

# GRANT'S

INTEREST RATE OBSERVER®

Vol. 34, No. 20d

Two Wall Street, New York, New York 10005 • www.grantspub.com

OCTOBER 28, 2016

## Disabled no more

Seven-plus years into a bull market, undiscovered value is almost an oxymoron. Vanishingly rare is the profitable, market-leading, stockholder-attuned, reasonably large, reasonably cheap business that would stand to gain by a rise in interest rates. Unum Group (UNM on the New York Stock Exchange) would seem to tick every box.

We say “seem.” The No. 1 provider of disability insurance in the United States and the United Kingdom, Unum belongs to an alien culture. Not your typical life insurer—despite conventionally being lumped into that industry grouping—Unum is nonetheless a party to the mysteries of actuarial science and insurance accounting. Outsiders may aspire to understand the details, and we do, to a degree, understand. But the non-expert resembles, at best, a competent American student of French trying to make conversation in a noisy Parisian restaurant. This disclaimer out of the way, we are prepared to declare that we’re bullish.

To get right down to cases: In the 12 months through June 30, Unum reported \$10.9 billion in operating revenue, of which premium income—that is, revenue received from Unum-underwritten policies—contributed \$8.2 billion. Net investment income delivered \$2.5 billion. Administrative fees and other miscellany provided the balance. Trailing-12-month operating earnings totaled \$916 million. Shares change hands today at 91% of book value and 9.7 times trailing-12-month GAAP earnings, as well as at

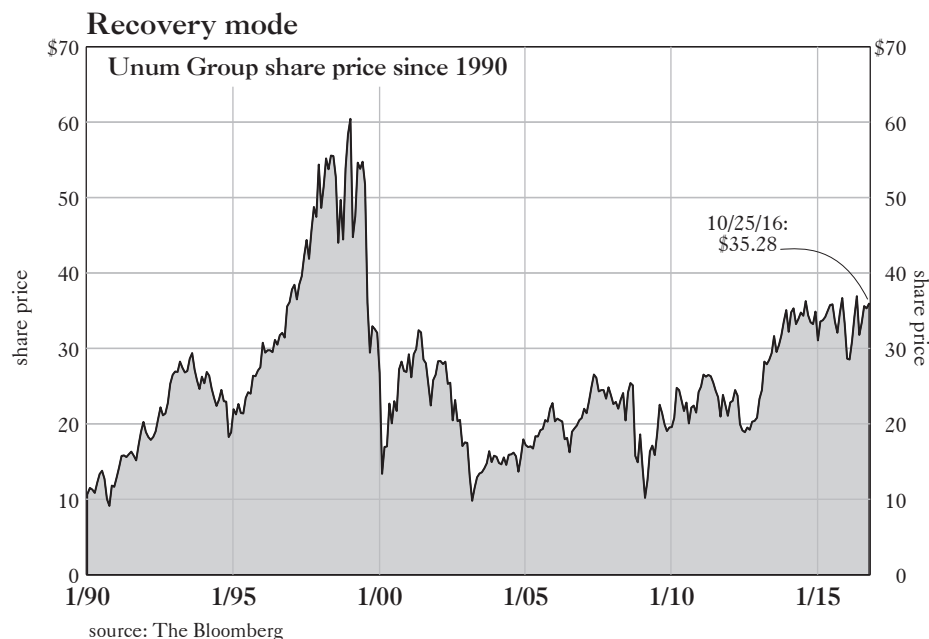
94% of their adjusted book value and 9.3 times trailing non-GAAP earnings (of which more below). Third-quarter results are due on Wednesday, Oct. 26, at which moment you, noble reader, will be more current than we are now, on Oct. 25.

Wading into the life-insurance business means leaving the land of generally accepted accounting principles. Unum and its peers, consistent buy-and-hold bond buyers, report non-GAAP “operating” figures, such as those just mentioned. These metrics are intended to eliminate such transitory factors as gains and losses on the sale and maturity of securities (so-called realized gains) and to highlight underlying business

results. Operating earnings, book value excluding accumulated other comprehensive income (“book value ex.-AOCI”) and operating return on equity are examples of insurance-reporting conventions.

There are more. Insurance companies submit filings to state regulators in the language of statutory accounting principles. SAP measures a company’s ability to meet policyholder obligations. It forms a basis for evaluating capital adequacy, liquidity to policyholders and funds available for distribution to shareholders.

Unum reports its results across three core segments, of which the largest is Unum US, which accounted for \$5.1 billion in premium income,

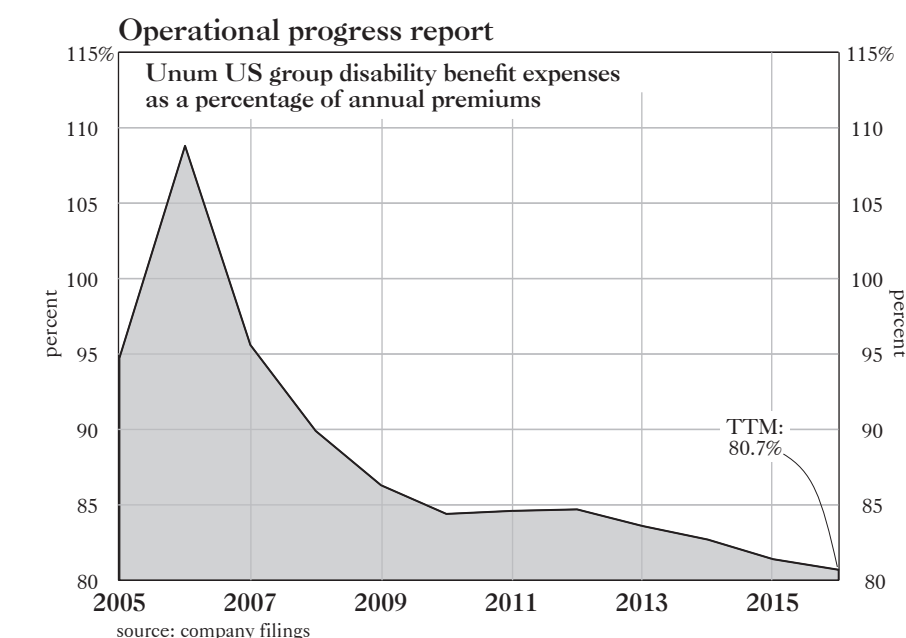


or 62% of the total, in the 12 months through June. Unum US sells group policies to employers (45% of the segment's aforementioned premium income) and individual disability policies to employees (10%). It supplements these products with a range of term life-insurance policies (27%), accidental death and dismemberment policies (3%) and other voluntary benefits (15%). The next largest segment is Colonial Life, which accounted for 17% of company-wide premium income. Colonial Life operates in the United States exclusively but, unlike Unum US, enlists independent agents to market its policies to employees. The third-largest segment is Unum UK, which provides a similar assortment of policies to Unum US and contributed 7% of premium revenue in the past 12 months.

There's a fourth unit, too—the Unum problem child—called the “Closed Block” segment. It consists of policies no longer actively sold, but for which premium dollars still flow in and claims must still be paid out. Capital must be set aside to fund future disbursements until the policies have run their course. In the most recent quarter, 54% of Unum's total assets and 38% of its equity were allocated to this segment. In the past 12 months, just under half of the premium income it generated came from non-cancellable individual disability policies that Unum mostly stopped selling in the mid-1990s. Nearly all the rest of the premium income comes from the company's long-term care policies, which it ceased offering to individuals in 2009 and to groups in 2012. Such policies pay benefits if the policyholder becomes physically infirm or cognitively impaired.

“Mistakes in life insurance don't just last a few quarters or a few years, they last decades,” Colin Devine, principal at C. Devine & Associates, a strategic advisor to the life-insurance industry, tells colleague Alex Hess. “Unum's Closed Block has a break-even return or a very modest return. That depresses your [return on equity], depresses the stock.”

Just how problematic is Unum's fourth unit comes into relief by observing that the three core business segments generate operating returns on equity in the mid- to high teens. In the second quarter of 2016, for ex-



ample, they delivered an annualized operating return on equity of 16.2%. However, because the Closed Block barely eked out a profit, the company's consolidated operating return on equity amounted to just 11.6%.

“On several occasions, the long-term care block has torpedoed entire fiscal years,” Hess notes. “In 2011, the company took both a \$290 million impairment charge and a \$574 million charge to increase reserves related to that block. This was followed by a 2014 charge in which the company increased reserves by an additional \$698 million due to lowered expectations for interest rates. Further drops in long-term interest rates have raised concerns about Unum's taking yet another charge. In its 10-K for the year ended December 31, Unum noted that a 25 basis point drop in assumptions for discount rates within its long-term care block would lead to a \$430 million decrease in reserves.”

“When we set the [2014] charge,” CFO Jack McGarry told listeners on the company's July 28 earnings call, “we anticipated a 5% flat interest-rate environment for four years to five years, and then [a] reverse to the long-term average over the next five years.” That is, the company values its long-term care liabilities assuming it can earn income of 5% per year on its fixed-income portfolio—primarily concentrated in single-A- and triple-B-rated corporate bonds. As of the second quarter, that portfolio

fetched 5.28%.

That it won't yield that much for long is a top reason why, according to Bloomberg, just four analysts rate Unum a buy, seven rate it a hold and another four call it a sell. Credit Suisse analyst John Nadel (he's neutral) tells Hess that, at the margin, “we think they're probably investing closer to 4% right now, maybe 4.25% [the Moody's Baa-rated index yields 4.36%], but someplace reasonably below the 5% assumed level. Assuming they stay on the same cycle for the evaluation of those reserves and those assumptions, we think they're going to be falling short if rates don't move higher.”

It's a risk, certainly. Suppose that Unum whittles down the discount rate for the Closed Block by 50 basis points and that the impact of this charge is twice the \$430 million just mentioned: That \$860 million hit would reduce net assets by almost 10% from the \$8.8 billion in book value reported for the most recent quarter.

So we do not lightly transpose our bearish view on bonds to a top-down judgment on Unum. We rather build our bullish case from the bottom up, not forgetting the terrible back story.

In their 2008 book, *Billion Dollar Lessons: What You Can Learn from the Most Inexcusable Business Failures of the Last 25 Years*, authors Paul B. Carroll and Chunka Mui examine the 1999 merger of Unum Corp. and Provident Companies into UnumProvi-

dent (today's Unum Group). Their verdict: "Everything started to fall apart from the moment the merger was completed."

UnumProvident CEO James F. Orr III lasted just four months after the combination, as the firm took a near immediate \$624 million charge "mostly related to problems with group disability policies and with a reinsurance business that was being sold," Carroll and Mui write. Back-office inefficiencies at both companies eliminated all the touted potential synergies, while UnumProvident defended itself from volleys of lawsuits alleging the improper rejection of claims. Doctors came forward to say they had been hired explicitly to deny claims. The authors reported that "UnumProvident allegedly handed out a 'Hungry Vulture' award to claims agents who were especially aggressive about denying claims, according to lawsuits."

More than 200,000 claims had to be reevaluated. The year 2004 brought \$967 million in charges due to mispriced disability policies. A deluge of new shares arrived as well. In early 2003, the share count stood at 244 million. By year-end 2007, 119 million more had come into this world. In 2008, the company was found guilty of fobbing off claimants on the Social Security disability system.

"Unum is a company that underwent tremendous change from the early 2000s until probably about 2010," says Devine. "Tom [Watjen, Unum's CEO from 2003 to 2015] had a strategy that you had to shrink before you could grow. And so they divested some non-core operations, they greatly cleaned up their claims-paying process, and—the third thing they did—they really focused on generating profitable business even if that meant that they had to walk away from some clients."

Results are apparent in, among other metrics, the benefits ratio pertaining to Unum US's group disability insurance, the company's most popular set of products. Thus, in 2006, 108.8% of the premiums Unum earned were disbursed or added to reserves. In the latest 12 months, that figure was only 80.7% of premium income.

Asked about pricing and competition, Tom White, senior vice presi-

dent of investor relations at Unum, says this: "Competitor companies will get aggressive, [or] they'll back away from the market and that will create some pricing dynamics for us. We try to be very consistent, very stable. . . . Sometimes, we'll see companies that get a little more aggressive, ramp up sales. That can lead to profitability pressure fairly quickly in this business. So we try to avoid that."

At Unum US, for example, sales of new policies (as measured by expected premiums) fell by 2% in the first six months of 2016, after they had risen by 4.2% in 2015 and 21% in 2014. The tailing-off came in response to a decline in operating margins, defined as pre-tax operating earnings divided by premium income, to 17.2% in the latest trailing 12 months from 18.8% in 2013. CEO Rick McKenny confirmed as much at the Sept. 9 Keefe, Bruyette & Woods Insurance Conference: "When you get into an environment where people are—other competitors are—less disciplined from a pricing perspective, we'll write less business."

Unum has another significant advantage in holding at bay prospective new entrants into the disability-insurance market. "Unum's secret sauce is not price," says Devine. "Unum's secret sauce is, if you're an employer, they're the best company in the business [of] successfully rehabilitating employees. It would take you 25 to 30 years, at least, to build up that kind of expertise. They have a real barrier to entry. And that's why there are only a few really size players in disability, because it's a very hands-on business." A July report from J.P. Morgan estimates Unum's 2015 market share at 13.8% for group disability, followed by health insurer Cigna (11.3%), life insurer MetLife (9.5%) and property and casualty insurer Hartford Financial (8.6%). The top-10 players in the industry, the bank estimates, accounted for almost three-quarters of the market.

"Thanks to disciplined underwriting and narrow focus," Hess relates, "Unum's businesses reliably generate significant cash flows. Here we return to SAP accounting, as management uses statutory net income, as opposed to GAAP, as a proxy for the cash flow available to dividends, share buybacks and acquisitions. In the 12

months through June, net income under SAP totaled \$737 million. That compares with \$877 million in GAAP earnings and \$916 million in non-GAAP operating earnings. The biggest reason for the difference in these earnings is that SAP does not allow for the capitalization of deferred acquisition costs—that is, the commissions, agency compensation and other expenses associated with acquiring or renewing policies—which are usually amortized over the life of their respective policies."

The use of cash takes three forms: dividends (which have grown at a compound annual rate of 9.9% in the past 10 years; the stock today yields 2.3%), share repurchases (the share count now stands at 235 million, down by 35% from the 2007 peak) and acquisitions (e.g., National Dental, a UK dental-benefits provider, for \$54.3 million in 2015 and Starmount Life, which extends vision benefits as well, for \$127 million in 2016).

As to choosing between returning and reinvesting capital, on the one hand, and setting it aside for regulatory purposes, on the other, Unum targets a financial-strength rating of single-A. That's the third-highest category in the S&P grade book. How to achieve that rating is a matter of negotiation between Unum and the ratings agencies. Customers insist on a decently high rating, lest they be left holding the benefits bag after their carrier goes broke. Stockholders chafe at an unnecessarily high rating, lest return on equity suffer. As it is, only Unum's UK insurance subsidiary falls short—it's rated single-A-minus at S&P and unrated at any other agency. All four other major policy-issuing subsidiaries—Colonial Life & Accident, Paul Revere Life, Provident Life & Accident and Unum Life of America—rate single-A or their equivalent at each of A.M. Best, Fitch, Moody's Investors Service and S&P. As a bond issuer, Unum is designated triple-B or the equivalent at three of the four agencies and triple-B-plus at Fitch.

"Even without a boost from the Fed," Hess points out, "Unum is making incremental progress on reducing the drag from its long-term care block. In April, Pennsylvania's insurance regulator approved rate increases averaging 56% for 6,914

policies. In August, Florida's insurance regulator held hearings on rate increases for long-term life policies; Unum has requested rate increases averaging 48% for 45,666 policies, paying an annual total of \$26 million in premiums. Adds Credit Suisse's Nadel, 'I can tell you that there is no question that state-by-state premium rate increases are being approved. In some cases, dramatic increases. It's necessary. The assumptions that were embedded in the pricing formulas for these products, sold 10 to 15 years ago and still in force, were just completely erroneous. The world has changed.'"

The past year's record of insider transactions features 400,000 shares

sold, for a consideration of \$13.7 million, by former CEO, current chairman of the board and turnaround architect Tom Watjen. Mitigating this negative fact is the company's policy on aligning the interests of the company with those of the front office. The proxy says that the CEO must hold 600% of his or her salary in equity. Above the 600%, the CEO must retain 75% of the shares awarded, net of any sales to offset taxes and commissions, for three years. So a sale with an asterisk.

•

*Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc.  
PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else.  
Copyright ©2016 Grant's Financial Publishing Inc. All rights reserved.*