, a $10 billion outlay produced only 2% incremental EPS growth in 2019. In 2020, the company spent $4.3 billion more on shares and added only 0.5% incremental EPS growth. Through 3-quarters of 2020, UNH issued more shares than it purchased. It looks like the heavy buying in 4Q allowed the share count to drop by a minor amount. It is tough to make a case that shareholders are seeing much benefit from spending about 30%-35% of earnings on these repurchases every year.

What to watch

- We need to the 10-K to see what happened to medical cost estimates in 4Q20 and to see what the new sensitivity analysis for outcomes differing from estimates. This has been a continual source of incremental profits for UNH as the outcome has been favorable year after year. Through 3Qs in 2020, the same trend was being seen. This could be another source of 2%-5% of UNH's income.

- We also need the 10-K to see the current status of acquisitions and impairment analysis. In 2020, UNH spent another $7.1 billion on deals with $2.8 billion hitting in 4Q. We remain skeptical of UNH's accounting policies as much of the acquired assets are assigned to goodwill, which is not expensed. Goodwill is now $68 billion and 100% of equity. We had a problem with acquisitions made in 2019 and 2018 – which the company said had immaterial revenues and earnings – yet those deals are supporting $16 billion of intangible assets.

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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