Torchmark Corporation

3rd Quarter 2017 Conference Call

October 25, 2017

CORPORATE PARTICIPANTS

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

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

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

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

Brian Mitchell Torchmark Corporation – *General Counsel*

CONFERENCE CALL PARTICIPANTS

Erik James Bass Autonomous Research LLP - *Partner of US Life Insurance*

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

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

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

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

PRESENTATION

Michael C. Majors - *Torchmark Corporation - 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 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 will 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 third quarter, net income was $153 million or $1.29 per share, a 3% increase on a per share basis. Net operating income from continuing operations for the quarter was $146 million or $1.23 per share, a per share increase of 7% from a year ago.

On a GAAP reported basis, return on equity as of September 30 was 11.7%, and book value per share was $43.78. Excluding unrealized gains and losses on fixed maturities, return on equity was 14.4% and book value per share was $34.27, an 8% increase from a year ago.

In insurance operations -- in the life insurance operations, premium revenue increased 5% to $576 million and life underwriting margin was $153 million, up 7% from a year ago. Growth in underwriting margin exceeded premium growth due primarily to favorable results at American Income, and to a lesser extent, Direct Response. For the year, we expect life underwriting income to grow around 4% to 5%.

On the health side, premium revenue grew 3% to $243 million, while health underwriting margin was up 5% to $56 million. Growth in underwriting margin exceeded premium growth due primarily to favorable claims experience. For the year, we expect health underwriting income to grow around 3% to 5%.

Administrative expenses were $52 million for the quarter, up 6% from a year ago, and in line with our expectations. As a percentage of premium from continuing operations, administrative expenses were 6.4%, compared to 6.3% a year ago. For the full year, we expect administrative expenses to be around 6.4% 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 $253 million, and life underwriting margin was up 13% to $83 million. Net life sales were $57 million, up 10%, primarily because we have a higher concentration of veteran agents than a year ago. The average producing agent count for the third quarter was 7,165, up 2% from a year ago and up 2% from the second quarter. The producing agent count at the end of the third quarter was 6,981.

At Liberty National, life premiums were up 2% to $69 million, while life underwriting margin was down 6% to $19 million. Net life sales increased 19% to $12 million, while net health sales were $5 million, up 9% from the year-ago quarter. The sales increase was driven primarily by growth in agent count.

The average producing agent count for the third quarter was 2,132, up 19% from a year ago and up 6% compared to the second quarter. The producing agent count at Liberty National ended the quarter at 2,123. We continue to be encouraged by the positive results at Liberty National.

In our direct response operation at Globe Life, life premiums were up 4% to $200 million. Although net life sales were down 11% to $31 million, life underwriting margin increased 7% to $31 million. The actions that have been taken that have resulted in reduced sales have increased margins in total dollars.

At Family Heritage, health premiums increased 7% to $64 million, and health underwriting margin increased 11% to $15 million. Health net sales grew 2% to $14 million. The average producing agent count for the third quarter was 1,024, up 4% from a year ago, and down 1% from the second quarter. The producing agent count at the end of the quarter was 1,030.

At United American General Agency, health premiums increased 1% to $89 million. Net health sales were $9 million, down 8% compared to the year-ago quarter.

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 to be in the following ranges: At American Income, for the full year 2017- 7,000 to 7,200; for 2018- 7,200 to 7,500. At Liberty National, for the full year 2017- 2,050 to 2,150; for 2018- 2,100 to 2,300. At Family Heritage, for the full year 2017- 1,020 to 1,060; for 2018- 1,090 to 1,150.

Approximate life net sales are expected to be as follows: At American Income, for the full year 2017- 7% growth; for 2018- 6% to 10% growth. At Liberty National, for the full year 2017- 16% growth; for 2018- 10% to 14% growth. In Direct Response, for the full year 2017- 10% decline; for 2018- 2% to 6% decline.

Health net sales are expected to be as follows: At Liberty National, for the full year 2017- flat; for 2018- flat to 3% growth. At Family Heritage, for the full year 2017- 8% growth; for 2018- 4% to 8% growth. At United American Individual Medicare Supplement, for the full year 2017- flat; for 2018- 3% to 7% growth.

I will now turn the call back to Gary.

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

Thanks Larry. I want to spend a few minutes discussing our investment operations. First, let's talk about excess investment income.

Excess investment income (which we define as net investment income less required interest on net policy liabilities and debt) was $61 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 was up 9%. The higher than normal increase is due primarily to higher investment income resulting from the decline in the negative impact from the lengthy delays in receiving Part D reimbursements. For the full year 2017, we expect excess investment income to grow approximately 8% and excess investment income per share to grow around 11%.

Regarding the investment portfolio

Invested assets were $15.6 billion, including $14.9 billion of fixed maturities at amortized cost. Of the fixed maturities, $14.3 billion are investment grade with an average rating of A-, and below investment grade bonds are $661 million compared to $753 million a year ago. The percentage of below investment grade bonds to fixed maturities is 4.4%, down from 5.4% a year ago. The decline is due primarily to upgrades of bonds that were previously classified as below investment grade.

With a portfolio leverage of 3.7X, the percentage of below investment grade bonds to equity, excluding net unrealized gains on fixed maturities, is 16%, down from 20% a year ago. Overall, the total portfolio is rated BBB+, just slightly under the A- of a year ago.

Regarding investment yield

In the third quarter, we invested $376 million in investment grade fixed maturities, primarily in industrial sectors. We invested at an average yield of 4.43%, an average rating of BBB+ and an average life of 26 years.

For the entire portfolio, the third quarter yield was 5.64%, down 13 basis points from the 5.77% yield in the third quarter of 2016. As of September 30, the portfolio yield was approximately 5.63%.

The midpoint of our guidance assumes an average new money yield of 4.6% in the fourth quarter and a weighted average rate of 4.9% in 2018.

We are still hoping to see higher interest rates going forward. 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 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 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 benefit from higher interest rates, Torchmark would continue to earn substantial excess 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 third quarter, we spent $80 million to buy 1 million Torchmark shares at an average price of $77.34. So far in October, we have used $12 million to purchase 144,000 shares at an average price of $80.91. Thus, for the full year through today, we have spent $255 million of Parent Company cash to acquire more than 3.3 million shares at an average price of $76.65. These purchases are being made from the Parent Company's excess cash flow.

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. We expect the Parent Company's excess cash flow in 2017 to be around $325 million. With $255 million spent on share repurchases thus far, we can expect to have approximately $70 million available for the remainder of the year from our excess cash flow plus other assets available to 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 of Parent assets at the end of 2017, absent the need to utilize any of these funds to support our insurance company operations. For 2018, we preliminarily estimate that the excess cash flow available to the Parent will be in the range of $310 million to $320 million.

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. We intend to target a consolidated RBC of 325% for 2017 and 2018.

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

As Gary noted earlier, during the third quarter we saw growth in the direct response underwriting margin--the first time in several quarters. The margin, as a percent of premium, was 15.6%, up from 15.2% in the year-ago quarter. While higher claims will cause the underwriting margin to be lower for the full year 2017 versus 2016, the increase in the quarter was fully in line with our expectations.

On previous calls, we noted that we anticipated the margin for the full year of 2017 to range between 14% to 16%. We still anticipate the margin for the full year to be near the midpoint of this range or 15%. While it's still very early, we currently estimate the margin percentage for direct response will remain in the 14% to 16% range in 2018.

Now with respect to our guidance for 2017 and '18--we are projecting the net operating income from continuing operations per share will be in the range of $4.77 to $4.83 for the year ended December 31, 2017. The $4.80 midpoint of this guidance reflects a 7% increase over 2016. The increase in the midpoint of our guidance is primarily attributable to the continued positive outlook for life underwriting income at American Income and in our various health insurance businesses. For 2018, we estimate that our net operating income per share will be in the range of $5.00 per share to $5.25 per share, a 7% increase at the midpoint from 2017.

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

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

Hi good morning. I have a couple of questions. First, on direct response margins. I think they improved for the second consecutive quarter on a sequential basis. So if you could give us some insight on what's driving this? And then your 2018 margin guidance is consistent with '17 and I recognize it's a pretty wide range. Do you expect to see improvement as you go through 2018 or should they -- should margins be roughly flat over the next year? And then I had a question on sales, on whether you have seen an impact from the hurricanes, or do you expect an impact on the hurricane -- from the hurricanes especially in Florida, Texas, in the fourth quarter on sales?

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

Morning Jimmy, yes with respect to the direct response margin, really, what you're kind of seeing was what we had anticipated over the year, a little bit of seasonality, in that the expenses -- the claims were running a little higher the first couple quarters. They were more -- closer at the bottom end of that range. And then here, for second half of the year, we're really just -- we are seeing the policy obligation percentage being more at the top end. That is kind of the pattern that we were really expecting to see over the course of the year. And I think, again, it's largely due to some seasonality. As we look into 2018, it could be, especially on a quarterly basis, fluctuating anywhere in that 14% to 16% range, but we really just kind of see it flattening out here for the next year. And as we move forward from that, too early to really see where we go on beyond '18, but probably following somewhat of the same pattern again with a little seasonality in 2018.

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

Jimmy this is Larry. I'll address your hurricane question. Overall, the hurricanes slowed sales and recruiting in the three exclusive agencies during September. We think recruiting and sales should return to normal levels during the fourth quarter. The Florida hurricane caused United American sales to be lower-than-expected in the third quarter, direct response sales were not affected by hurricanes during the third quarter, but we think sales will be down about 1% to 2% in the fourth quarter. There's a lag between circulation in direct response and responses from applicants, so the impact will be felt a few weeks later than it was in the agencies.

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

And just following up on direct response margin, is it fair to assume that there's a block within the overall business, the block written with prescription drug data, that's really what's pressuring your margins, the rest of the business is higher? So over the next several years, as that block becomes a smaller proportion of the overall in force mix, then margins should naturally improve, but it's -- they're going to be depressed versus historical levels given lower margins on that part of the business?

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

Jimmy, that's exactly correct. The margin that we're putting on, on the new business is higher than what's being reported today. So we do see that as we – you know that business starts to blend in and the 2011 to 2014 block really starts to run off that we would see, eventually, that margin increasing. But there are a lot of different factors that work into that and it could just take a little bit of time for that to occur.

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

Okay thank you.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Hi, thank you. Frank, you mentioned estimated free cash flow for 2018 of $310 million to $320 million, which is a little bit below the $325 million you expect for '17. Is this just due to the strong sales growth, or is there any other reason that you expect that to decline year-over-year?

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

Yes. Really, the drop from -- that we're looking to see for next year's free cash flow really stems from, if you remember, in 2016, which is driving our -- the dividends that we have here in 2017 and the free cash flow in 2017, the 2016 statutory earnings had some Part D operations still in them. That has fallen off, and of course, we don't have the Part D income in our 2017 statutory income. The after-tax earnings that we had in '16 with the sale was a little over $20 million, so that's really coming off the books that we're not seeing again. I think looking forward, then we should be at a kind of a low point, if you will, and we should be able to move forward after that, after 2018.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Got it. And then your EPS guidance, are you assuming that, that $310 million to $320 million is kind of the proxy for share repurchases?

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

Yes.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Okay. And then just one question on health margins, which continue to come in a bit ahead of your expectations, and you mentioned favorable experience, but should we infer that - -, that business is more profitable than you initially expected? And I guess, on that note, what are you assuming for health margins in your 2018 guidance?

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

Yes. Overall, we really think that the difference is primarily at Liberty National and American Income where we both had some favorable claims here in really the second and third quarter that we see continuing on through the remainder of the year. Looking forward to -- and it is just being a little bit more profitable than what we had anticipated and especially at American Income, it just -- really, the claims have been at the really very low end on a quarterly basis of what we would kind of normally see. Looking forward into 2018, I think for Liberty National, continuing probably close to those same levels, maybe coming back just a little bit, but we're thinking the overall margins will probably be in that 23% to 25% range. And then for American Income, probably still remaining in that 48% to 50% range.

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

Erik, this is Gary. The overall margin is going to be very similar in '18 as it was in '17, which is similar to '16. So we've had some changes within the mix, but it's still going to be, overall, will be about the same profit margin.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Got it, thank you.

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

Hi thanks, good morning I just had a couple 2018 expectation questions. I guess, one, can you talk about your expectations -- for the overall life underwriting margin, could you talk about your expectation for the growth in 2018?

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

Ryan, on the -- as far as underwriting on the life side, remember, this is really early. We'll refine this more when we get to February, but we're looking at somewhere between a 4% and 8% increase in life underwriting margin in 2018.

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

Got it. And then can you, I guess, same for excess investment income, what are your expectations for the growth in 2018 there?

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

There, we're looking at somewhere between 2.5% to 4% growth, at the midpoint a little over 3%. And that would translate into about a 7% increase on a per share basis.

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

Okay great thanks a lot.

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

Ryan snuck my -- 2 of my questions. The last one I had was on American Income margin improvement that we saw this quarter. You seem to suggest, I think, it's perhaps sustainable. Anything specific? Is it driven by better revenues or something on the expense side?

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

Yes at this point in time, Bob, there's really nothing that's very specific with respect to that. We -- just are seeing some favorable claims here the past couple of quarters, clearly, a little bit better than what we've historically seen. When you look at that overall margin, it's typically been in that 31% to 32% to 32.5% range. We're looking at being -- year-to-date, we're close to 32% and we, at least, for the remainder of the year, we do see, with the favorable results that we've had so far, really continuing in through the remainder of the year and probably being somewhere in that 32% to 32.5% range for the full year on that margin. And at this point in time, and Gary said, it's really early and difficult to say, we're really looking at probably still being in that 31% to 33% range for 2018 you know and probably at the midpoint, still being right around that 32%.

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

Bob, the thing that has caused margins to be up a little bit is the policy obligations, where last year, policy obligations were 32%. Year-to-date, that's where we are, but we -- the quarter was at 31%, and we look for that to be fourth quarter as well. Does that improvement continue? We think it will. That's not a big difference between 31% and 32%. And over -- if you go back in the past, we've been in that 31% to 32% range in terms of policy obligations. Right now, it looks like the 31% is going to hold. But we'll know more when we get to February after we've had another quarter's experience.

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

So it's just favorable mortality, or just more revenues?

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

Well I think it's favorable mortality, but also, it's -- there's - - a part of it is due to the conservation program providing more revenue. But I think the bigger part of it is improved mortality.

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

Okay. And that's just through better underwriting or just luck? Or I mean, I'm just trying to -- extrapolation of that trend?

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

Well I think it's too early to determine if that trend is going to continue.

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

Okay

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

We think it'll continue until the end of the year...

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

It may be luck, it may be better underwriting. You're not sure, you haven't figured it out. The fine -- you haven't parsed the fine difference there?

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

Well, it is something we're continuing to take a look into to make sure that we do better understand what's really driving that.

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

Thanks Frank and Gary.

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

Sure

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

Thanks for taking the question. I have one on the RBC ratio, and I guess, more specifically, just given that the denominator is a tax-affected item, what would you say would be the expected impact of potential tax reform? And would it have any implications on your cash flow guide for 2018?

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

Yes. Alex, no, you're exactly right in that, if there is some tax reform, that it can have some impact on that -- on the RBC factors themselves and the tax benefits that are assumed in getting those. So clearly, we would end up having some reduction in our RBC percentage from that. We've estimated that if the tax rates were to go down from about 35% to 25%, there probably would be an RBC reduction of around 50 basis points. You know and at this point in time, it's really difficult to determine how the regulators and rating agencies will react to that and what may be an appropriate RBC percentage -- really should be targeted going forward with that. But at this point in time, we are comfortable that we can fund whatever additional capital might be required either through the issuance of additional debt or the excess cash flow if necessary. But at this point in time, we would think that we don't see that we would need to -- or at least we're not anticipating that we would need to reduce our use of excess cash flows to fund any shortfall. You have to remember also that the tax reform is also going to be generating lower current taxes as well, so that will be replenishing that over time as well.

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

Got it okay, thank you.

Operator

And there appears to be no additional questions at this time. Mr. Majors, I'll turn things back over to you for any additional or closing remarks.

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

Okay. Thank you for joining this morning, and we'll talk to you again next quarter.