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BEHIND THE NUMBERS
Quality of Earnings Analysis

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UnitedHealth Group Incorporated (UNH)
Earnings Quality Update- 6/21 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 of UNH to 5+ (Strong) and maintain our Top Buy rating.

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

Summary

UNH's adjusted EPS of $4.70 (adjusted primarily by adding back acquired intangible amortization) beat forecasts by 24-cents. It was known that the tax rate would decline by 300bp due to the elimination of the Obamacare tax at the end of 2020, so that 20-cent source of EPS was already baked into forecasts. This was a solid beat and UNH boosted forecasts for the year by 95-cents. UNH still believes it will face some headwinds from more Covid testing and treatments for the rest of the year.

We see several areas at this point getting back to normal for UNH and cash flow is being helped by payables returning to normal levels. Rebates are being collected too. This was the last very difficult comp as UNH collected premiums in 2Q20, but fewer people went for medical care with Covid lockdowns, thus 2Q20's profit was significantly inflated. We see revenue growth is picking up with acquisitions and some normalcy and there appear to be fewer headwinds which is why we boosted our earnings quality rating back to a 5+ (Strong).

What is strong?

- It was obvious that 2Q20 was an anomaly looking at the core business as UNH had flat premiums but medical costs plummeted with the lockdowns. The gross profit of premiums less costs was $14.7 million vs. the more normal $8.3-$8.5 million per quarter.

  What we liked about 2Q21 is UNH's Medical Ratio returned to normal levels, but the higher revenue growth still produced higher profits. The working capital trends also returned to normal, we envisioned this being a slight headwind:

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19
Premium Rev	$56.2	$55.5	$50.6	$50.9	$49.4	$50.6	$47.6
Med Costs	$46.5	$44.9	$42.1	$41.6	$34.7	$41.0	$39.3
Profit	$9.7	$10.6	$8.5	$9.3	$14.7	$9.6	$8.3
Medical Ratio	82.7%	80.9%	83.2%	81.7%	70.2%	81.0%	82.6%
Med Costs Payable	$25.1	$24.8	$21.9	$21.2	$19.2	$22.8	$21.7
DSPs	49.3	50.5	47.4	46.5	50.5	50.7	50.4
Othr Pay/Accruals	$23.0	$23.0	$22.5	$21.2	$25.4	$22.9	$19.0
Other Op. Cost	$18.0	$17.8	$19.1	$13.9	$17.5	$17.7	$15.8
DSPs	116.6	117.9	107.3	139.0	132.4	117.8	109.7
Other A/R (rebates)	$12.6	$11.6	$12.5	$13.2	$11.4	$10.3	$9.6
Premium Rev	$56.2	$55.5	$50.6	$50.9	$49.4	$50.6	$47.6
DSOs	20.5	19.0	22.6	23.7	21.1	18.5	18.5

- The medical costs dropped off considerably in 2Q20, which made the medical ratio only 70.2%. It appears that UNH has some additional Covid testing and treatment claims now, but the ratio is back to the 81%-82% range. Also, the higher revenues are setting the company up for more earnings growth. There is some seasonality and some lumpiness to this ratio. A 50bp change in the medical ratio is about 25-cents in quarterly EPS and investors should expect that to continue.

- Medical costs are paid in arrears and the oddities of 2Q20 led to lower payable balances for two quarters as fewer new payables were created. While the dollar figure is up with the growth, the ratio for DSPs has returned to normal. At the same time, growth here in dollar figures is helping cash flow. For the 1H21, payables are up with growth along with other receivables and the net is essentially a wash for cash flow impact on working capital. The transition back to normal may be over, and we are less concerned about significant headwinds here.

- UNH accrues rebates it expects to receive at the time it records premiums. However, the company cannot bill for the rebates until the patient has a prescription written and delivered. Rebates are recorded in other Accounts Receivable. This account clearly grew in dollar terms and days outstanding after the worst of Covid but is close to normal levels again for DSOs. This also is a small help to cash flow.

What to Watch?

- UNH does make incremental profits that can boost its income from favorable outcomes on medical costs. UNH tracks the process and cost of many medical procedures and uses that to estimate what the total costs will be. When it sees that a particular treatment costs less than others – it can push for that procedure to be used more often in similar cases. It can also control its own back-office costs and payment systems to reduce expenses. The end result is UNH always seems to have actual medical costs come in below the initial forecast which helps earnings. In 2020, the level of favorable outcome saw another jump to $880 million:

	2020	2019	2018	2017	2016
Favorable Med Costs	$880	$580	$320	$690	$220
Operating Income	$22,405	$19,685	$17,344	$15,209	$11,863
% of Op. Income	3.9%	2.9%	1.8%	4.5%	1.9%

- UNH is guiding to $18.30-$18.80 per share for 2021. $100 million of favorable cost outcome is 8-cents in EPS. Given the swings in this area, this can easily be 24-40 cents. Also, keep in mind that 2020's huge figure is actually diluted because operating income was so high when 2Q20 posted $5 million in incremental profit. UNH may have pulled closer to 5% of operating income from this source in 2020 if it's normalized for that.

- On the plus side, UNH has already baked in $1.80 in lower EPS in its forecasts due to more Covid-related expenses. On the negative side, the commentary is pointing to the level of favorable outcomes coming down already on some of the y/y comps.

- We also see that UNH continues to spend much of its cash flow after capital spending and acquisitions on the dividend and share repurchases. Since the company continually makes acquisitions, we do consider that to be a part of capital spending and free cash flow. In the first half of 2021, free cash flow was $5.8 billion and the company spent $2.5 billion on dividends and $2.9 billion on stock. Our bigger concern is not affordability questions or balance sheet destruction – it's how much are shareholders benefitting from the repurchases? The repurchases are largely going to offset new share issuance to employees. The company is spending $4-$5 billion per year on stock, and the impact on EPS growth has been almost immaterial. Most years, EPS growth is helped 0%-1%, with 2020 being 0.5%. 2019 was actually the best year at 2.1%. So far for 2021, it's been 0.5% of EPS growth for $2.9 billion spent. Is there a better way to spend $4-$5 billion than adding 50bp to EPS growth?

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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