BTN Research

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Unum Group (UNM) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
2+	2-

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 raising our quality rating to 2+ (Weak) indicating improvement

This is a fairly recent report, so we will just update on some key near-term risks and urge readers to use the April 17, 2020 EQ report for more detail on some of the accounting rule changes and insurance company structure changes that may impact UNM. Our initial rating on UNM focused on four primary risks:

- A holding company structure that sees the bulk of parent cash flow coming from dividends paid by subs. There are many legal limitations on dividends from the subs and the structure may need to change.

- Much tighter cash flow at the parent company level to cover cash payments to reinsurance companies, dividends, and stock repurchases. Cash flow has not covered this outflow for years and Unum has borrowed the difference.

- Issues with the investment portfolio such as investments in energy and transportation bonds, long-duration making interest rate swings, and credit spreads having more pronounced impacts and owning direct mortgage loans in retail.

- The Long-Term Care unit having more issues with reserve levels and new accounting rules that may require more frequent updating of assumptions and capital requirements.

Some of this situation has improved for the better:

- Holding company parent is more liquid at the moment with $1.55 billion in cash at the end of June after issuing $500 million of debt in 2Q20.
  - It has already paid two dividends and half its interest expense for the year – It will still have payments of just over $200 million for the 2nd half of 2020.
  - It is not buying shares back at this time – which saves about $400 million in cash based on historical spending levels.
  - Payments for capital to reinsurance subsidiaries are expected to be about $600 million this year - $150 million has been paid – leaving $450 million.
  - There is a bond maturity payment of $400 million in September and no other maturities until 2024.
  - Adding that up, it's $1.05 billion in cash outflow for the 2nd half against $1.55 billion in cash plus additional dividends from subsidiaries that it should receive.

- The structure here is still complex in our view and that puts limits on subsidiaries sending cash up to the parent via dividends – however, we don't see a COVID issue
  - UNUM has reported some higher claims in short-term disability, but not beyond what was expected.
  - Some mortality claims for COVID are up – but that is being offset by lower mortality due to other causes.
  - Persistency is down for some insurance lines but not by a material amount as could have happened with so many offices closed.
  - We are not seeing big signs that the operating subs are being strained.

- The investment book saw a rally in the 2Q with oil prices recovering and the credit spreads tightening again

    - The energy part of the portfolio is $4.45 billion or 9% with $2.15 billion as mid-stream bonds. Independent Oil & Gas is $1.16 billion or 2% of the total portfolio. Energy rallied back from $3.73 billion in valuation at the end of 1Q.
    - Unum cut its expected problem forecast from $1.6 billion in downgrades to $1.3 billion and $85 million in forecasted to defaults to $70 million.
    - It is not out of the woods yet with transportation at 5% of the portfolio or $2.4 billion and some of that may take longer to recover.
    - Also, we would still be concerned about the direct mortgage loans to retail properties.
    - From first quarter, the portfolio grew from $45.3 billion to $48.2 billion. Realized losses of $144 million in 1Q became gains of $34 million in 2Q. Unrealized gains rose $963 million in 2Q too.
    - The bigger issue may remain putting new money to work at earning a high enough return at this point.

- The Long-Term Is Still a Cash Drain
    - Funding the reinsurance company dealing with this issue is a major part of the cash outflow to subs by the parent company discussed above for $600 million.
    - That annual cash outflow is not expected to peak for many years still.
    - Unum has warned that the capital requirements for the reinsurance company may be raised by regulators, which could mean even more capital toward this area.

Explanation of EQ Rating Scale

Rating	Explanation
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.

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