2nd Quarter 2016 Conference Call

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PRESENTATION

Mike Majors - Torchmark - VP of IR

Thank you. Good morning everyone. Joining the call today are Gary Coleman and Larry Hutchison, our co-Chief Executive Officers, Frank Svoboda, our Chief Financial Officer, and Brian Mitchell, our General Counsel.

Some of our comments or answers to your questions may contain forward-looking statements that are provided for general guidance purposes only. Accordingly, please refer to our 2015 10-K and any subsequent forms 10-Q on file with the SEC. Some of our comments may also contain non-GAAP measures. Please see our earnings release and website for discussion of these terms and reconciliations to GAAP measures.

I will now turn the call over to Gary Coleman.

Gary Coleman - Torchmark - Co-CEO

Thank you Mike and good morning everyone. In the second quarter net income was $138 million or $1.13 per share, a 13% increase on a per share basis. Net operating income from continuing operations for the quarter was $137 million or $1.11 per share, a per share increase of 8% from a year ago.

On a GAAP reported basis, our return on equity as of June 30 was 11.8% and book value per share was $39.87, an increase of 17% from a year ago. Excluding unrealized gains and losses on fixed maturities, our return on equity was 14.6% and our book value per share was $31.11, an 8% increase from a year ago. In our life insurance operations, premium revenue grew 5% to $549 million, while life underwriting margin was $144 million, up 3% from a year ago.

Growth in underwriting margin lagged premium growth due primarily to higher-than-expected direct response claims. For the full year, we expect life underwriting margin to increase 1% to 2% over 2015. Net life sales were $110 million, up 2% from the year-ago quarter.

On the health side, premium revenue grew 2% to $237 million and health underwriting margin was also up 2% to $53 million. For the full year, we expect health underwriting margin to grow 1% to 2%. Health sales increased 6% to $33 million. Individual health sales grew 8% to $30 million. Administrative expenses were $48 million for the quarter, up 6% from a year ago and in-line with our expectations. The primary reason for the increase in administrative expenses is increased investments in information technology.

As a percentage of premiums from continuing operations, administrative expenses were 6.2% compared to 6.0% a year ago. For the full year we anticipate administrative expenses will also be around 6.2% of premium. I will now turn the call over to Larry Hutchison for his comments on the marketing operations.

Larry Hutchison - Torchmark - Co-CEO

Thank you, Gary. At American Income, life premiums were up 9% to $226 million, and life underwriting margin was up 13% to $72 million. Net life sales were $55 million, up 10% due primarily to increased agent productivity. The average agent count for the second quarter was 6,599, approximately the same as a year ago, and up 6% from the first quarter. The producing agent count at the end of the second quarter was 6,773. We expect the producing agent count to be in a range of 6,650 to 6,850 at the end of 2016. We expect 7% to 9% life sales growth for the full year 2016.

In our direct response operation at Globe Life, life premiums were up 5% to $199 million. Life underwriting margin declined 10%, to $33 million. Net life sales were down 9% to $40 million, due primarily to decreases in circulation. We expect life sales to be down 5% to 7% for the full year 2016.

At Liberty National, life premiums were $68 million, down 1% from the year-ago quarter, while life underwriting margin was $19 million, up 6%. Net life sales increased 12% to $10 million, while net health sales increased 13% to $5 million. The sales increases were driven primarily by improvements in agent count. The average producing agent count for the second quarter was 1,739, up 12% from a year ago and up 13% compared to the first quarter. The producing agent count at Liberty National ended the quarter at 1,812. We expect the producing agent count to be in a range of 1,700 to 1,800 at the end of 2016.

Life net sales growth is expected to be within a range of 9% to 12% for the full year 2016. Health net sales growth is expected to be within a range of 6% to 10% for the full year 2016.

At Family Heritage, health premiums increased 7% to $59 million while health underwriting margin increased 16% to $12 million. Health net sales grew 1% to $14 million.

The average producing agent count for the second quarter was 933, down 3% from a year ago, but up 13% from the first quarter. The producing agent count at the end of the quarter was 955. We expect the producing agent count to be in a range of 975 to 1,000 at the end of 2016. We expect health sales growth to be in a range from 2% to 4% for the full year 2016.

At United American General Agency, health premiums increased 2% to $90 million. Net health sales were $10 million, up 6% compared to the year-ago quarter. Individual Medicare Supplement sales grew 14% to $8 million, while group sales declined 13% to $2 million. For the full year 2016, we expect growth in Individual Medicare Supplement sales to be around 7% to 9%.

I will now turn the call back to Gary.

Gary Coleman - Torchmark - Co-CEO

I want to spend a few minutes discussing our investment operations.

First, excess investment income

Excess investment income, which we define as net investment income less the required interest on net policy liabilities and debt, was $55 million, a 4% decrease compared to the year-ago quarter. On a per share basis, reflecting the impact of our share repurchase program, excess investment income declined 2%.

On April 5th, we issued $300 million of junior subordinated debt, primarily to refinance a $250 million debt issue that matured on June 15th. Issuing a new debt 70 days before the debt maturity resulted in a negative carry of $3 million. Excluding the negative carry, excess investment income in dollars and per share would have been up 1% and 4% respectively.

As discussed on previous calls, the Part D segment has a negative impact on excess investment income due to negative cash flows that occur during the year including the long delay in receiving reimbursement from CMS for excess claims paid by the Company. The impact of the lost investment income from the delayed receipt of reimbursements is reflected in income from continuing operations rather than in discontinued operations, in accordance with the applicable accounting rules.

In the second quarter, Part D had a negative impact on excess investment income of approximately $2.5 million, compared to a negative impact of $2.3 million in the year-ago quarter. For the full year 2016, we expect excess investment income to grow by about 1% to 2%. However, on a per share basis, we should see an increase of about 5% to 6%. At the midpoint of our 2016 guidance, we are expecting a drag on excess investment income from Part D of approximately $9 million, compared to a drag of $8 million in 2015.

Now, regarding the investment portfolio

Invested assets were $14.4 billion, including $13.8 billion of fixed maturities at

amortized cost. Of the fixed maturities, $13 billion are investment grade with an average rating of A-, and below investment grade bonds are $763 million compared to $580 million a year ago.

The percentage of below investment grade bonds to fixed maturities is 5.5% compared to 4.4% a year ago. The increase in below investment grade bonds is due primarily to downgrades of securities in the energy and metals and mining sectors in previous quarters. However, due to the increases in the underlying commodity prices the current market value of these securities are significantly higher than at the time of the downgrades.

With a portfolio leverage of 3.6X, the percentage of below investment grade bonds to equity, excluding net unrealized gains on fixed maturities is 20%. Overall, the total portfolio is rated A-, same as a year ago. In addition, we have net unrealized gains in the fixed maturity portfolio of $1.7 billion, approximately $700 million higher than at the end of the first quarter.

Now, to complete the discussion of the investment portfolio I'd like to give an update on our $1.6 billion of fixed maturities in the energy sector. At June 30, we had a net unrealized gain of $32 million compared to an unrealized loss of $165 million at the end of 2015, an improvement of $197 million. The average rating of the energy fixed maturities is BBB with 90% of the holdings being investment grade.

Regarding investment yield

In the second quarter we invested $364 million in investment grade fixed maturities, primarily in industrial sectors. We invested at an average yield of 4.75%, an average rating of BBB+ and an average life of 24 years. For the entire portfolio, the second quarter yield was 5.80%, down five basis points from the 5.85% yield in the second quarter of 2015. At June 30, the portfolio yield was approximately 5.79%.

For the remainder of 2016, we have assumed a new money rate of 4.4% at the midpoint of our guidance. This rate is lower than previously expected. The low and declining interest rate environment continues to be an issue; however, our concern regarding an extended period of lower interest rates is the impact on the income statement, not the balance sheet.

As long as we are in this interest rate environment, the portfolio yield will continue to decline and place downward pressure on excess investment income. However, this decline will be lessened by the fact that on average only about 2% of our fixed maturity portfolio will run off each year over the next 5 years. Torchmark would continue to earn substantial excess investment income in an extended low interest rate environment.

As I mentioned earlier, lower interest rates negatively impact the income statement and not the balance sheet. Since we primarily sell non-interest sensitive protection products accounted for under FAS 60, we don't see a

reasonable scenario that would require us to write off DAC or put up additional GAAP reserves due to interest rate fluctuations. In addition, we do not foresee a negative impact on our statutory balance sheet, as our cash flow test results indicate that our reserves are more than adequate to compensate for lower interest rates. As we have said before, Torchmark can thrive in either a low or high interest rate environment.

Now I will turn the call over to Frank.

Frank Svoboda - Torchmark - CFO

Thanks, Gary. First, I want to spend a few minutes discussing our share repurchases and capital position. In the second quarter, we spent $83 million to buy 1.4 million Torchmark shares at an average price of $57.77. So far in July, we have used $10.6 million to purchase 174,000 shares. For the full year through today, we have spent $174 million of parent company cash to acquire more than 3.1 million shares at an average price of $55.77. These are being made from the parent's free cash flows.

The parent's free cash flows, as we define it, results primarily from the dividends received by the parent from the subsidiaries, less the interest paid on debt, and the dividends paid to Torchmark shareholders. We expect free cash flow in 2016 to be around $320 million. With $174 million spent on share repurchases thus far, we can expect to have around $146 million available for the remainder of the year from our free cash flow, plus other assets available at the parent.

As noted on previous calls, we will use our cash as efficiently as possible. If market conditions are favorable, we expect that share repurchases will continue to be a primary use of those funds. We also expect to retain approximately $50 million to $60 million of parent assets at the end of 2016, absent the need to utilize any of these funds to support our insurance company operations.

Now, regarding RBC at our insurance subsidiaries

We currently plan to maintain our capital at the level necessary to retain our current ratings. For the past several years that level has been around an NAIC RBC ratio of 325% on a consolidated basis. This ratio is lower than some peer companies, but is sufficient for our companies in light of our consistent statutory earnings and the relatively lower risk of our policy liabilities, and our ratings.

As we discussed on the last call, we do not calculate RBC on a quarterly basis. However, we estimated that because of lower-than-expected capital levels as of year-end 2015, plus downgrades in our investment portfolio during the first quarter of this year, we would need around $60 million of additional capital to return to a 325% RBC level. As we also discussed on the last call, and for the following reasons, we believe this shortfall may be temporary and thus may choose to maintain an RBC ratio slightly below 325% for 2016.

First, we anticipate that the sale of our Medicare Part D business will generate

approximately $20 million to $25 million of additional capital to be available for 2016, plus an additional $55 million to $60 million of additional capital that will be available in 2017. Thus, the additional capital available from this sale alone would be sufficient to offset the shortfall noted above. Additionally, we anticipate that certain investments that were downgraded by the NAIC in the first half of this year will be upgraded by the end of 2017. Thus, we are comfortable with our ability to meet responsible RBC levels for 2016, and to return to our targeted 325% RBC ratio no later than 2017.

Next, a few comments to provide an update on our direct response operations

In the quarter, growth in total life underwriting income lagged the growth in premium, primarily due to higher than expected policy obligations in our direct response operations. In previous quarters, we had seen a higher trend in policy obligations, primarily due to higher than originally expected claims related to policies issued in calendar years 2000 through 2007 and 2011 through 2015. While claims this year are emerging on the 2000 through 2007 policies as anticipated, we are seeing higher policy obligations than anticipated for policies issued in 2011 through 2014.

The higher obligations for these policy years are the primary cause for the increase in the policy obligation percentage for the second quarter from the 53.5% we anticipated to 56%. Last quarter, we indicated that policy obligations for the full year 2016 would be in the range of 52% to 53% of premium or 52.5% at the midpoint.

With the additional claims experienced through June 30, we now anticipate that the direct response policy obligations for the full year 2016 will be in the range of 54% to 55% of premiums, or around 54.5%, at the midpoint of this range. This 2% increase in the midpoint is primarily due to the higher expected obligations on the 2011 through 2014 policy years. As a result of the higher policy obligations, we now estimate that the underwriting margin percentage for our direct response operations will be in the range of 17% to 19% for the year.

Now, a few comments about the sale of our Medicare Part D operations

Effective July 1, 2016, Torchmark entered into an agreement to sell its Medicare Part D prescription drug business to SilverScript Insurance Company, a subsidiary of CVS Health. Under the terms of the agreement, Torchmark will retain all rights to the assets and liabilities as well as corresponding profits or losses for the 2016 plan year, and SilverScript will assume all rights and obligations related to the business after 2016.

We will continue to administer the plans for the remainder of this year and will transition all administration to SilverScript early in 2017. The net proceeds from the sale are expected to be offset by the write-off of approximately $16 million of deferred acquisition costs related to Torchmark's Part D business. As such, the net impact of the sale is

expected to be immaterial to Torchmark's financial statements.

The remaining net assets reflected on the balance sheet related to discontinued operations are receivables and payables that are expected to be settled in the ordinary course of business during 2016 and 2017. We expect the balance of any remaining receivables to be less than $100 million by the end of 2016.

Those are my comments. I will now turn the call back to Larry.

Larry Hutchison - Torchmark - Co-CEO

Thank you, Frank. For 2016, we expect our net operating income from continuing operations to be within a range of $4.40 per share to $4.50 per share, an 8% increase over 2015 at the midpoint. Those are our comments. We will now open the call up for questions.

QUESTION AND ANSWER

Jimmy Bhullar - JPMorgan - Analyst

Hi, good morning. My first question is just on direct response life margins. Frank, you mentioned a benefit ratio guidance of, I think, 54.5%. That's better than the 55.7% you had in the second quarter. So just wondering what gives you the confidence that trends in the business will get better from where they were in the second quarter?

Frank Svoboda - Torchmark - CFO

Yes Jimmy, we do see some higher claims in the first half of the year just due to some regular seasonality. You know that typically adds probably about 1% to the policy obligations percentage in the first couple quarters of the year. We don't see that continuing on to the second half of the year. And then just with the additional claims experience that we are seeing here now in the first half of the year, we are getting a little bit more experience with the 2011, 2012 and more on the 2013. We just have that little bit better experience to feel more comfortable with where we're going for the remainder of the year.

Jimmy Bhullar - JPMorgan - Analyst

Okay. And then on sales and direct response, I think you mentioned that you're expecting sales to be down 5% to 7%. They are down 9% in the first half, so I'm assuming -- does your guidance imply that you are going to be seeing a pickup in circulation volumes in the second half of the year? Or is there something else that's going on there?

Larry Hutchison - Torchmark - Co-CEO

I think you'll see a slowing of sale decreases, Jimmy, in the third quarter. We'll have a smaller sales decrease in the fourth quarter. We'll be slightly down or flat for the fourth quarter.

Gary Coleman - Torchmark - Co-CEO

Jimmy, it's more because the comparisons in the third and fourth quarter are easier than the first couple quarters.

Jimmy Bhullar - JPMorgan - Analyst

Okay. And then lastly on the increase in EPS guidance, you raised the midpoint by about $0.02. What was the driver there?

Frank Svoboda - Torchmark - CFO

Yes Jimmy, on the $0.02 is -- the basic increase ends up being from the increased expectation with regard to the new accounting guidance. But the decreases that we are expecting in direct response are really being offset by really some improved outlook in several other areas of the Company with respect to some of our other life operations, at American Income and Liberty National. As well as just a little bit better expectations with our investment income and as well as a little bit of an impact from a lower federal income tax rate as well. All those tend to offset each other

Jimmy Bhullar - JPMorgan - Analyst

Okay

Frank Svoboda - Torchmark - CFO

and the net impact ends up being a little bit from this accounting guidance change.

Jimmy Bhullar - JPMorgan - Analyst

And lastly, if I could ask one more, on Family Heritage your results have been strong and the margins have improved in each of the last two quarters. I think this quarter was the highest margin that you've had since you've been reporting that business, so what's -- is it just an aberration or have you made any changes in the product mix, anything else that are driving the improvement in margins?

Gary Coleman - Torchmark - Co-CEO

Jimmy, there hasn't been a change in the product mix, but what we're seeing is -- we are seeing improvement in the claims and we expect that to continue for the rest of the year. Also, the amortization is slightly higher than in the past. That should continue, in other words, we were at 21% for the quarter and year to date and we expect that to follow through for the year.

Jimmy Bhullar - JPMorgan - Analyst

Okay. Thank you.

Yaron Kinar - Deutsche Bank - Analyst

Good morning, everybody. Just want to follow up on Jimmy's question on direct response. What is it about the 2011 to 2015 vintages that's tracking maybe below your original estimates?

Frank Svoboda - Torchmark - CFO

Well, as we've talked about on some of the prior calls, we had used -- we started to introducing the use of prescription drug database in our underwriting, starting with that 2011 year. As we understand, we were really the first to use that with respect to simplified underwriting as well as in the direct response and -- to where we had expected to see some mortality improvements. Now that the claims are coming in, the claims are just not coming in as favorable. Our actual experience is just not as favorable as what we had originally anticipated from the use of that prescription drug database.

Yaron Kinar - Deutsche Bank - Analyst

Right and I do remember you discussing this in previous calls. But in previous discussions I think you were still a little unclear as to where precisely this higher claims experience was coming from, if you saw any specific -- or you couldn't identify specific trends within the vintages. Are you getting maybe better clarity now as to whether it's a certain type of disease or issue that that seems to be recurring?

Frank Svoboda - Torchmark - CFO

We are definitely seeing certain segments where we're still getting some benefits and were definitely seeing some segments where we're not seeing the benefits that we had anticipated. And we're able to take that knowledge and put that into play as we think about our marketing efforts going forward and in our mortality assumptions as well.

Yaron Kinar - Deutsche Bank - Analyst

Okay, so I think you had started to take some action last year, already, are the actions that you took last year still sufficient in your view or given the fact that claims experience has deteriorated a little more than you had initially expected, does that mean that there's maybe additional corrective action that you need to take?

Frank Svoboda - Torchmark - CFO

Well, we will continue to tweak, as always, when we see more -- get more experience and get more information we will continue to tweak how we utilize that information and how we think about that within our pricing and our reserve assumptions on a going forward basis. At this point in time, we're comfortable with the assumptions that we put into place with respect to the 2015 and then our 2016 business.

Yaron Kinar - Deutsche Bank - Analyst

Okay. And then with regards to headcount, I think both American Income and Liberty National showed some nice trends the last few quarters and as I look at your guidance for year end it seems like maybe a little bit of flattening there. Can you maybe talk about why you don't see the continued growth that we saw earlier?

Larry Hutchison - Torchmark - Co-CEO

Sure. We look at our historical data. We believe that recruiting will slow in the third

quarter for both American Income and Liberty National. In the fourth quarter, really that's just seasonality. We have the holidays to deal with. So if you look at the fourth quarter over the last several years, there is generally a decline in the number of agents at the end of the fourth quarter. We're very happy with the results with American Income, Family Heritage and Liberty National. We've had good agent growth in the first and second quarters.

Yaron Kinar - Deutsche Bank - Analyst

Okay. Thank you very much.

Ryan Krueger - KBW - Analyst

Hi thanks, good morning. Regarding the debt issuance, you issued $50 million of debt in excess of the maturity. What would you expect to be the use of that $50 million of additional capital at the Holding Company?

Frank Svoboda - Torchmark - CFO

We are anticipating using that additional -- just to finance certain activities going on down at the insurance companies. We have some additional investments that we are making in our IT systems, as well as continued growth supporting our agencies and we anticipate to use it in that fashion.

Ryan Krueger - KBW - Analyst

Okay. So you would contribute it to the subsidiaries likely?

Frank Svoboda - Torchmark - CFO

In some form or fashion.

Ryan Krueger - KBW - Analyst

Okay. And then on the $9 million drag on excess investment income from Part D, is that something we should expect to get back in 2017 given the sale of the operation?

Frank Svoboda - Torchmark - CFO

Yes. We really should. I indicated that we expect the receivables as of the end of this year to be a little less than $100 million. We anticipate receiving those fairly ratably over the first three quarters of 2017. So we really estimate that the drag that we'll see in 2017 to be more in the $1 million to $2 million range, rather than you know the $8 million to $9 million that we're seeing this year.

Gary Coleman - Torchmark - Co-CEO

And then, Ryan, in 2018 there will be no drag.

Ryan Krueger - KBW - Analyst

Okay got it. Thank you.

Bob Glasspiegel - Janney Montgomery Scott - Analyst

Good morning, Torchmark. As we think about statutory earnings, run rate, I think you

said you're growing a little faster so that's a pressure -- how is credit sort of write-offs trending through the first seven months of the year and could STAT earnings grow just a little bit slower than GAAP earnings? Is my guess?

Frank Svoboda - Torchmark - CFO

Yes. We do, Bob -- we do anticipate that our statutory earnings will grow a little bit. I'm trying to think of whether it's -- how we look at that compared to the growth in the GAAP earnings, but it might be just a little bit slower than the GAAP earnings in 2016. We really haven't -- we will be in the process here over the next quarter to kind of look at that a little bit more closely and be able to give some guidance on that on the next call. But as far as the impairments are concerned, we did not have any impairments for the first six months of the year, for statutory or GAAP purposes. And right now we don't foresee any that would impact us here for the remainder of the year.

Bob Glasspiegel - Janney Montgomery Scott - Analyst

Okay and –

Gary Coleman - Torchmark - Co-CEO

Bob also

Bob Glasspiegel - Janney Montgomery Scott - Analyst

go ahead.

Gary Coleman - Torchmark - Co-CEO

Bob, I was going to say, first quarter we had a fair amount of downgrades, but we've seen improvement in the second quarter. So downgrades are not maybe the issue that some people thought they would have been earlier.

Bob Glasspiegel - Janney Montgomery Scott - Analyst

Okay. So you're feeling more relaxed about that issue on the margin?

Gary Coleman - Torchmark - Co-CEO

Yes.

Bob Glasspiegel - Janney Montgomery Scott - Analyst

Run rate for interest costs, I calculate at about $18.8 million when you get rid of the double debt costs in Q3, is that in the order of magnitude?

Frank Svoboda - Torchmark - CFO

I think on a going forward basis we would anticipate that interest expense to be closer to probably $20 million.

Bob Glasspiegel - Janney Montgomery Scott - Analyst

$20 million?

Frank Svoboda - Torchmark - CFO

Yes.

Bob Glasspiegel - Janney Montgomery Scott - Analyst

Okay. Appreciate it.

Operator

And there are no further questions.

Mike Majors - Torchmark - VP of IR

All right, thank you for joining us this morning; those are our comments and we'll talk to you again next quarter.