4th Quarter 2018 Conference Call

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PRESENTATION

Michael C Majors - Torchmark Corporation - EVP of Administration and 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 2017 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 L Coleman - Torchmark Corporation - Co-Chairman & CEO

Thank you Mike, and good morning everyone. In the fourth quarter, net income was $165 million or $1.45 per share, compared to $1.03 billion or $8.71 per share a year ago. As a reminder, in the fourth quarter 2017, we recorded $874 million of net income primarily as a result of re-measuring our deferred tax assets and liabilities using the lower corporate tax rate.

Net operating income for the quarter was $177 million or $1.56 per share, a per share increase of 26% from a year ago. Excluding the impact of tax reform, we estimate that the growth would have been approximately 8%.

On a GAAP reported basis, return on equity as of December 31 was 12.3%, and book value per share was $48.11. Excluding unrealized gains and losses on fixed maturities, return on equity was 14.6% and book value per share grew 11% to $44.32.

In our life insurance operations, premium revenue increased 3% to $600 million and life underwriting margin was $168 million, up 5% from a year ago. Growth in underwriting margin exceeded premium growth due to higher margins at direct response and our military business. In 2019, we expect life underwriting income to grow around 3% to 5%.

On the health side, premium revenue grew 5% to $257 million, and health underwriting margin was up 6%

to $58 million. Growth in underwriting margin exceeded premium growth due to higher margins at Family Heritage and American Income. In 2019, we expect health underwriting income to grow around 2% to 4%.

Administrative expenses were $57 million for the quarter, up 5% from a year ago and in line with our expectations. As a percentage of premium, administrative expenses were 6.7% compared to 6.6% a year ago. For the full year, administrative expenses were $224 million or 6.5% of premium compared to 6.4% in 2017. In 2019 we expect administrative expenses to grow approximately 4% to 5% 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 & CEO

Thank you Gary. At American Income, life premiums were up 7% to $276 million, and life underwriting margin was up 5% to $90 million. Net life sales were $54 million, down 2%. The average producing agent count for the fourth quarter was 6,936, approximately the same as the year-ago quarter, but down 2% from the third quarter. The producing agent count at the end of the fourth quarter was 6,894.

Net life sales for the full year 2018 were flat due to the lack of growth in agent count and productivity. We have not seen any drop in union leads or their resulting sales.

As I mentioned last quarter, low unemployment across the country is having an impact on our agent growth. We continue to see growth in agent recruiting, but we are seeing a drop-off in retention of new agents due to the unusually high number of other work opportunities. We are confident we can work through this even if unemployment rates persist at these historically low levels, and we are optimistic about future growth at American Income.

At Liberty National, life premiums were up 1% to $70 million, while life underwriting margin was down 1% to $18 million. Net life sales increased 6% to $13 million, and net health sales were $6 million, up 9% from the year ago quarter. The average producing agent count for the fourth quarter was 2,172, up 3% from a year ago, but approximately the same as the third quarter. The producing agent count at Liberty National ended the quarter at 2,159.

Net life sales for the full year 2018 grew 5%. Net health sales for the full year of 2018 grew 8%. The sales increase was driven by increases in agent count and agent productivity.

In our direct response operation at Globe Life, life premiums were up 1% to $200 million, and life underwriting margin increased 6% to $39 million. Net life sales were $29 million, the same as the year-ago quarter. For the full year 2018, net life sales declined 7%. We continue to refine and adjust our marketing programs in an effort to maximize the profitability of new business.

At Family Heritage, health premiums increased 8% to $70 million, and health underwriting margin increased 15% to $18 million. Net health sales grew 3% to $15 million. The average producing agent count for the fourth quarter was 1,129, up 10% from a year ago and up 4% from the third quarter. The producing agent count at the end of the quarter was 1,097. Net health sales for the full year 2018 grew 7%.

At United American General Agency, health premiums increased 6% to $97 million. Net health sales were $30 million, up 7% compared to the year-ago quarter.

To complete my discussion on the marketing operations, I will now provide some projections. We expect the producing agent count for each agency at the end of 2019 to be at the following ranges: American Income, 2%

to 4% growth; Liberty National, 2% to 11% growth; Family Heritage, 8% to 13% growth. Approximate life net sales trends for the full year 2019 are expected to be as follows: American Income, 4% to 8% growth; Liberty National, 2% to 10% growth; direct response, flat to 2% growth. For direct response, we expect to begin the year slowly and then start to see sustainable growth at some point during the middle of the year.

Health net sales trends for the full year 2019 are expected to be as follows: Liberty National, 4% to 8% growth; Family Heritage, 5% to 9% 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 & 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 the net policy liabilities and debt, was $62 million, a 7% increase over the year-ago quarter. On a per-share basis reflecting the impact of our share repurchase program, excess investment income increased 10%. For the year, excess investment income grew by 2%; 6% on a per share basis. In 2019, we expect excess investment income to grow around 5%, which would result in a per-share increase of around 9%.

Now regarding the investment portfolio

Invested assets were $16.6 billion, including $15.8 billion of fixed maturities at amortized costs. Of the fixed maturities, $15.1 billion were investment grade with an average rating of A-, and below investment grade bonds were $666 million compared to $702 million a year ago. The percentage of below investment grade bonds to fixed maturities is 4.2%, compared to 4.7% a year ago. This is the lowest this percentage has been since 2000. With a portfolio leverage of 3.2X, compared to peer company average of around 7X, the percentage of below investment grade bonds to equity, excluding net unrealized gains on fixed maturities, is 13%, which is lower than the average of our peers.

Overall, the total portfolio is rated BBB+, same as a year ago. Bonds rated BBB are 58% of the fixed maturity portfolio, which is high relative to our peers. However, due to our low asset leverage, the percentage of BBBs to equity is in line with peer companies. In addition, we have no exposure to higher risk assets such as derivatives or equities, and little exposure to commercial mortgages and asset-backed securities.

Finally, we have net unrealized gains in the fixed maturity portfolio of $544 million, approximately $225 million lower than the previous quarter, due primarily to changes in market interest rates.

Regarding investment yield

In the fourth quarter, we invested $409 million in investment grade fixed maturities, primarily in the industrial, municipal, and financial sectors. We invested at an average yield of 5.26%, an average rating of A-, and an average life of 23 years. For the entire portfolio, the fourth quarter yield was 5.56%, down 5 basis points from the 5.61% yield in the fourth quarter of 2017. As of December 31, the portfolio yield was approximately 5.55%. For 2019, at the midpoint of our current guidance, we are assuming an average new money yield of 5% for the full year.

Now I will turn the call over to Frank.

Frank M Svoboda - Torchmark Corporation - Executive VP & CFO

Thanks Gary. First I want to spend a few minutes discussing our share repurchases and capital position.

In the fourth quarter, we spent $122 million to buy 1.5 million Torchmark shares at an average price of $82.11. For the full year 2018, we spent $372 million of Parent Company cash to acquire 4.4 million shares at an average price of $84.38. So far in 2019, we have spent $29 million to purchase 359,000 shares at an average price of $79.56.

These purchases are being made from the Parent Company's excess cash flow. However, it should be noted that in December, due to the significant pullback of the overall stock market, we accelerated approximately $25 million of repurchases from 2019 into 2018. These repurchases were made at an average price of approximately $76, and were paid from cash at the Parent and the issuance of commercial paper.

The Parent ended the year with liquid assets of approximately $41 million. In addition to these liquid assets, the Parent will generate excess cash flow in 2019. 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 shareholders. While our 2018 statutory earnings have not yet been finalized, we expect excess cash flow in 2019 to be in the range of $350 million to $370 million. Thus, including the assets on hand at the beginning of the year, we currently expect to have around $390 million to $410 million of cash and liquid assets available to the Parent.

We anticipate using around $15 million of our 2019 excess cash flow to pay for the accelerated share repurchases by reducing commercial paper. That will leave around $375 million to $395 million available to the Parent during the year, including the normal $50 million of Parent assets we expect to retain. As noted on previous calls, we will use our cash as efficiently as possible. If market conditions are favorable and absent alternatives with a higher value to the shareholders, we expect that share repurchases will continue to be a primary use of those funds.

Now regarding capital levels at our insurance subsidiaries

Our goal is to maintain capital at levels necessary to support our current ratings. After discussions with the rating agencies and as noted on the last call, Torchmark intends to target a consolidated RBC ratio in the range of 300% to 320%. Although we have not finalized our 2018 statutory financial statements, we anticipate that our consolidated RBC ratio will be within that range at around 315% to 320%. For 2019, we expect the target ratio will remain in the 300% to 320% range.

As has been previously discussed, the National Association of Insurance Commissioners, or the NAIC, is considering a change in the capital factors that relate to fixed maturity investments. These factors are commonly referred to as C1 factors. At this time, it is unclear when any such changes might be implemented as it was not included on the agenda at the NAIC's latest meeting. As such, we do not expect the implementation of any new C1 factors to occur before year-end 2020. If implemented, the new C1 factors would generally increase the amount of required capital for fixed maturity investments. Using our fixed maturity portfolio as of year-end 2018, we have estimated that the impact of the new factors would result in a 30 to 35 point reduction in our RBC percentage, requiring additional capital in the range of $175 million to $190 million to retain the same RBC percentage as before the change. Given our current incremental borrowing capacity at the holding company of approximately $475 million and our cash flow generation capabilities within our insurance operations, we are confident we will have the necessary resources to

provide the additional capital if needed. Furthermore, any additional borrowings to fund the additional capital should not adversely impact earnings as the additional capital would be invested by the insurance companies in long-duration assets.

Given the maturity of the current credit cycle and the possibility that our fixed maturity portfolio could experience some downgrades or defaults in the coming years, we have also stress-tested the impact a downturn in the economy could have on our statutory capital and related RBC percentage. In this test, we utilized the same ratings migration and default rates that actually occurred in the 3-year period of 2008 through 2010, as published in Moody's annual default study. Under this severe scenario, our RBC ratio could decrease over the 3-year period by approximately 40 to 45 points, requiring approximately $200 million to $225 million to retain the same RBC percentage as before the downturn.

Again, our incremental borrowing capacity is well in excess of the additional capital necessary, especially given the likelihood that any ratings migrations and defaults would likely occur over a period of time. Even more importantly, the Parent Company's ability to generate well over $300 million in excess cash flows on an annual basis provides additional confidence that we would have the liquidity necessary to address any capital needs in an economic downturn. As previously noted, the earnings impact of financing additional capital should not be significant since any proceeds will be invested in long-duration assets.

Next, a few comments on our operations

With respect to our direct response operations, the underwriting margin as a percent of premium in the quarter was 19% compared to 18% in the year-ago quarter due to slightly favorable claims in the current quarter as well as lower amortization due to a fluctuation. The underwriting margin percentage for the full year 2018 was 17.8%, toward the higher end of the range provided on our last call. For 2019, we are estimating the underwriting percentage -- margin percentage for direct response to be approximately the same as in 2018, with a range between 17% and 18%. We also expect the underwriting margin percentage to be seasonally lower in the first 2 quarters versus the second half of the year.

With respect to our stock compensation expense, we anticipated an increase during the fourth quarter this year compared to last year, primarily attributable to the decrease in the tax rate and excess tax benefits in 2018. However, the expense for the fourth quarter was higher than we anticipated due to lower excess tax benefits than expected. The lower excess tax benefits were a direct result of the lower stock price in December which greatly reduced the number of options exercised by our employees in the quarter. For 2019, at the midpoint of our guidance, we currently anticipate the expense to be approximately the same as in 2018. This is higher than our previous guidance and is primarily attributable to lower projections of excess tax benefits for the year.

Finally, with respect to our earnings guidance for 2019, we are projecting net operating income per share will be in the range of $6.50 to $6.70 for the year ended December 31, 2019. The $6.60 midpoint of this guidance is unchanged from our previous guidance.

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

Larry M Hutchison - Torchmark Corporation - Co-Chairman & CEO

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

A couple of questions; first, on just direct response life margins. They have been better than expected the past couple of quarters. Do you expect them to improve off of the 4Q level? Or was that just an aberration in terms of loss trends?

Frank M Svoboda - Torchmark Corporation - Executive VP & CFO

Yes, Jimmy, I think the fourth quarter, was a little bit higher, kind of given some seasonality, than what we might see going forward, even though on some quarterly basis you might see the same percentage being in that range. I think overall for 2019, we really expect it to be pretty similar overall to what we saw in 2018, somewhere there in between 17% and 18%.

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

And then on the agent count, it seems like your projections are a little optimistic given just what the recent results have been and also just the comment on labor market trends. What gives you the confidence that you can grow at the levels that you are suggesting in the various channels?

Larry M Hutchison - Torchmark Corporation - Co-Chairman & CEO

I think American Income is the primary focus. And at American Income, to increase our retention, we are changing our first-year agent commission and bonuses attached to -- to encourage retention. We also have an increase of bonus for managers that train new agents, and bonusing middle managers and agency owners for recruiting and new agent retention. So we think those changes will lead to an increase in our agent count in 2019.

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

Okay thank you.

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

Hey, just a follow-up on the last question. When I think about some of the actions you are taking there, some of the bonuses and so forth, I mean, where would we expect that to come through? Like do those costs get amortized? Do those bonuses get paid as they make their first sales and do they get amortized? Or is that part of sort of the expenses that you have included in all of your guidance that you laid out today?

Larry M Hutchison - Torchmark Corporation - Co-Chairman & CEO

We are not increasing the amount of commission, we are just restructuring the commission to encourage the new agent production and new agent retention.

Frank M Svoboda - Torchmark Corporation - Executive VP & CFO

And then, yes, Alex, any of those bonuses are directly tied to that particular sale, so they do get capitalized as part of our overall deferred acquisition cost calculation and amortized over time. And they are -- those are all reflected in our guidance.

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

Got it. Okay, so it is -- overall, those expenses are not really going up, though, is what you are saying. It is just sort of a restructuring of the allocation of them?

Gary L Coleman - Torchmark Corporation - Co-Chairman & CEO

That is right.

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

Okay, and then maybe a high-level question on sort of spread compression. I know you guided to excess investment income already, but I was just interested in -- can you talk about new money yield versus portfolio yield. When in your base case you are expecting to get to a point where you have a more neutral impact from new investing, and when spread compression sort of ends for you guys?

Gary L Coleman - Torchmark Corporation - Co-Chairman & CEO

Well, Alex, there is a little bit of – we are almost there, but there is a little bit of a timing issue on the way the interest works through the net policy liabilities versus the assets. But -- so we are -- right now, we are at a slight negative spread, but we expect that on average to become at least neutral in the next year or so, which means that most of our excess investment, or almost all our excess investment income is coming from our equity assets. But within the next year we should see the improvement -- really, 2020, we should see a point where we are getting back where the investment rate is higher than what we are showing as required interest.

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

Got it, then maybe one final one for me. Looks like lapses were ---had ticked up a little bit here or there. I mean, would just be interested to know if that is anything abnormal. I mean, it looked like it was on first year policies. Maybe that is just sort of normal fluctuation. But interested if there is any color you can provide on that.

Gary L Coleman - Torchmark Corporation - Co-Chairman & CEO

Well, actually, we -- I think you are probably referring to Liberty National. In American Income, we are actually continuing to see improvement in both first year and renewal rates. But we did -- we have seen the last 2 quarters tick up in the lapse rates for first year business at Liberty National. We do not think there is an issue there, but we have had sales growth in the last 2 or 3 years, and when you have higher sales growth, you tend to see a little bit of tick up in the first year rate. But that is something we will continue to watch, but right now, I think it is just a fluctuation.

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

Got it, thanks for taking the questions.

John Matthew Nadel - UBS Investment Bank, Research Division - Analyst

Good morning everybody. Maybe, Frank, I was hoping we could go through the sensitivities in some of your prepared remarks as it is related to the C1 factor changes and some stress analysis that you guys did on the portfolio. It seemed pretty consistent with some of the numbers that we were coming up with on our end. I am just curious though, I understand that there is significant earnings power and, frankly, very predictable earnings power at the company, and you have got some borrowing capacity. I just wonder, under that kind of a stress scenario, and then you layer on C1 factor changes, how do you think -- I mean, have you guys had conversations with the rating agencies as to how you think they would respond in that kind of scenario? Do you think incremental borrowings to shore up capital at the insurance entities would be met with stable ratings?

Frank M Svoboda - Torchmark Corporation - Executive VP & CFO

We have not been given any indication that if we were to increase borrowings to fulfill some capital obligations, that it would be a problem within the rating agencies, especially to the extent that we are staying at or underneath the guidelines that they have already set out for us. And as we talked on earlier calls, they like to see that debt-to-cap ratio be no greater than 30% to support our existing ratings. So the one thing that gives us comfort is as we think about some of the downgrades and defaults that they really should occur over a period of time. And as we take a look at the growth of our overall capital over a period of time, it should continue to grow. If we were to borrow $400 million, say, at the end of 2019, given our projected growth in our overall stockholders' equity, we would still be a little less than 28% in a debt-to-cap ratio. So that is kind of assuming, really worse case, that all this happened now. If that happens over a period of several years, that - - our debt-cap ratio will be coming down from its current levels and give us even more capacity. And I think - - and I say that not from a standpoint that we want to use up all that capacity, but I think from a rating agency perspective, that they would have comfort that we are not getting too close to that maximum amount.

John Matthew Nadel - UBS Investment Bank, Research Division - Analyst

Okay. That is really helpful. I appreciate that. And then back to -- flipping to your outlook for agent count growth, I think -- I guess, similar question along the same lines as Jimmy. I know, Larry, you commented on American Income. Maybe that is an area that is a little bit more sensitive to employment levels, et cetera. Can you just maybe contrast why you feel like the growth rate target for agent count at Liberty and Family Heritage are, number one, obviously more robust, but number two, why your confidence is a little different there?

Larry M Hutchison - Torchmark Corporation - Co-Chairman & CEO

Of the 2 agencies, Liberty and Family Heritage are much smaller agencies. So as a percentage of growth off a base of 7,000 agents at American Income versus 2,000 agents at Liberty, we would not expect the percentage to be the same. I think there is a difference in the 3 agencies, too, is that American Income is located in urban areas, versus the other 2 companies have a more rural presence. Internet recruiting is a much bigger – higher part of recruiting at American Income than the other 2 agencies. What we see during low unemployment is that those resumes continue to be contacted by other potential employers, and so the drop we have seen in retention has been 3-month retention, not 12-month retention. What we are encouraged by is that we saw an increase in recruiting at American Income of 6% in 2018. Unfortunately, the terminations of those new agents was just above that level, that is why we did not have agency growth. I think we will see that settle down. I think with our initiatives, we will see some agency growth in American Income this year.

John Matthew Nadel - UBS Investment Bank, Research Division - Analyst

Okay. That is helpful, too. And then last one is just on direct response. It seems like a flat underwriting margin outlook for 2019, at least relative to what you have seen the last couple of quarters, some real nice improvement or recovery. It seems like that is conservative. Is there anything sort of in the underlying mix that could say -- actually,-- I do not know. Do you feel like that is a conservative outlook given what you have seen recently?

Frank M Svoboda - Torchmark Corporation - Executive VP & CFO

I think it is a pretty realistic outlook. If you look at our last several quarters, our policy obligation percentage has kind of stabilized in

between 54% and 55%. We have really -- we have seen some settling down, normalization, of some of our call it nonmedical type claims where we have seen some increases in that over the last couple of years. We just see that continuing on, and we always have the potential of having again some higher -- individual quarters, but we think, overall, it still should be in that same area.

Gary L Coleman - Torchmark Corporation - Co-Chairman & CEO

John, I would add, I think we are pleased with where we are in direct response. It is a pretty big ship to turn around. When you consider 2015 -- '14,'15, '16, we had a decline in earnings, we had an increase in earnings this year as the margins improved. Next year, we are looking to grow premiums in the 2% to 3% range. We would expect the margins to grow in the same range. When you look back over the last few years, that is -- we feel very good about that and, hopefully, that will accelerate as we go on.

John Matthew Nadel - UBS Investment Bank, Research Division - Analyst

Yes. I was just going to ask, just as a quick follow-up. I mean, if you look out the next couple of years for direct response, do you see an opportunity for the margin, underwriting margin to return to sort of the pre -- I do not know if you want to call it 2016 kind of level -- to return to prior levels?

Gary L Coleman - Torchmark Corporation - Co-Chairman & CEO

Well, we do not project out that far, but I would assume it is going to stay more where it is now, around 18% level, as opposed to the – I think we had 22% to 23% 4 or 5 years ago.

John Matthew Nadel - UBS Investment Bank, Research Division - Analyst

Okay thank you.

Costa – Evercore- Analyst

This is Costa on behalf of Tom. I just have a question on free cash flow. If you could help us with what -- how much of the -- how much of that is impacted by new business strain? In other words, if you stopped growing, how much capital would you -- how much cash flow would you be generating? And then will free cash flow ever -- it seems like it is been pretty stable over time. Will it -- will we ever see a step function higher? Or should we just expect it to be around these levels?

Frank M Svoboda - Torchmark Corporation - Executive VP & CFO

Yes, I think. Overall, I think from a free cash flow and an expectation, in kind of a normal -- and with a steady growth perspective, we would anticipate that free cash flow to slowly grow over time. And so it definitely has that potential to continue to grow from the current level. Where you do see reductions in the overall free cash flow is where we may have spikes in our sales and where we end up having a very high growth year, then the expenses associated with putting on that higher growth in sales tends to be that drag on the statutory earnings. And it does take a couple of years before the profits of the new sales and of the higher sales pay back that front-year investment. And then it takes several years, ultimately, you end up -- totally negates it over a period of 7 or 8 years. I do not have the specific numbers as far as certain level of sales and exactly what that has – what impact that has on the free cash flow. But clearly, as our sales slowdown and that ends up helping our free cash a little bit as we kind of catch up on the profits that we -- that are emerging on the prior year sales. And then if we end up having some good growth years, then that will tend to have a little bit of a drag on it as well.

Costa – Evercore- Analyst

Got it thanks.

Operator

At this time, I am showing no further questions in the queue.

Michael C Majors - Torchmark Corporation - EVP of Administration and IR

All right, thank you for joining us this morning and we will talk to you again next quarter.