4th Quarter 2017 Conference Call

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PRESENTATION

Michael C. Majors - *Torchmark Corporation - VP of IR*

Thank you. Good morning everyone. Joining the call today are Gary Coleman and Larry Hutchinson, 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 2016 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'll now turn the call over to Gary Coleman.

Gary L. Coleman - *Torchmark Corporation - Co-Chairman of the Board and Co-CEO*

Thank you Mike, and good morning everyone.

In the fourth quarter, net income was $1 billion, twenty-seven million, or $8.71 per share, compared to $135 million or $1.12 per share a year ago. The increase is due primarily to the reduction of deferred income tax liabilities resulting from the tax legislation passed late in 2017. While we view tax reform as being very beneficial to Torchmark and its shareholders in the long run, the positive impact of the new lower tax rates on current taxes paid will be largely offset by the expanded tax base over the next several years. Frank will discuss this in more detail in his comments. Without the impact of tax reform, net income for the fourth quarter would have been $153 million or $1.30 per share.

Net operating income from continuing operations for the quarter was $147 million or $1.24 per share, a per share increase of 8% from a year ago. On a GAAP reported basis, return on equity as of December 31 was 28.2% and book value per share was $52.95. Excluding unrealized gains and losses on fixed maturities and the impact of tax reform, return on equity was 14.4% and book value per share was $34.68, an 8% increase from a year ago.

In our life insurance operations, premium revenue increased 6% to $581 million, and life underwriting margin was $160 million, up 12% from a year ago. Growth in underwriting margin exceeded the premium growth, due primarily to favorable results in direct response and to a lesser extent, American Income. In 2018 we expect life underwriting income to grow around 4% to 5%.

On the health side, premium revenue grew 3% to $246 million, while health underwriting margin was up 4% to $55 million. In 2018 we expect health underwriting income to grow around 3% to 5%.

Administrative expenses were $55 million for the quarter, up 9% from a year ago, and in line with our expectations. As a percentage of premium from continuing operations, administrative expenses were 6.6%, compared to 6.4% a year ago. For the full year, administrative expenses were $211 million or 6.4% of premium. In 2018 we expect administrative expenses to grow approximately 6% and to remain around 6.5% of premium.

I will now turn the call over to Larry for his comments on the marketing operations.

Larry M. Hutchison - *Torchmark Corporation - Co-Chairman of the Board and Co-CEO*

Thank you, Gary. At American Income, life premiums were up 9% to $258 million, and life underwriting margin was up 14% to $86 million. Net life sales were $56 million, up 7% due primarily to higher agent productivity. The average producing agent count for the fourth quarter was 6,959, up 1% from a year ago, and down 3% from the third quarter. The producing agent count at the end of the fourth quarter was 6,880. Life sales for the full year 2017 grew 6%.

At Liberty National, life premiums were up 2% to $69 million, while life underwriting margin was down 3% to $18 million. Net life sales increased 19% to $12 million, while net health sales were $6 million, up 21% from the year-ago quarter. The sales increase was driven primarily by growth in agent count and worksite activity. The average producing agent count for the fourth quarter was 2,112, up 19% from a year ago, but down 1% compared to the third quarter. The producing agent count at Liberty National ended the quarter at 2,106.

Life net sales for the full year 2017 grew 17%. Health net sales for the full year 2017 grew 5%.

In our direct response operation at Globe Life, life premiums were up 4% to $199 million. Net life sales were down 15% to $29 million. For the full year of 2017, life sales declined 10%. As we have discussed on previous calls, this sales decline is intentional. We have made operational changes designed to improve profitability in certain segments. Our primary marketing focus is to grow overall new business profits by maximizing margin dollars, rather than emphasizing sales levels or margins as a percentage of premium. We are pleased with the increase in profit margins.

At Family Heritage, health premiums increased 8% to $65 million, and health underwriting margin increased 9% to $15 million. Health net sales grew 12% to $15 million. The average producing agent count for the fourth quarter was 1,026, up 8% from a year ago, and approximately the same as the third quarter. The producing agent count at the end of the quarter was 1,076. Health sales for the full year 2017 grew 10%.

At United American General Agency, health premiums increased 3% to $92 million. Net health sales were $28 million, up 17% compared to the year-ago quarter due to increases in both the group and Individual Medicare Supplement units.

To complete my discussion of the marketing operations I will now provide some forward-looking information. We expect the producing agent count for each agency at the end of 2018 to be in the following ranges: American Income, 7,000 to 7,400; Liberty National, 2,300 to 2,500; Family Heritage, 1,125 to 1,185.

Approximate life net sales trends for the full year 2018 are expected to be as follows: American Income, 6% to 10% growth; Liberty National, 11% to 15% growth; Direct Response, 1% to 9% decline.

Health net sales trends for the full year 2018 are expected to be as follows: Liberty National, 1% to 5% growth; Family Heritage, 3% to 7% growth; United American Individual Medicare supplement, 4% to 8% growth.

I will now turn the call back to Gary.

Gary L. Coleman - *Torchmark Corporation - Co-Chairman of the Board and 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 required interest on net policy liabilities and debt, was $58 million, a 1% decrease over the year-ago quarter. The decrease is due in part to the negative carry from the early refinancing of a debt issue. On a per share basis, reflecting the impact of our share repurchase program, excess investment income was up 2%. In 2018, we expect excess investment income to grow around 3%. However, on a per share basis, we expect the increase to be around 6% to 7%.

In our investment portfolio, invested assets were $15.8 billion, including $15 billion of fixed maturities at amortized cost. Of the fixed maturities, $14.3 billion are investment grade with an with average rating of A-, and below investment grade bonds were $702 million, compared to $751 million a year ago. The percentage of below investment grade bonds to fixed maturities is 4.7%, compared to 5.3% a year ago. And with a portfolio leverage of 3.2X, the percentage of below investment grade bonds to equity, excluding net unrealized gains on fixed maturities, is 15%.

Overall, the total portfolio is rated BBB+, same as the year-ago quarter. In addition, we have net unrealized gains in the fixed maturity portfolio of $2 billion, approximately $916 million higher than a year ago.

Regarding investment yield

In the fourth quarter, we invested $262 million in investment grade fixed maturities, primarily in industrial sectors. We invested at an average yield of 4.36%, an average rating of BBB+, and an average life of 25 years. For the entire portfolio, the fourth quarter yield was 5.61%, down 14 basis points from the 5.75% yield in the fourth quarter of 2016.

As of December 31st, the portfolio yield was approximately 5.60%.

For 2018, the midpoint of our current guidance assumes an increasing new money yield throughout the year, averaging 4.75% for the full year. We are encouraged by the prospect of higher long-term interest rates. Higher new money rates will have a positive impact on operating income by driving up excess investment income. We are not concerned about potential unrealized losses that are interest rate driven since we would not expect to realize them. We have the intent, and more importantly, the ability to hold our investments to maturity. However, if rates don't rise, a continued low interest rate environment will impact our income statement, but 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 to put up additional GAAP reserves due to interest rate fluctuations. In addition, we do not foresee a negative impact on our statutory balance sheet. While we would definitely benefit from higher interest rates, Torchmark would continue to earn substantial investment income in an extended low interest rate environment.

Now, I will turn the call over to Frank.

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

Thanks, Gary. First, I want to spend a few minutes discussing our share repurchases and capital position. In the fourth quarter, we spent $82 million to buy 950,000 Torchmark shares at an average price of $86.06. For the full year 2017, we spent $325 million of Parent Company cash to acquire 4.1 million shares at an average price of $78.67. So far in 2018, we have spent $26.8 million to purchase 292,000 shares. These purchases are being made from the Parent Company's excess cash flow.

The Parent ended the year with liquid assets of $48 million. In addition to these liquid assets, the Parent will generate excess cash flow in 2018. The Parent Company's excess cash flow, as we define it, results primarily from the dividends received by the Parent from its subsidiaries, less the interest paid on debt and the dividends paid to Torchmark's shareholders. While our 2017 statutory earnings have not yet been finalized, we expect excess cash flow in 2018 to be in the range of $320 million to $330 million. Thus, including the assets on hand at the beginning of the year, we currently expect to have around $370 million to $380 million of cash and liquid assets available to the Parent during the year.

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 of Parent assets at the end of the year -- end of 2018, absent the need to utilize any of these funds to support our insurance company operations.

Next, a few comments on the new tax legislation.

As you know, on December 22nd, 2017, the Tax Cut and Jobs Act was signed into law. This legislation significantly revises corporate income tax rates from 35% to 21% and makes other changes affecting the tax law. Overall, the legislation will provide significant long-term benefits to Torchmark since future profits of the business will be taxed at the lower rate, benefiting our long-term shareholders.

The tax rate reduction required the Company to make a one-time adjustment to reduce the deferred income tax liability carried on the GAAP financial statements. This adjustment, along with other one-time adjustments, resulted in a non-recurring GAAP tax benefit of $874 million recorded in the fourth quarter, approximately $275 million of which related to unrealized gains on fixed maturity investments. The entire $874 million adjustment was treated as a non-operating item, but as noted earlier by Gary, increased the GAAP net income per share significantly. The tax adjustment also increased our book value per share at December 31st, 2017 by $5.09, or approximately 15%. Looking forward, we expect our 2018 operating income effective tax rate to be in the range of 19% to 20%, resulting in an expected increase in net operating income of approximately 17%.

While the new tax rate will result in a lower GAAP tax expense, cash taxes paid will not show a similar reduction in the near or intermediate term. On a cash tax basis, the lower tax rate will be virtually offset by provisions of the new legislation that limit the tax deduction for policy reserves and acquisition costs. As such, we do not expect a significant increase in statutory earnings from the lower tax rate.

In addition, the lower tax rate will have a negative impact on our insurance companies' statutory capital by reducing their deferred tax assets. Although we have not completed the statutory filings for our insurance subsidiaries, we expect the reduction in total statutory capital to be in the range of $130 million to $140 million as of December 31st, 2017.

Thus, in short, the GAAP tax rate will decline by 12 to 13 basis points, but in the intermediate term, cash taxes will only be slightly lower, and we may be required to infuse capital into our insurance subsidiaries over time to make up for the lower deferred tax assets.

In the coming months, we will evaluate further the short and long-term effects of the new tax legislation on our operations.

Now regarding capital levels at our insurance subsidiaries.

We currently plan to maintain our capital at the level necessary to return -- 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. While our 2017 statutory financial statements are not finalized, we anticipate that our consolidated RBC ratio will be in the range of 300% to 310% of company action level RBC, reflecting roughly a 30 basis point reduction in the ratio as a result of the reduction in deferred tax assets previously discussed.

Should the NAIC adjust the RBC factors in 2018, as is expected, to take into account the lower tax rate, we would expect a further reduction of approximately 45 basis points in our RBC ratio for the year ended December 31st, 2018. We are still in the early stages of determining the appropriate target RBC ratio for our insurance subsidiaries in 2018 in light of the tax legislation and will need to have discussions with our rating agencies and regulators on the topic. Should we choose to make additional capital contributions, we are confident that we can fund any required amounts without a significant impact on our excess cash flow.

Next, a few comments to provide an update on our Direct Response operations.

In the fourth quarter, we again saw growth in the direct response underwriting margin. The underwriting margin, as a percent of premium, was 18.4%, up from 15.1% in the year-ago quarter. This reflects higher than normal policy obligations in the fourth quarter of 2016 as compared to lower policy obligations in the fourth quarter of 2017. While the lower policy obligations were generally expected due to seasonality, the overall underwriting margin percentage for the fourth quarter was at the high end of our expectations.

The underwriting margin percentage for the full year 2017 was 15.6%, toward the higher end of the range provided on previous calls. For 2018, we are estimating the underwriting margin percentage for direct response to be approximately the same as in 2017, in the 14.5% to 16.5% range. We also expect the underwriting margin percentage to be seasonally low in the first half of the year and then higher in the second half of the year.

Finally, with respect to our earnings guidance for 2018. We are projecting the net operating income from continuing operations per share will be in the range of $5.90 to $6.10 for the year ended December 31st, 2018. The $6.00 per share midpoint of this guidance reflects a 24% increase over the 2017 earnings per share of $4.82. The increase is primarily attributable to the lower tax rate in 2018, offset by higher after-tax compensation expense due to the lower tax benefits. We now estimate that our stock compensation expense will be in the range of $18 million to $22 million, as compared to approximately $5 million absent tax reform.

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

Larry M. Hutchison - *Torchmark Corporation - Co-Chairman of the Board and Co-CEO*

Thank you, Frank. Those are our comments. We will now open the call up for questions.

QUESTIONS AND ANSWERS

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Hi, I had a question, first on just capital and cash flow. What are some of the actions that you're considering to replenish capital at the subs? And do you expect this to sort of affect share buybacks, especially if the rating agencies don't change their RBC thresholds?

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

Yes, Jimmy. At this point in time, they really indicated -- we still have some work to do to determine what we think are really the appropriate target RBC levels for the organization, given the changes in the tax rates. We have yet to have any real in-depth discussions with the rating agencies with respect to any anticipated levels. We do think that to the extent that we do need to put in any additional capital to at least make up for the lower deferred tax assets that we can -- we're really taking a look at being able to do that through some type of a debt financing rather than through our excess cash flows, but that will have to be something we'll have to work through.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. And then on the direct response business, your margins improved. I think this is the third straight quarter that they improved, and the magnitude of the improvement was higher this quarter than in the past few. Is that just because of the actions that you've been taking on limiting marketing and pricing or was there like an aberration or something else that helped the results this quarter?

Gary L. Coleman - *Torchmark Corporation - Co-Chairman of the Board and Co-CEO*

Jimmy, I think, as far as the impact on the fourth quarter, it's more just the fact that we had -- the claims came in a little bit lower than we expected on the overall block. The changes that we're making in sales -- we are seeing higher profit margins on new business sold, but the contribution to margin from new business in the first year is not that high. So the increase in the fourth quarter really is more due to the lower claims.

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

Yes, part of that, Jimmy, is also, just the seasonality. We really did expect the policy obligation percentage in the fourth quarter to probably be around that 55%, maybe 56% range, it came in around 54%. So it was really at the low end of what our expectations were, but we were expecting improvement there in the fourth quarter. Now again, as we look to 2018, we've really -- we expect some high seasonal claims in the first half of the year, so we kind of expect that underwriting margin percentage to be a little lower in the first half and then come back up again in the second half of the year.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. And then just lastly, I don't know if you mentioned and I missed it, but what's the tax rate that you're embedding in your new EPS guidance?

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

Between 19% and 20%

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay, alright thank you.

Robert Ray Glasspiegel - *Janney Montgomery Scott LLC, Research Division - MD of Insurance*

Good morning Torchmark, and thank you for the extensive tax discussion. Believe it or not, I have one follow-up question on that. That is, I'm just trying to understand, help me on how the rating agencies and the regulators would look at an event that causes your GAAP earnings to go up, your GAAP equity to go up, your -- over time, your GAAP taxes paid to go down, although not over the short to intermediate term. Why would you need more capital when all those events are happening? Are we assuming they just look at historic math formulas, or are they actually thinking intellectually about how these things interplay?

Gary L. Coleman - *Torchmark Corporation - Co-Chairman of the Board and Co-CEO*

Well Bob, we had a lot of those same questions. And that's one thing we -- as Frank mentioned, we haven't talked -- talked to the rating agencies yet, but that's -- I think that would be a part of our discussion when we talk to them. Frank, do you have anything to...

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

Yes. No, it's just kind of one of those funny anomalies where the tax rate goes down, which should be a good long-term benefit, but yet require additional capital. So those are some of the questions that we will have to get answered.

Robert Ray Glasspiegel - *Janney Montgomery Scott LLC, Research Division - MD of Insurance*

But you think there is a chance that logic would prevail, or you think the more likely scenario is that they blindly hold to their math calculations?

Gary L. Coleman - *Torchmark Corporation - Co-Chairman of the Board and Co-CEO*

I think, Bob, for us, it's -- we don't have enough information to know. We -- again, we haven't had discussions with them, so we will just have to wait and see.

Robert Ray Glasspiegel - *Janney Montgomery Scott LLC, Research Division - MD of Insurance*

Okay, thank you very much.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Hi, I was hoping you can touch on how much debt capacity you believe you have at this point. I know one thing that happened with tax reform was you've got a meaningful uplift to GAAP book value. Can you talk a little about where you -- where the debt-to-cap could go, and how you are thinking about debt capacity?

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

Yes. Our debt-to-cap ratio at the end of 2017 is going to be a little under 24%, and we really -- we're projecting that the ratio will go down below 23% by the end of 2018. We looked at that and -- if we were going to bring our debt-to-cap ratio back up to some of the levels that we've had the last couple of years, which has been around 26%, we'd probably have around $300 million of capacity, just to keep it at that level. And then, if –- our discussions with the rating agencies, we usually have a higher kind of limit, if you will, with respect our debt-to-cap ratio before they would be too concerned about it, so that would give us some -- even additional capacity above that, if we think we needed it.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Got it. And you did not -- is it correct that you did not assume any debt issuance in your EPS guidance at this point for 2018?

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

That is correct.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Okay. And then last one was on the -- the free cash flow guidance for -- of $320 million to $330 million for 2018. It's obviously more based on the 2017 financials. If we roll it forward another year, and taking into consideration changes in cash taxes, would you still expect a similar amount of free cash flow as 2018, into 2019?

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

Yes. With all things else being equal, from a statutory earnings perspective, looking forward a year, we really anticipate probably between $5 million and $10 million of lower cash taxes, solely because of the tax reform. So we think there could be a slight uptick from that perspective, and then obviously there's several other items in there that could affect the cash flow going forward. But we would expect it to be at that level or starting to tick up a little bit from there.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Got it, thank you.

Taylor Alexander Scott - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Good morning, had a question on RBC. Just in light of, I guess, you guys having done a bit less of the XXX transactions and sort of statutory capital optimization, and I know, the NAIC, I guess is looking at a wide range of options with a group capital calculation. If -- one of those things I think is sort of applying PBR to kind of level the playing field between those that have used XXX and AXXX and those that haven't. If you apply that sort of methodology, how much of a benefit would that be for you guys, just in thinking about like surplus or how much of your reserves would decline if you use PBR? Just like, rough, rough numbers? I just want to get a feel for if something like that was occurring, would that just totally alleviate any kind of issues you had around like RBC, like optically declining around tax rates -- or tax reform?

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

Yes. The PBR that's come out, it's really more focused on some of the aggressive term insurance and the UL products and secondary guarantees. Products that we don't write. So we have a few blocks of business where PBR will come into effect, but it is pretty minimal. And at this point in time, we really don't anticipate that PBR will have much -- any real material impact on the amount of our statutory reserves.

Taylor Alexander Scott - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. And I guess, second question, just on the guide for 2018. The updated guide versus the guide you provided previously. I mean, are there -- could you highlight just if there are any other sort of adjustments, moving parts in there other than just the tax rate and how to think about those?

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

Sure. Really, from the previous guidance, we really saw a little bit better experience on the health lines, so we are kind of following that into 2018. So we are expecting a little bit -- I think that overall, the margins to be -- for the overall, on health side, to be pretty similar to where they are in 2017. That was actually a little bit of an improvement from what we had anticipated back in October. So the experience that we saw in the fourth quarter kind of helped us with that. But then that uptick maybe offset a little bit, due to some higher administrative expenses. We're looking -- our pension expense is going to be going up a little bit again in 2018, so that will be a little bit of a headwind. Short-term interest rates, affecting our short-term debt, those costs will have a bit of higher interest expense as well, and then of course, the higher share price -- a little bit of a drag with respect to the impact of the buyback program. And then we really look at the option expense. And I think one of the items that we really looked at is while the increase in the -- or the decrease in overall tax rate gave us about $1 of additional earnings per share, from just a change in the rate, the excess tax benefits that we've had, that's an offset against our stock option expense. Of course, we have, with respect to the stock option expense, you have a lower tax benefit, plus we have lower excess tax benefits. So that's what's kind of helping to -- or causing that decline of the overall impact of the tax benefit, of the tax rate.

Taylor Alexander Scott - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay thank you.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Hi, I just wanted to follow-up on the tax rate. Is the primary reason for the tax rate being lower than the statutory rate of 21% just tax preferred investments, like Build America Bonds or is there something else as well?

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

It's primarily low-income housing tax credit investments that we've made over the years.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay, and how should we think about the duration of those? Is that something that comes into play in your tax rate over the next 2 to 3 years or are they longer duration, so you shouldn't expect much of a change in the '19 to '20?

Frank M. Svoboda - *Torchmark Corporation - CFO and EVP*

Yes, a longer duration of those, we continue to build that portfolio over the years. They generally receive credits over 10 years. 10 to 12 years, is -- there's a little bit of a grade-in period, so they're still several years out with respect to those benefits.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay thank you.

Operator

And at this time, there are no further questions.

Michael C. Majors - *Torchmark Corporation - 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.