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September 11, 2020 | www.btnresearch.com

United Healthcare (UNH) EQ Review

Current EQ Rating*	Previous EQ Rating
5-	na

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We initiate earnings quality coverage of UNH with a 5- (Strong) rating

UNH's overall operating model looks solid with the company able to drive growth through a combination of making its physician base larger and its purchasing size bigger – which leverages fixed costs and enables UNH to gain larger rebates and pass savings on to customers. There is a tailwind for 2021 coming as the ACA tax will be gone. In 2019, there was a moratorium on this tax and in 2020, it is expected to be a $3 billion expense for UNH. The elimination of that tax after this year should give a strong earnings tailwind for 2021.

There are some common accounting red flags here, but they are minor, often amounting to only 1%-2% of earnings or even less. For example, the company's adjusted EPS was $15.11 in 2019. They cut bad debt reserves on receivables in 2019 and picked up 17-cents in EPS or 1%. **The issues for 3Q and 4Q of 2020 should be rising medical costs that fell during COVID as patients missed check-ups and elective procedures. As that returns to normal and people make up missed appointments, costs should rise faster than premiums and squeeze income.** That will tighten the spread between premiums received and medical costs incurred and potentially represents several billion dollars per quarter which is more in the range of $1.50-$2.50 in EPS. Rebates seem poised to help cash flow in 4Q and earnings in 2021 more. The transition headwinds due to COVID should be largely complete by year-end and then there may be more tailwinds for earnings.

Our biggest negative item is UNH's acquisition accounting. In our opinion, the disclosure of the deals is very light. Also, assumptions used such as allocating the bulk of assets to goodwill and amortizing the rest over a period 2-3x longer than that used for internal assets could be inflating earnings by as much as 22%. To UNH's benefit, non-amortization of goodwill is required by GAAP and the rules are not going to change plus, most people are going to argue this is all non-cash. So, beyond a potential future non-cash write-off in this area, we cannot argue that there is an imminent problem for earnings in this area. Using 2019 as more normalized figures, net debt to EBITDA is only 1.2x and ROI is 23%.

- **COVID caused customers to skip elective medical care while still paying premiums. The spread between premiums and medical costs is normally just over $8 billion in income per quarter. 1Q20 saw it rise to $9.6b and 2Q20 to $14.7b. This spurred earnings and cash flow.** People are returning to more normalized medical visits and there should be a backlog that needs to be cleared through the rest of 2020. Keep in mind net income is normally $3.5 billion/quarter but hit $6.7 billion in the 2Q due to lower medical costs. That could set up UNH for a headwind on earnings in 3Q and 4Q and income may dip below $3.5 billion as the backlog normalizes. This should be temporary in our view.

- **UNH runs estimated rebates through the income statement as premiums are recognized. With lower medical visit activity, UNH could not bill these rebate receivables at normal speeds to the drug companies and thus receivables in this area grew nearly $2 billion and DSOs are up from 16 to 21 days.** So, this maintained normal rates of income but sapped cash flow. It normally takes 2-5 months after medical procedures for UNH to get paid on rebates. This should represent a source of enhanced cash flow in 2021. Management believes rebates may increase by another $1 billion in the near term which could help earnings this year and cash flow further in 2021.

- **Cash flow overall should see some pressure in 3Q and 4Q in addition to seeing medical costs grow faster than premiums.** The lag on rebates may cause that receivable to continue rising in 3Q. Medical payables fell with lower activity by $2.5 billion since 4Q and should rise again as more customers get medical care. However, other payables rose by $6.4 billion over that time and from 110 DSPs to 132. All of this looks like a short-term issue that should normalize in 2021.

- **Medical Cost Estimates may have a smaller impact on earnings in the near term. These occur when customers have procedures but not all the costs are supplied to UNH immediately.** For example, if a customer needs physical therapy that is expected but doesn't occur for two months or an ambulance ride was given, but it wasn't billed for 4 months. **UNH estimates these final costs and books it in the current period. Over time, the final bills arrive and UNH squares the estimate against the real bill.** If the estimate is too high, UNH books a favorable adjustment to income and vice versa.

- **We see two issues with the Medical Cost Estimates. The first is we would expect to see years of favorable and unfavorable adjustments. In UNH's case – every year is favorable so** this is a tailwind for earnings. **The second is COVID slowed the number of medical cases so there are fewer cases to have estimates on.** The company is already seeing a smaller amount of favorable adjustments. This is an area of favorable outcome where we expect some headwind. This has been running between 2%-5% of income in recent years. Until UNH builds up to a higher level of medical costs to restock the pipeline of estimates, we would expect fewer adjustments to help 3Q and 4Q.

- **UNH has a sizeable acquisition history and completes them in essentially every year. They consume significant cash flow and the company also highlights potential liabilities for additional payments. The overwhelming bulk of acquired assets are allocated to goodwill which stands at $68 billion and other intangibles at $11 billion compared to equity of $67 billion.**

- **UNH reports adjusted earnings that add back the amortization of intangibles. That is a fairly mild adjustment given what we see from other companies. However, it is clear these acquisitions consume cash. Moreover, the amortization period is 2-3x internally developed assets that are capitalized and most of UNH's work at building the business internally is expensed as incurred.** If we cut the amortization period in half and assume goodwill is amortized over 40 years – this would reduce income by 22%. This is one area where some of the assumptions made have a meaningful impact on results.

- **The company tests for impairment on these assets by discounting cash flows. One issue we have is UNH noted that acquisitions made in 2019 and 2018 were immaterial to revenues and earnings even on a pro forma basis. How are immaterial**

results supporting nearly $16 billion of intangible asset value? We will concede the full company is reporting a pre-COVID ROI > 20%, but these intangibles are supposed to be assigned specifically to those acquired assets, not the whole business.

- **Share repurchases have consumed a large amount of free cash flow since 2018. UNH continues to issue new shares as stock compensation and spending billions repurchasing only aided EPS growth by 2.1% in 2019 and 0.9% in 1H20.** The company does not appear overleveraged to us and its underlying growth rate is historically stronger than what this repurchase program is producing. We'd argue UNH may be able to use that cash to lower its cost structure and drive better growth than through the repurchases. They can gain 1% earnings growth by cutting the cost structure by only 8bp. That may cost less than $4-$5 billion in cash spent annually on repurchases.

- **There is a large bond portfolio as UNH does own insurance companies. Rising interest rates would hurt the value of that portfolio, but it does not book those unrealized losses/gains into income. They instead adjust the equity position.** A 100bp move is worth about $1.3 billion. They also have a short duration of only 3.5 years and a rating of AA.

- **Where the bond portfolio could create a problem is the insurance companies would see their equity capital decline if rates move up. UNH is funded by dividends and return of capital from its subsidiaries.** Of the $10.1 billion from subsidiaries last year, $6.9 billion came from regulated entities that have to watch statutory capital. There was a sizeable cushion in December of $22.7 billion in capital against minimum requirements of $9.7 billion. This is not a major concern at this point.

COVID Tailwinds/Headwinds – Strong Cash Flow from Rising Payables and a Wider Spread between Premiums and Medical Payments Should Reverse in 3Q and 4Q

A quick review of recent results shows that UNH had a sizeable benefit from COVID in 1Q and 2Q. This is due to cash flow gained from other payables (non-medical payables) and accruals rising. Also, during the lock-down period, UNH was still collecting premiums but customers were unable to get non-essential/check-up type medical visits. Therefore, premiums were flat but medical costs fell noticeably and that became higher income:

	2Q20	1Q20	4Q19	3Q19
Med Costs Payable	$19.2	$22.8	$21.7	$20.9
Qtr Med. Costs	$34.7	$41.0	$39.3	$39.0
DSP Medical Costs	50.5	50.7	50.4	48.9
Premium Rev.	$49.4	$50.6	$47.6	$47.4
Medical Ratio	**70.2%**	**81.0%**	**82.5%**	**82.4%**
Premiums - Med Costs	**$14.7**	**$9.6**	**$8.3**	**$8.4**
Other Payables/Accruals	$25.4	$22.9	$19.0	$18.6
Other Op. Costs	$17.5	$17.7	$15.8	$15.6
DSP Other Payables	132.4	117.8	109.7	108.7

	2Q19	1Q19	4Q18	3Q18
Med Costs Payable	$20.9	$21.1	$19.9	$19.9
Qtr Med. Costs	$39.2	$38.9	$37.0	$36.2
DSP Medical Costs	48.7	49.5	49.1	50.1
Premium Rev.	$47.2	$47.5	$44.9	$44.6
Medical Ratio	**83.1%**	**82.0%**	**82.3%**	**81.1%**
Premiums - Med Costs	**$8.0**	**$8.6**	**$7.9**	**$8.4**
Other Payables/Accruals	$17.1	$16.9	$16.7	$19.0
Other Op. Costs	$16.0	$15.9	$16.3	$15.2
DSP Other Payables	97.7	97.0	93.4	114.0

- Medical Ratio is quarterly medical costs divided by premium revenue – smaller figure = higher income.

Medical cost DSPs have held at basically 50 days for the last 8-quarters. However, other DSPs have increased noticeably in 4Q19, but the next change in dollar terms was only about $2 billion y/y. Since COVID, the y/y change became $6 billion in 1Q20 and over $8 billion in 2Q20. Also, related to the medical ratio, look at the amount of income produced by premiums less medical costs. That figure has been about $8.0-$8.5 billion for all periods pre-COVID. Suddenly, it becomes $9.6 billion and $14.7 billion. These are the areas where UNH has picked up significant income and cash flow:

	2Q20	1Q20	4Q19	3Q19
Net Income	$6.7	$3.5	$3.7	$3.6
change A/P	$0.0	$5.3	$1.6	-$0.1
Cash from Ops	$10.0	$2.9	$6.2	$3.2

	2Q19	1Q19	4Q18	3Q18
Net Income	$3.4	$3.6	$3.2	$3.3
change A/P	-$1.0	$1.5	-$2.4	$1.0
Cash from Ops	$5.9	$3.2	$2.4	$0.9

We believe there will be headwinds in 3Q and 4Q that see some of these sources of cash reverse:

- Premiums will remain flat, but customers who deferred medical care will get those elective procedures and check-ups done. That should push the medical ratio from 70% to perhaps as high as 90% in the near-term.

- The income from premiums less medical costs could drop from close to $15 million to below the normal $8 million on a quarterly basis.

- As customers clear out the delayed treatments, medical cost payables should rise and help cash flow. However, other payables and accruals may be consuming cash as they are paid down.

- During 2Q, UNH also waived some premiums and saw fewer rebates coming through cash flow as customers used less medical care – those areas should return to help results. UNH is estimating it will see $1 billion in higher rebates coming in future quarters.

- All in all, we think 1H EPS of $10.84 was likely inflated by about $3 due to net COVID impacts. We expect much of that $3 to reverse back out in the next 2-3 quarters. UNH noted on the earnings call that patients' use of medical care was back to about 90% of normal vs 60% in April. The rising medical costs returning to normal against largely flat premiums should be the biggest part of this headwind.

Rebates Are Still Helping Earnings, but Lower Medical Activity May Cause the Time Until Cash Collection to Lag in 2020, but Helping in 2021

The way rebates work is UNH estimates the amount of rebates to be received and nets them with premium revenues. So, most rebates go through the income statement at the time premium revenues are recognized. For non-affiliated customers – rebates are netted against cost of products sold. For other product revenues, these are equal to the cost of drugs net of rebates + a dispensing fee + customer co-pays. Thus, rebates work through the income statement at the time a premium is earned and a customer is eligible for medical service. UNH sets up a receivable for the rebates, that will become cash when paid. It may bill for the rebates monthly or quarterly and typically they are paid on a lag of 2-5 months. So, rebates impact income upfront and cash flow lags.

Rebates accrue in "other current receivables." It is defined as amounts due from pharmaceutical manufacturers for rebates and Medicare Part D drug discounts, accrued interest, and other miscellaneous amounts due to the Company. UNH details this annually. For December 2019, total other current receivables were $9.6 billion, with $4.7 billion being rebates and $2.3 billion Medicare Part D discounts – so 73% of that account.

As we would expect with the COVID lockdowns, the premium revenue kept coming in with estimated rebates accruing, but the volume of actual medical activity was down meaning the UNH couldn't bill for rebates. Thus, the receivable account rose and consumed cash flow:

Rebate DSOs	2Q20	1Q20	4Q19	3Q19
Other A/R	$11.4	$10.3	$9.6	$10.2
Premium Rev.	$49.4	$50.6	$47.6	$47.4
DSOs	21.1	18.5	18.5	19.5

Rebate DSOs	2Q19	1Q19	4Q18	3Q18
Other A/R	$8.4	$7.6	$6.9	$7.3
Premium Rev.	$47.2	$47.5	$44.9	$44.6
DSOs	16.3	14.7	13.9	14.5

As noted above, UNH generates rebates and discounts from more than just premium revenue, but that is the largest part of revenues. This account has grown more of late which we think is partially due to Medicare Part D changes. At both December 2019 and

2018 – UNH reported 9.0 million Medicare Part D users in its system. In 2019, it had a receivable of $2.3 billion for discounts for Medicare Part D vs. only $0.8 billion in 2018. The difference is about 2 days of receivables. We think this trend is why United Health expects to see rebates increase going forward too.

However, we can see that receivables rose over $1 billion on a slight sequential dip in revenues in 2Q20. We would expect to see that receivable number and DSO figure to decline by the end of 3Q and into 4Q as customers get their normal medical care and prescriptions. This should also offset some of the lost cash flow from lower earnings as medical costs rise faster than premium revenues.

Adjustments to Medical Costs Payable May Be a Headwind for the Rest of 2020

When UNH customers visit the doctor, the doctor submits a bill to UNH. UNH records this as a cost and a payable. The company reports that 90% of these bills are settled within 90 days. But there are some complications and estimates to the process:

- The patient may have had a procedure done by multiple healthcare providers. Some may submit a bill much quicker than the others.

- There may be follow-up procedures in some cases and the bills are not submitted for several months.

- There may have been complications that resulted in additional bills that are not completely known yet either.

- A patient has knee surgery that will require the knee to heal for a couple of months – then have 3 months of physical therapy.

UNH will estimate what the total expense may ultimately be and record it as an expense. It will then compare the actual costs to the estimate when the final figure is known. If the actual cost comes in below estimate – UNH will adjust by lowering costs recorded in a future period when the resolution is known. If the cost comes in above estimates – UNH will record an adjustment to boost costs in that future period.

This can create a significant change in the costs if the estimate is +/- only a small percentage. Based on 2019 results, there is a sensitivity for +/- 75bp on income:

2019 sensitivity	-75bp	-50bp	-25bp	25bp	50bp	75bp
Medical Costs ($mm)	$584	$388	$194	-$193	-$384	-$575

So basically there is a $200-$600 million swing for adjusting this estimate between 25-75bp. To put this in some perspective, UNH had over $156 billion in medical costs in 2019. However, pretax earnings were about $18 billion in 2019. So, this small sensitivity range is 1-3% of income.

The first issue is we would think UNH could see periods when this estimate review produced both favorable and unfavorable adjustments. But we are not seeing that. Every period is showing a positive outcome. This continually helps earnings:

Estimate chg.	1H20	1H19	2019	2018	2017	2016	2015
Fav. Med Costs	$660	$400	$580	$320	$690	$220	320
Pretax Income	$13,370	$8,758	$19,685	$17,344	$15,209	$11,863	$10,231
% of Income	4.9%	4.6%	2.9%	1.8%	4.5%	1.9%	3.1%

The factors UNH is looking at when making these estimates include tracking similar cases at certain times of the year, percentages that have complications or hospitalizations historically, economic strength that may encourage/discourage patients from having procedures, and its own ability to control costs for procedures or completing the payment more efficiently.

We believe COVID may also have a negative impact on this earnings source in 3Q20. Many people wouldn't go to the doctor in 1Q and 2Q. Elective surgeries were delayed as well as annual check-ups. Even after that started to be available again in 3Q, schedules were not ramped up immediately. Also, we know of people who were rescheduled – but delayed again for having a COVID test that was too many days prior to their surgery or had visited another state within 14-days. In most quarters UNH is continually settling older estimates, but it also normally is incurring new ones. We think that has not been the case in 2020. Thus, the backlog of estimates to be resolved may be low at this point. Look at the changes to total medical costs and adjustments in 2020:

Estimate chg.	2Q20	2Q19	1Q20	1Q19
Current Med Costs	$35,338	$39,584	$41,000	$38,939
Fav. Adjustment	-$80	-$100	-$580	-$300

Current medical costs dropped noticeably in 2Q (after spiking in 1Q), and the favorable adjustments did not create much of a drive to earnings. The company notes that it normally settles all bills within 90 days and all estimates are normally resolved within 12 months. We think the level of unresolved estimates has likely declined since March, creating less room for additional favorable adjustment. What drove earnings in 2Q was premiums still grew, but there was $4 billion in lower medical costs as people didn't go to the doctor. In 3Q and 4Q, there could be a bounce back in medical costs overall, which could reflect normal spending levels and picking up delayed procedures. At the same time, there may be a much smaller backlog of estimates to show a favorable adjustment.

This can also be seen in the account called IBNR – (Incurred But Not Reported) – Medical Costs. This account normally has some seasonality where it declines in 4Q. However, it normally rises y/y and that is not happening in the last two quarters:

$ in bills	4Q	3Q	2Q	1Q
IBNR 2020			$13.7	$14.3
IBNR 2019	$13.8	$14.2	$14.5	$14.3
IBNR 2018	$13.2	$13.8	$13.5	$13.3

This is unlikely to go to zero, but it may be a 1% tailwind for earnings instead of 3%-4% until the quantity of estimates rebuilds.

Growth Through Acquisition Issues

UnitedHealth routinely makes acquisitions often adding new types of services to offer existing clients. In 2019 and 2018, the company noted that acquisitions were immaterial to revenues and earnings after spending $14 billion:

> *"The results of operations and financial condition of acquired entities have been included in the Company's consolidated results and the results of the corresponding operating segment as of date of acquisition. Through December 31, 2019, **acquired entities' impact on revenues and net earnings was not material.*** *Unaudited **pro***

<u>forma revenues for the years ended December 31, 2019 and 2018 as if the acquisitions had occurred on January 1, 2018 were immaterial for both periods. The pro forma effects of the acquisitions on net earnings were immaterial for both years."</u>

From a cash flow perspective, UNH routinely spends all of its free cash flow on acquisitions, dividends, and share repurchases.

$ in bills	1H20	2019	2018	2017	2016	2015
Cash from Ops	$13.0	$18.5	$15.7	$13.6	$9.8	$9.7
Cap-Exp.	$0.9	$2.1	$2.1	$2.0	$1.7	$1.6
Acquisitions	$3.5	$8.3	$6.0	$2.1	$1.8	$16.2
Free Cash Flow	$8.5	$8.1	$7.7	$9.5	$6.3	-$8.0
Dividends	$2.2	$3.9	$3.3	$2.8	$2.3	$1.8
Repurchases	$1.7	$5.5	$4.5	$1.5	$1.3	$1.2

Given that acquisitions are material and frequent – we would consider them to be part of capital spending. That leaves the dividend at about 50% of free cash flow. Remember that so far in 2020, free cash flow as benefitted from customers being unable to visit doctors as they paid premiums. Thus, we do not consider the recent 26% payout ratio to be a realistic picture. The dividend looks solid enough at this point, as the share repurchases can be seen largely as a plug-figure in our view even though they are expected by investors.

Our issues with the acquisitions include the following:

- **Nearly all of the acquisition prices are allocated to intangible assets and goodwill.** In 2019, $9.9 billion spent on acquisitions was allocated as $2.0 billion in intangibles and $6.9 billion of goodwill. In 2018, $1.6 billion went to intangibles and $5.2 billion to goodwill.

- **The goodwill is not amortized at all, and the intangibles are amortized over 17 years for 2018 and 13 years for 2019 acquisitions. That compares to internally created assets that are either fully expensed immediately as wages and lower-income or are depreciated or amortized over a much shorter period.** Furniture/equipment is depreciated over 3-10 years and capitalized software over 3-5 years. We think a case can be made that amortization should be happening at least twice as quickly.

- **UNH adds back all the amortization as a non-cash charge to adjusted earnings too. We would argue that the acquisitions clearly consumed huge amounts of cash and**

are ongoing every year. If we look at the difference between UNH's adjusted EPS to GAAP EPS and then an EPS with a more reasonable amortization schedule (subtracting a double amount of amortization for intangibles and accounting for some amortization of goodwill) – it is obvious that a sizeable amount of UNH's EPS (about 22%) is due solely to the accounting assumptions behind acquisitions:

EPS issues	2019	2018	2017
Adjusted EPS	$15.11	$12.88	$10.07
Amortization added back	$0.78	$0.69	$0.57
GAAP EPS	$14.33	$12.19	$9.50
2x Amortization	$0.78	$0.69	$0.57
Goodwill on 40-year Amort.	$1.70	$1.50	$1.41
BTN Adjusted EPS	$11.85	$10.00	$7.52
EPS % from assumptions	22.0%	22.0%	25.0%

- 2017 also had a one-time adjustment on deferred taxes for tax reform that amounted to -$1.22 in EPS. Thus, actual GAAP EPS was $10.72 in 2017. We do consider that to be a one-time event and left its impact out of this table.

- **Also, supporting that these are actually cash expenses is UNH has $9.3 billion in liabilities that is a catchall for several items including,** *"obligations associated with contingent consideration and payments related to business acquisitions, certain employee benefit programs, amounts accrued for guaranty fund assessments, unrecognized tax benefits, and various long-term liabilities."* These are not quantified in more detail and clearly from the list, the full $9.3 billion is not solely an issue for acquisitions, but contingent payments for acquisitions is listed first. This may still be several billion dollars.

- **We cannot fully square how UNH is doing impairment tests for goodwill and the other intangible assets. It computes fair value of business units that are carrying the goodwill and intangibles on a discounted cash flow method** which makes forecasts for revenues, costs, productivity, and future capital needs. That is very common and we don't have an issue with that method. **The problem we have is the company specifically says in the 10-K that the recent acquisitions had immaterial revenues and earnings.** The company is carrying $67.9 billion in goodwill and $10.6 billion in intangibles. For the 2019 and 2018 deals, that is $15.7 billion of these intangible assets. We would think to justify those large carrying values, there would need to be material revenues and earnings to result in some sizeable discounted cashflows.

- **There is almost no disclosure about the acquisitions either.** There are no details quantifying how much if any revenue growth or earnings growth came from deals. There are no details for multiples of EBITDA or sales paid. If there is one deal or twenty deals, they are all lumped together by year for total purchase price and total allocation of assets.

Our conclusion for the acquisitions from a positive standpoint is UNH can afford this source of growth. Cash flow more than covers deals in most years. Nor is UNH terribly leveraged – 2019 EBITDA pre-COVID was $22 billion vs. net debt of $26 billion.

Our conclusion for acquisitions from a negative standpoint is UNH earnings are being boosted by aggressive assumptions regarding expenses related to deals. The huge cash outlays and contingent payments point to acquisitions being a cash cost in our view. Also, we think the risk of an impairment of intangibles may be higher than many believe simply due to the significant amount of intangibles as the company also says some fairly large deals had immaterial earnings and revenues.

Share Repurchases Are Consuming Tremendous Cash Flow for Minimal EPS Growth

To UNH's credit, it does not add back stock compensation expense to adjusted EPS. We consider that a conservative policy. However, UNH is routinely issuing 10 million new shares annually from the exercise of stock options and realizing far lower cash inflow than it is spending to prevent the dilution. In 2019, it finally picked up some EPS growth from buying back twice as many shares as were issued and the impact was only 2% incremental EPS growth.

Repurchases	1H20	2019	2018	2017	2016
Fully diluted Shares	960	966	983	985	968
Shares Issued	8	10	10	26	9
Shares Purchased	6	22	19	9	10
Proceeds from Issuance	$870	$1,037	$838	$688	$429
Cash spent on Repurchases	$1,691	$5,500	$4,500	$1,500	$1,280
EPS Impact of Repurchases	$0.03	$0.25	$0.02	-$0.19	-$0.01
EPS growth rate from Repurchases	0.9%	2.1%	0.0%	-2.6%	0.0%

We showed the total spending on capital investments, acquisitions, dividends, and repurchases earlier. In our view, it will be difficult for UNH to maintain such large cash outlays on shares going forward. More importantly, the repurchases are not really adding much to EPS growth in most years. The yield on the stock is only 1.6% and the best year for share repurchases was 2019 with an incremental 2.1% EPS growth. Most years the repurchases are producing under 1% incremental EPS gains. We'd argue that investors would be better off if the repurchase money was spent on lowering operating costs or boosting revenue. Earnings growth of 1% could be achieved with $170 million in lower expenses against total expenses in 2019 of $222 billion. That's only 8bp of improvement and achieving that goal may cost less than $5.5 billion.

Interest Rate Risks May Not Have a Negative Impact on Earnings

Obviously, interest rates have declined during the COVID issues and may well increase as more normalcy reemerges. UNH has a $36 billion fixed-income portfolio with a duration of about 3.5 years. It is essentially one-half US government bonds, municipal bonds, and agency mortgage backs along with the other half in corporate bonds. The average rating is AA.

UNH notes that a 100bp move in interest rates causes a $1.3 billion swing in fair market value for the portfolio. The key is they carry these securities as Available-for-Sale. While they account for unrealized gains or losses, they are reported in comprehensive income:

> *"The Company **<u>excludes unrealized gains and losses on investments in available-for-sale debt securities from net earnings</u>** and reports them as comprehensive income and, net of income tax effects, as a separate component of equity."*

That means, UNH's reported earnings didn't benefit from falling interest rates and is unlikely to see much pressure from rising rates unless they sell the securities. The low duration should also be a mitigating factor and enable the company to roll over maturing securities at higher rates under that scenario. The bulk of its debt is fixed too. We do not see much earnings risk from interest rates – and if rates rise for debt on roll-over, it should rise for securities rolling over too.

Dividends from Subsidiaries Is a Risk Worth Understanding but Is Not a Problem at this Time

If there is a risk from rising interest rates it may be in this area. A big part of UNH's parent company cash flow that pays the common stock's dividend, funds acquisitions, and share repurchases comes from dividends paid by subsidiaries plus other payments classified as return of capital. Some of these subsidiaries are regulated insurance companies which are likely where the bulk of the bond investments are located. So, if there is a 100bp rise in interest rates, it may not impact UNH's earnings, but it would lower the capital base at those subsidiaries. Here is the statement from the 10-K:

> *"**For the year ended December 31, 2019, the Company's regulated subsidiaries paid their parent companies dividends of $5.6 billion, including $1.3 billion of extraordinary dividends**. For the year ended December 31,2018, the Company's regulated subsidiaries paid their parent companies dividends of $3.7 billion, including$1.1 billion of extraordinary dividends. **The Company's regulated subsidiaries had estimated aggregate statutory capital and surplus of $22.7 billion as of December 31, 2019. The estimated statutory capital and surplus necessary to satisfy regulatory requirements of the Company's regulated subsidiaries was approximately $9.7 billion as of December 31, 2019**."*

This sounds like there is a considerable cushion and we do not want to overhype this as a risk factor. We just want to point out there are some considerations here and it is not always easy to move cash out of a captive insurance company. Also, all the subsidiaries paid $5.6 billion in dividends plus $4.5 billion was received as a return of capital – of that $10.1 billion, $6.9 billion came from the regulated companies.

At this point, we would only point out that all of the consolidated cash flow generated by UNH's subsidiaries may not be easily or fully accessible for the benefit of the parent company and its stockholders.

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 Concerns"	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 may 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 the next quarter. 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.

Disclosure

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The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

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