BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

April 17, 2020 | www.btnresearch.com

Unum Group (UNM) EQ Review

Current EQ Rating*	Previous EQ Rating
2-	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 are starting coverage of UNM with an earnings quality rating of 2- (Weak) indicating a weak situation with negative implications in the near-term.

Unum is an insurance company that focuses primarily on short-term and long-term disability payments to offset lost income for employees. It also has life insurance policies and legacy long-term care policies that it has not offered for groups since 2011 and for individuals since 2009. This is another company that is now trading for half the price where it was before the market swoon and yields 7.6%. It historically traded at a discount to book value, but the current 30% of book value is also down from the normal discount of 60%-70%. There are reasons to expect the book value to be impaired. The underlying insurance businesses should weather the storm – but the corporate structure may multiply the pain to shareholder value.

There are several accounting and operating structure risks to owning Unum. It is a parent company with operating subsidiaries in the insurance business. All of the debt is at the parent company and it is also the unit buying back shares and paying the dividend. It just declared its normal dividend this week. The problem is the primary source of cash for the parent is distributions received from the insurance

subsidiaries. There are many regulations and limitations on that process and current market actions could result in lower reserves at those subsidiaries making it tougher to move cash to the parent.

On top of that, anyone screening for Unum statistics will see numbers based on consolidated results. Unum does not have access to all of that cash flow and already has been paying out more than 100% of the cash it has had access to for several years and borrowed the difference. Of the consolidated free cash flow of about $1.6 billion, Unum's parent only has free cash flow of about $500-$600 million. It has short-term investments of about $600 million and a revolver of $600 million, so the parent has some liquidity. However, the cash flow it has available to it is supporting $3.9 billion in debt including the pension, which net of the $600 million in short-term investment is 4.7-5.5x the annual cash flow figure. That $500-$600 million in cash flow may face some downward pressure too based on what happens to the value of the investment portfolio and thus reserve levels.

- **The dividend, the debt service, the underfunded pension, the stock repurchases are all done by the parent company. The parent has $1.1-$1.2 billion in revenue with all but $64 million coming from its insurance subsidiaries distributing cash up to the parent.**

- Unum stopped writing new Long-Term Care policies nearly 10-years ago, but it still has to deal with the existing customers of that closed business. Those policies have been moved to a captive reinsurance unit that loses money. **Of the parent's $1.0-$1.1 billion in dividends received from other subsidiaries – it is putting $200-$400 million on average per year into that reinsurance unit.** Management believes the reserve needs will not peak for another 12-years for that situation.

- **General screening of Unum at 30% of book value would also show the dividend is only 14% of free cash flow. In reality, net of the payments for Long-Term Care, we see the dividend as 44%-48% of actual free cash flow.** Plus, Unum has a history of generating about 5% EPS growth via stock repurchases – that may be difficult to maintain.

- **Immediate cash needs at the parent are a $400 million debt maturity, $200-$400 million to shore up reserves at the reinsurance business, a $630 million commitment to alternative investments for that same reinsurer (some of which**

may be covered with current investments and the shoring up payment), the pension will consume $80 million, and $230 million for the dividend – which is quite a bit to cover from $1 billion in contributions from subs and a $600 million credit line and maturing short term investments.

- **The subs are state regulated insurance companies. There are limits as to how much they can pay in dividends, usually 10% of excess Statutory Capital or last year's operating income. Without regulatory approval, Unum has access to just over $1 billion from that source again in 2020.**

- **The investment portfolio of over $55 billion has been suffering from declining interest rates over time reducing its yield. Now widening credit spreads may cut the value of the portfolio which is dominated by longer term corporate bonds. A 100bp change in valuation to the bond portfolio would cut $3.8 billion in value against Unum's book value of $10 billion. That could shrink surplus capital reserves at the subs and pressure the $1 billion dividend Unum is receiving.**

- **The investment portfolio is largely investment grade, but we did see $7.2 billion in bonds from energy and transportation companies. Another $1.5 billion is in AAA tranches of mortgage backed securities that may prepay and have to be deployed at lower rates. There is also $2.4 billion in direct mortgage loans – with 24% of that in retail. Those look like some areas where more hits to book value could materialize.**

- **Falling interest rates have hurt investment income, led to falling discount rates to measure future claims – which necessitated higher reserves for the insurance companies, and boosted the pension obligations.** Unum has offset some of that with raising prices on new customers and renewals. **Overall, this company would benefit from some higher interest rates. However, that would also immediately hurt the value of the investment portfolio more quickly than the positives would kick in of having higher premiums and rising investment income.**

- **Covid-19 does not seem likely to derail the basic business** – it sells primarily via businesses and much of the insurance is tied to wage levels of employees. It did not see a surge in cancellations in 2008-09. It is working with customers

now to continue benefits for furloughed employees and has grace periods in place.

- **The Long-Term Care issues may still get worse.** They have already taken $1.9 billion in charges to boost reserves there and it is consuming considerable cash flow. **There are discussions among regulators to require captive reinsurers to carry capital requirements equal to traditional insurers.** That would require Unum to put more capital into that unit. Also, new accounting rules for 2022 will require assumptions be updated more frequently and Unum sees that as having a material impact on the company.

- Deferred Acquisition Costs are another 23% of equity. We believe the assumptions here have become more conservative. Also, Unum is not seeing rapid declines in renewals at this point and we didn't see them in 2008 either. We are not concerned of write-offs in this area having a major impact on book value.

Basic Corporate Structure of Unum – The Parent Company Review Gives a Less Flattering View of Dividend and Stock Repurchase Coverage

Unum is the parent company of several insurance companies. The parent company relies on dividends from the subsidiaries to primarily service its own debt, pay a dividend, and repurchase stock:

Unum Parent	2019	2018	2017
Dividends from Subs	**$1,089**	**$1,135**	**$830**
Other Income	$64	$67	$67
Total Revenue	$1,153	$1,202	$897
Interest Exp.	**$173**	**$161**	**$154**
Other Exp.	$53	$53	$37
Income of Parent	$921	$989	$590
Undist. Inc. of Subs	$179	-$466	$404
Net Income	$1,100	$523	$994
Cash From Ops	**$1,000**	**$1,052**	**$741**
CapX	$86	$73	$83
Cash to Subs	$389	$531	$80
Dividends Paid	$229	$216	$196
Stock Repo.	$400	$356	$402

Notice that the dividends from subsidiaries less interest expense is essentially the parent's income. Also notice that figure is essentially the cash from operations figure too. It is clear that the cash that makes Unum run – is coming from subsidiary dividends. It is also clear that cash being paid to other subsidiaries (mostly captive reinsurers) is consuming a sizeable amount of the parent's cash flow. These payments have been common for years – which we will explore more fully below. They are largely tied to boosting reserves for the company's Long-Term Care insurance that has been closed to writing new business since 2011. After speaking to the company – they do not expect the reserve requirements growth to peak until 12-14 more years. Although, the level of payments to subs may decline from 2019 levels.

The internally generated cash flow is not covering all these uses of cash outflow. The result is Unum has been borrowing more money:

Unum Parent	2019	2018	2017	2016	2015	2014	2013
Cash from Ops	$1,000	$1,052	$741	$685	$672	$683	$613
CapX	$86	$73	$83	$56	$79	103	$79
Cash to Subs	$389	$531	$80	$144	$231	$316	$225
Dividends Paid	$229	$216	$196	$183	$174	$159	$147
Stock Repo.	$400	$356	$402	$405	$418	$306	$317
Cash Left	-$104	-$124	-$20	-$103	-$230	-$201	-$155
Net Borrowing	$409	$91	$0	$259	$271	$347	$0

There were also acquisitions in 2018 of $146 million and in 2016 of $140 million. This is why the parent company is carrying basically 100% of the consolidated debt at $3.2 billion and the pension liabilities of $642 million. It has a $400 million principal payment due in 2020.

What we think investors should see here is the cash flow available to pay the dividend and repurchase shares is much tighter than it appears for consolidated results. If the payment to the subs is necessary – free cash flow has really been only $525 million in 2019 and $448 million in 2018. The dividend is consuming 44%-48% of that cash and the free cash flow is not covering the share repurchase.

On the consolidated results, Unum reported adjusted earnings of $5.44 per share for 2019 against the dividend of $1.44 or a payout of only 21%. Also, consolidated results net out the payment to the subs and includes all the cash flow generated by the subs

that wasn't sent the parent. So free cash flow is was $1.6 billion in 2019 and the dividend was only 14% of that. Plus, the $400 million spent on shares only consumed 25% more.

There are significant restrictions on the subs paying dividends as the state regulators and statutory accounting is more concerned with each of the insurance companies having the ability to pay their claims than the parent repurchasing stock. Unum warns of this in the risk factors citing rules that generally limit dividends to either 10% of the statutory surplus of the preceding year ($3.6 billion combined capital and surplus) for its US life insurers or the income from operations excluding realized gains and losses from the preceding year (which was just over $1 billion in 2019).

Statutory capital requirements are also run on several areas of sensitivity for interest rates, payment claims, changes in mortality. Unum met these tests at a ratio for the Risk Based Capital standards in 2019 at 365%. With interest rates falling and some issues with the investments we'll describe below – we think Unum may see that 365% figure decline. However, the limits on dividends appear to leave little room for much growth in the cash flow from the subs.

From the 2019 10-K:

> "*During 2020, we intend to maintain a level of capital in our insurance subsidiaries above the applicable capital adequacy requirements and minimum solvency margins. Although we may not utilize the entire amount of available dividends, **based on applicable restrictions under current law, approximately $1,035 million is available, without prior approval by regulatory authorities, during 2020 for the payment of dividends from Unum Group's traditional U.S. insurance subsidiaries, which excludes our captive reinsurers***."

Unum has a credit revolver that it was not tapped of $600 million and another of $100 million. The debt covenants appear tolerable here. The first is maintain a maximum debt to total capital of under 35%. If Unum borrowed $200 million on the revolver – it could withstand a $3.4 billion hit to equity vs. the current value of $10 billion. The second is minimum net worth must stay above $5.96 billion plus 25% of consolidated income in any quarter after 2Q19 when income is positive and 50% of any equity issuance. That would require a bigger reduction in net worth than the debt ratio.

Our view is Unum can handle the dividend and the debt maturity but may be tapping the revolver. It may not be able to maintain the share repurchases at previous levels. That has been adding 4-5% to EPS growth annually. One could argue that at current stock prices, UNUM could buy back the same number of shares to produce 4%-5% EPS growth for half of what it has been spending.

Long-Term Care Has Been an Issue for Several Years

Since Unum stopped selling LTC insurance to individuals in 2009 and groups in 2011, it has seen several large one-time charges to deal with Long-Term Care. These charges have been:

- 2011 - $573.6 million based on termination levels coming in lower than forecast, investment returns coming in below forecast, longer life expectancy indicating more claims were likely to be paid and lower interest rates causing the discount rate to determine the present value of needed reserves. The net result was it needed to ramp up reserves for the business.

- 2014 - $698.2 million to boost reserves based on forecasts for rising future claim levels.

- 2018 - $750.8 million more to deal with lower discount rates again increasing the PV of future claims and previous estimates being negatively updated causing reserve requirements to increase again.

This business was moved to captive reinsurance carriers within the Unum family umbrella. The company continues to push for the ability to raise prices on current clients with state regulators to offset some of the negative trends working against it. The table in the previous section shows $1.9 billion in cash going to the subs from 2013-19. The vast part of that cash is going to shoring up the LTC reserves. Unum is indicating that this will be a use of cash for several more years. Also, interest rates are lower still in 2020, which is a driver to boost reserves. Plus, people still are not quitting their policies – the persistency is 96%. That is why Unum does not expect the cash drain to stop any time soon. That will keep the pressure on the parent company's cash flow. Right now, the cash is going in to cover current claims - since

Unum's captive reinsurers are posting losses for Statutory income - as well as build some reserves.

Statutory Income	2019	2018	2017
US Insurance Subs	$982	$953	$807
Captive Reinsurers	-$123	-$110	-$137

Unum's outlook also noted that it has $629.8 million in commitments to buy alternative investments primarily for the investment portfolio that relates to LTC. Some of that can likely be met with premium income from the insurance and selling other investment assets. But that is a sizeable amount of cash commitments in our view that needs to come from subsidiary dividends first and then be transferred to the reinsurance companies for Long-Term Care.

Two other risks exist in this area. The first is there are discussions to have captive reinsurance companies meet the same capital requirements as traditional insurers. That could cause Unum to put even more capital into those units:

> *"In 2012, the NAIC established a subgroup to study the insurance industry's use of captive reinsurers and special purpose vehicles to transfer insurance risk and is considering ways to promote uniformity in both the approval and supervision of such reinsurers.* ***More recently, the NAIC adopted a proposal to subject certain captive reinsurers and special purpose vehicles to the same capital requirements as traditional insurers.*** *As the NAIC and state insurance regulators continue to examine the use of captive insurance companies to finance reserves required under current regulations, we cannot predict the ultimate outcome of their work, or how long or extensively they will continue to focus on this issue.* ***Although we believe it to be unlikely, a potential outcome of future NAIC decisions from its various committees, task forces, and working groups is that companies could be prohibited from using captive reinsurers.*** *No changes in the use or regulation of captive reinsurers have been proposed by the NAIC, and we are unable to predict the extent of any changes that might be made. Accordingly, we expect to continue our strategy of using captive reinsurers to manage risks and enhance capital efficiency while monitoring the NAIC's study and proposed changes in regulations.*

We use affiliated captive reinsurers for the limited purpose of reinsuring risks attributable to specified policies issued or reinsured by our insurance subsidiaries in order to effectively manage risks in connection with certain blocks of our business as well as to enhance our capital efficiency. ***If we were required to discontinue use of the captive reinsurers or to alter the structure of the captive reinsurance arrangements, our ability to maintain current RBC ratios and/or our capital deployment activities could be adversely affected."***

The next issue is ASC 944 which takes effect January 1, 2022. This will require more disclosure for long-duration insurance contracts. The updates for assumptions in determining future policy benefits will need to be done more frequently. Also, the discount rate will be to be updated at each reporting date. Unum expects the adoption to have a material impact on the financial position.

Covid-19 Issues for Cash Flow to Subsidiaries and How Unum's Insurance Works

Unum's subs offer primarily four types of insurance:

Long-term disability which doesn't begin paying for 90-180 days. It will pay a percentage of income and lasts until the claimant recovers or reaches age 65-70. As payment levels are based on income – if wages fall during this time, it may create some pressure on premium income.

Short-term disability begins paying immediately for an accident or one week after an illness. It also pays a percentage of income and has a maximum payment period of 26 weeks. The same pressure may exist here on premiums if client wages decline.

Voluntary benefits are normally paid by employees via deductions from their checks. These are often supplemental policies to handle the costs of hospitalization, cancer treatment, or a disability.

Life insurance is essentially term policies on employees for a set number of years.

Disability is over half the policies written with voluntary and life covering the rest – (there is a small amount of dental also). Based on their insurance we would not

expect a change in claims for long-term disability as Covid-19's shutdown issues will be over before it could be applied for by clients. Short-term disability could see an increase in claims if people claim they are unable to work due to illness.

As far as premiums being paid and keeping clients during this process – Unum has outlined its rules on the website. Here are some highlights:

- Payment due dates have a grace period. They may also be subject to various state-mandated grace periods
- Individuals who lose payroll deduction will be billed directly
- If the bills are paid (or within the grace period) employees are still covered
- Furloughed employees are considered on a leave of absence are remain eligible for 90 days or the term of the leave of absence.
- Employees who are rehired will not need to requalify for full coverage and benefits can begin immediately.

Unum recognizes premium income on non-interest products as revenue when due from policy holders. While it may not turn into cash immediately, it would be viewed as income at the various insurance subsidiaries it could support the dividend to the parent company. The company's DSOs on receivables was over 60 days before the virus. It is possible that the company will have most of its customers back to work before they start to trip over the grace period and may see a lumpy cash inflow in mid-2Q20 after a drop-off at the end of 1Q20.

Book Value Problems – Investment Assets

Like many financial companies – Unum's balance sheet is what matters and small changes to asset valuations can have huge impacts on earnings and book value. There are $67.0 billion in total assets, $10.0 billion in equity, generating $1.1 billion in income. Of those assets - $55.8 billion are the investment portfolio. The first $47.4 billion of the portfolio is in fixed income securities:

Unum Fixed Income Portfolio	Amount	%
US Gov/Agencies	$1.4	3%
States/Muni Bonds	$3.4	7%
Foreign Gov	$1.0	2%
Public Utilities	$7.7	16%
Mortgage/Asset Backed	$1.5	3%
Corp Bonds	$32.4	68%
Total	$47.4	100%

The fixed income is 93% investment grade and 7% non-investment grade. The fixed income portfolio is listed as available for sale which means it is reported at fair value. Fluctuations considered temporary and are unrealized gains/losses do not impact earnings. They do not affect net income – but flow to retained earnings via changes to accumulated other comprehensive income net of taxes.

These are bonds, so falling interest rates should help values, but widening credit spreads should hurt values – we would consider those largely temporary. The issue we'd be more concerned with is defaults/restructurings. We're not worried about the various government bonds in that area and sure public utilities can be hurt by industries running at less than full speed and people not going to commercial spaces. But, for the most part, we are not going to call for public utilities running at less than full speed for a month to be a dire issue for bond payments. We're also going to say that for mortgage backed securities. They own the AAA tranche and lower rates may create prepayments as a risk more than default, as the money returned may be invested at lower rates.

That leaves the corporate bonds at 68% of the portfolio for scrutiny. We would argue that the non-investment grade is concentrated there and would be 10% of that part of the portfolio. Behind that, there is some areas where we would look for losses to be realized:

Corp Bonds	Amount	%
Consumer Non-Cyclical	$7.3	23%
Energy	$4.8	15%
Transportation	$2.4	7%
Financial	$3.8	12%
Consumer Cyclical	$1.5	5%
Capital Goods	$4.4	7%
Basic Industry	$3.3	10%
Tech	$1.9	6%
Communications	$3.1	10%

We would speculate that consumer cyclicals include Ford and GM, while energy includes Exxon Mobil and Marathon Partners instead of being all Chesapeake Energy. We would also speculate on the information we see in the news that many companies will get government money to deal with the coronavirus issues. We're not sure that fixes everything though for some of these areas as the economy reopens. Here's the problem, Unum has $10 billion in equity. It has $7.2 billion in bonds from energy and transportation companies. In our view, there is more than a reasonable chance there are some future losses in those bond positions. That is offset by the 21% tax rate, so a 10% loss of $720 million in those areas becomes a $569 million hit to equity. It would be further offset by the company generating income to boost equity as losses are being recognized. In the end, we would consider this to be an area of sizeable risk. Downgrades to bonds would hurt income and to the extent anything restructures, Unum will lose investment income. Off of that impacts capital at the subs and the amount they can dividend to Unum.

The risk doesn't stop with corporate bonds. Unum also has $2.4 billion of direct mortgage bonds on commercial property and even with some geographic diversification – Unum still rates 80% of them as BBB in quality and 20% A-rated. 51% has a Loan-to-Value of less than 65% and another 44% with an LTV of 65%-75%. Here is the breakdown of this investment by sector:

Mortgage Bonds	%
Apartments	25%
Industrial	26%
Office	23%
Retail	24%

There are A-class shopping malls with lots of restaurants and entertainment venues for tenants that should do well as the virus ends. Retail also includes grocery stores. We do not consider all retail to be a zero. However, that could be another area where Unum has some risk of write-down.

A third area that could impact the total portfolio is interest rate changes. In our view, the risk is interest rate spreads over the 10-year being wider than when FMV estimates were made in December. This impacts all of the portfolio, not just energy or transportation. **A 100bp increase on average to the bond portfolio is a $3.8 billion hit or 8% of the FMV of $47.4 billion. For the mortgage loans, 100bp cuts $160 million off FMV. The reason this should be focused upon is 34% of the fixed income portfolio matures in 5-10 years and 50% in over 10-years. Interest rate changes would have larger impacts on longer bonds.**

We don't want to double count, but we see a company with $10 billion in equity and multiple reasons why almost 30% of that could be in jeopardy from a 10% hit to just corporate bonds and mortgage loans from a combination of higher spreads and having one-quarter of those corporate bonds in transportation, consumer cyclical and transportation bonds as well as 24% of mortgage bonds in retail.

Risks from 10-K:

> *"However, deterioration in the credit market may delay our ability to sell our positions in certain of our fixed maturity securities in a timely manner and adversely impact the price we receive for such securities, which may negatively impact our cash flows. Furthermore, **if we experience defaults on securities held in the investment portfolios of our insurance subsidiaries, this will negatively impact statutory capital, which could reduce our insurance subsidiaries' capacity to pay dividends to our holding companies.** A reduction in dividends to our holding companies could force us to seek external financing to avoid impairing our ability to pay dividends to our stockholders or meet our debt and other payment obligations."*

Even being conservative and forecasting only a few areas of significant concern in the portfolio – energy, transportation, retail mortgages, and wider credit spreads – reductions in the value of the portfolio reduces capital at insurance subsidiaries. That may lead to reduced dividends to the parent company and already we see several

reasons to that the current level is not meeting all of Unum's cash needs. At a minimum, the share repurchases seem likely to be reduced.

Deferred Acquisition Costs (DAC) Are Another $2.3 Billion of Equity

Deferred Acquisition Costs are the cost to acquire and renewal insurance policies. They include commissions, bonuses, examination costs for an applicant, and costs to write and administer the polices. These costs are amortized over the lives of the policies and are matched against premium income. Since premium income is higher upfront, the amortization tends to be front-loaded also. That is a conservative policy in our view and the purpose of the account is to match revenues and expenses more closely.

If policies terminate faster than expected, DAC amortization may increase and if policies renew longer than expected, DAC amortization may slow. The assumptions behind the speed of amortization relate to persistency rates, premium income levels, and in some cases mortality and investment income levels. The valuation of DAC is tested annually for discrepancies and an over-valuation is charged to expense. That also is conservative in our view.

If terminations rise faster because of the recent economic conditions, DAC could become a drag on income and hurt equity levels too. We looked at persistency levels from 2005-2010 to see what happened in 2008-09. What we saw is Unum's persistency was very sticky. In fact, the areas that saw declines were in 2006 and 2007 when Unum was raising prices to boost profitability by design:

Persistency Rate	2010	2009	2008	2007	2006	2005
US - LT Inc. Protection	89.4%	86.9%	87.8%	85.1%	87.8%	84.8%
US - ST Inc. Protection	88.6%	86.8%	**82.1%**	**74.0%**	**85.6%**	79.6%
US Group Life	91.5%	86.9%	**83.8%**	**78.8%**	**81.2%**	78.3%
US Accident	90.7%	88.1%	**86.4%**	**80.8%**	**82.8%**	76.9%
Individual Inc Protection	90.7%	89.6%	90.7%	90.6%	90.5%	89.6%
Long Term Care	95.8%	95.1%	95.5%	95.4%	95.3%	95.8%
Voluntary Benefits	80.1%	79.9%	80.4%	79.4%	80.9%	81.1%
UK - LT Income Protection	91.3%	88.5%	87.4%	88.0%	90.4%	94.2%
UK - Group Life	92.7%	80.1%	**74.9%**	**70.5%**	**69.1%**	**86.3%**
UK - Indiv. Inc. Protection	88.9%	88.2%	87.6%	89.4%	88.2%	88.4%

In 2006, Unum noted in several areas of its business that it planned to boost profitability by increasing prices on new and renewal policies. The dip in persistency

was expected in 2007 before the recession in 2008 and 2009. Still their renewal rates recovered to past levels quickly and improved as the economy improved.

In 2007, the amortization period for DAC on the group policies was dramatically shortened from 15-20 years to 6 years. In 2010, the UK group policy DAC amortization went to 3 years. As a result, DAC has gone from 39% of book value in 2006 to 23% in 2019.

Of the DAC on the books, 90% of it is related to three areas: Colonial which sells benefits to government employees and to small companies at 46%. Persistency there has been strong. Individual US policies for voluntary benefits at 26% and individual policies for income protection at 18%. Much of those are paid via paycheck deduction.

Our conclusion is the grace periods offered to customers during the coronavirus will help persistency as will classifying many furloughed employees as "taking a leave of absence." Plus, persistency held up well during a longer period of problems in 2008-09. So, we do not expect Unum to see material hits to equity values from write-downs in DAC.

Interest Rates – Low Rates Have Required More Reserves

Unum has been pointing out that falling interest rates complicate its business for several years at this point. When it writes new business, it estimates the future claims and costs and discounts back to present value to arrive at a level of reserves needed. When the discount rate falls – the estimated cost for claims increases and requires more reserves. Looking at the history of the Long-Term Care business illustrates this well.

On top of that, if the new accounting standard in 2022 will require a more frequently updated discount rate, this could become a more frequent issue of Unum if rates remain lower for longer. However, that story doesn't end with valuing the future cost of business expenses.

Low and falling interest rates make it tough to earn enough on investments to cover the future claims. The premiums are being invested at lower rates while the

liabilities rise. So far, Unum has been offsetting that with increases in premiums. Here is the snapshot of their US operations:

US Ops	2019	2018	2017	2019 growth	2018 growth
Premium	$6,017	$5,736	$5,444	4.9%	5.4%
Benefits	$4,022	$3,857	$3,693	4.3%	4.4%
Investment Inc.	$739	$729	$811	-5.0%	-4.0%

The key is boosting price to offset the increase in benefit reserves as the investment income is not keeping up with the growth in costs. The other key is Benefits to Premiums is only 67%. There is a considerable spread. In the case of Long-Term Care where premiums are about half the growth in Benefits, even adding in the investment income to premiums – the ratio is still about 90%. More evidence that Unum will need to keep putting cash into that situation.

The company's pension plan is also at the Parent Company and needs the subsidiaries dividend income to fund it. From the 10-K, Unum has been making contributions here:

We made contributions of $68.2 million and £3.4 million to our U.S. and U.K. defined contribution plans, respectively, in 2019 and expect to make contributions of approximately $75 million and £4 million during 2020.

The pension has $2.1 billion in PBO against $1.6 billion in assets for an underfunding level of $500 million. The PBO is calculated on a 3.6% discount rate down from 4.4% in 2018. Unum actually boosted its rate of return assumption for pension income in 2019 from 6.75% to 7.00%. Total pension expense is only about 6-cents in EPS (against the adjusted figure of $5.44) so we're not concerned from an earnings standpoint. But we do see this as another cash headwind for the parent company to deal with.

Higher rates or even stable rates would solve many of Unum's problems. A higher discount rate on future claims may lower the reserve level needed. New cash from premiums could be invested at a higher rate and investment income could rise. A higher rate would push down PBO and help the pension funding situation. All of that points to better cash flow for the parent company.

However, Unum still has a $56 billion investment portfolio that would see values decline amid rising interest rates. A high percentage of the portfolio matures in over 10-years too. So rising rates would likely hurt book value immediately while the rising income from future premiums builds over time.

We would be afraid of buying Unum ahead of a transition toward higher rates. Other companies we follow such as ARCC and STWD should do better than Unum in that situation. However, if your forecast is for interest rates to merely stabilize and only return to 2019 levels – then Unum could see its situation improve under that more benign scenario.

Explanation of EQ Rating Scale

Rating	Description
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

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

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.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.