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Price (Mar. 3, 2003 @ 1:47pm) \$12.96  
 52-Week Low \$12.51  
 52-Week High \$29.70

**Company Profile**

UnumProvident Corporation provides group disability and special risk insurance. The Company provides disability insurance, as well as group life insurance, long-term care insurance, and payroll-deducted voluntary benefits offered to employees at the worksites. UnumProvident operates around the world.

Source: Bloomberg

# UnumProvident: Don't Renew Our Policy

Recommendation: **SELL**      2,500 Shares @ \$32,400 MV

- UnumProvident's credit rating was lowered from A- to BBB+ and further credit rating drops are expected.
- The DCF valuation showed that the Intrinsic Value of UnumProvident is \$32.58. However, we believe Unum's WACC will increase due to a probable increase in Beta and cost of debt. Thus, the intrinsic value of Unum is likely to continue to decrease.
- UnumProvident's has invested heavily in Internet initiatives and foreign growth. The earnings growth associated with these investments are not expected to materialize for 3 to 5 years, if at all.
- UnumProvident has increased its MBS investments in 2002 by 40% to \$5.6 billion, thereby increasing its risk to default mortgages. Also, it increased its credit risk by increasing junk bonds to about 10.5% of its bond portfolio.
- **Our Bet:** The market has already discounted Unum for various qualitative issues, and we believe further price decreases are to come.



Current Price	\$12.96
DCF Valuation	\$32.58
P/B Valuation	\$35.41
P/E Valuation	\$27.06
P/S Valuation	\$37.64

**Selected Financial Data**

	<u>UnumProvident</u>
Shares Outstanding	241,587,000
Market Cap.	\$3,130,970,000
EPS (ttm)	\$2.53
LT Growth Rate	10.11%
PEG Ratio	0.51

	<u>UnumProvident</u>	<u>Industry</u>	<u>S&amp;P 500</u>
P/E	5.12	15.84	21.93
P/B	0.46	2.99	4.13
P/S	0.42	0.84	2.80
ROE	5.74%	19.46%	18.45%
Beta	0.98	0.59	1.00

Source: Bloomberg and Multex

## Industry Outlook:

- The Insurance Industry includes providers of life, health, property/casualty, auto, and other lines of insurance, as well as reinsurance companies and insurance brokers. Because the industry as a whole is placing greater emphasis on earning profits, rates are increasing accordingly. Recently, larger conglomerates are focusing more on lucrative lines and getting rid of unprofitable ones.
- Deregulation, globalization, technology, and the threat of terrorism have shaken up the industry causing insurance firms to compete more with financial service firms. As a result, banks, investment companies, and insurance firms have to provide a wide range of financial services to their customers. Although consolidation has been slower for insurance companies, when compared to commercial banks, niche insurance companies – like UnumProvident – will be threatened by the growth of these larger financial conglomerates.
- As a result of the widespread concern for positive earnings, large insurance firms have been heavily investing in technology, such as various Internet initiatives, to dispense information and sell products more quickly. By mid-decade, analysts predict UnumProvident and others to increase its bottom line 10% -15% to pay for internet initiatives.
- After September 11<sup>th</sup>, the insurance industry began selling more life insurance products. However, firms have recently downplayed mortality risk, asbestos claims, and liability suits to their consumers and have begun emphasizing managing investment risks. The demand for UnumProvident's niche products might be threatened by larger firms with a variety of product lines, including investment insurance.
- Financial deregulation amidst international territories, like Japan, has offered ample opportunities for banks and insurance firms as a result of the Gramm-Leach-Bliley Act and "Big Bang". It is likely that UnumProvident with recent management, litigation, and accounting problems will continue their troubled earnings trends and be unaffected by such international expansion.
- The insurance industry historically has very little operating leverage to the economy and usually doesn't attract positive early cycle performance. As a result, the industry will more than likely maintain very little benefit this year even if the economy stabilizes soon.

Sources: Hoovers, Goldman Sachs, ValueLine

## **Business Strategy and Outlook:**

### *Pros*

- ValueLine attributes depressed stock value levels, in part, to investor dissatisfaction with the company's results of late. It seems that the stock's performance has also been hampered by general weakness in the stock markets, plus allegations of unethical claims-handling procedures. ValueLine thinks the current stock price presents an entry point for patient investors by mid-decade. .

### *Cons*

- UnumProvident has been investing much into Internet initiatives and foreign growth. Unfortunately, this investment has not shown much successful growth potential. One of its Internet initiatives, EmployeeLife.com, took an \$11 million impairment on its goodwill in Q42002. Also, Unum's Japanese business is going to suffer a downgrade in its credit rating.
- Standard and Poor's plans to meet with company management by the end of February to discuss concerns about Unum's claim practices and market trends given pressure in the disability market. Recent media reports have alleged that UnumProvident engages in unethical claims-handling procedures and UnumProvident's claims practices are being scrutinized by state regulators in California, Georgia and Tennessee.
- UnumProvident is very much a niche player. It is the leading provider of group - and individual-disability insurance and owns a few life insurance companies. Given this lack of diversification in insurance exposure, UnumProvident is very much at the hands of its niche market and its niche market is not expected to perform well.
- According to Goldman Sachs, the management team and franchise value of UnumProvident scored last compared to its industry competitors. Also, UnumProvident was ranked most likely to revise its earnings and to miss its earnings estimate for 2003.
- UnumProvident currently has multiple lawsuits filed against them, including seven class action suits alleging that a series of materially false and misleading statements made by management to the market caused the Company's financial results to be inflated. In January, a California court ruled that UnumProvident acted with malice and fraud when it denied disability indemnification to a doctor and awarded the doctor \$31.7 million.

Sources: Goldman Sachs, ValueLine, Bloomberg, Yahoo! Finance

## Current Trading Data:

<b>UnumProvident Corp.</b> NYSE: UNM		P/E	Market Cap
		8.61	\$3.130B
		PEG	Div/Share
		0.52	\$0.59
Close	Change	EPS (ttm)	Yield
\$12.78	-\$0.04 (-0.31%)	\$1.51	4.52
Day's Range	1-Yr Target Est	EPS Est	Div Date
\$12.91 - \$13.07	\$21.00	\$2.49	Feb 21
52-Week Range	Volume	Average Volume	Ex-Div Date
\$12.51 - \$29.70	814,300	1,120,181	Jan. 23

Source for Financial Information: Yahoo! Finance

## Comparable Ratio Analysis:

	Unum Provident	Afac Inc.	Ceres Group	Cigna Corp.	John Hancock	Principal Fin.	Prudential	StanCorp	Average
	UNM	AFL	CERG	CI	JHF	PFG	PRU	SFG	
Price	\$12.96	\$30.90	\$1.53	\$42.80	\$27.79	\$28.50	\$30.49	\$49.98	\$28.12
Shares Outstanding	241.59	514.44	34.06	139.37	287.98	334.40	566.13	29.19	268.39
EPS (ttm)	\$2.530	\$1.560	\$0.410	\$6.630	\$2.820	\$2.160	\$2.090	\$4.150	\$2.79
Premiums Earned (\$M)	\$7,453.10	\$8,595.00	\$635.04	\$15,737.00	\$3,377.10	\$3,881.80	\$13,724.70	\$1,383.30	\$6,848.38
Market Cap. (\$M)	\$3,130.97	\$15,896.17	\$52.11	\$5,965.04	\$8,002.96	\$9,530.40	\$17,322.24	\$1,458.68	\$7,669.82
Book Value (\$M)	\$6,844.16	\$6,394.48	\$174.38	\$3,867.52	\$6,229.01	\$6,657.90	\$21,677.08	\$1,152.52	\$6,624.63
ROE	5.74%	13.89%	1.85%	-8.92%	8.54%	-0.75%	2.11%	10.44%	4.11%
<b>P/S Ratio</b>	<b>0.42</b>	<b>1.85</b>	<b>0.08</b>	<b>0.38</b>	<b>2.37</b>	<b>2.46</b>	<b>1.26</b>	<b>1.05</b>	<b>1.22</b>
<b>P/E Ratio</b>	<b>5.12</b>	<b>19.81</b>	<b>3.73</b>	<b>6.46</b>	<b>9.85</b>	<b>13.19</b>	<b>14.59</b>	<b>12.04</b>	<b>10.70</b>
<b>P/B Ratio</b>	<b>0.46</b>	<b>2.49</b>	<b>0.30</b>	<b>1.54</b>	<b>1.29</b>	<b>0.80</b>	<b>1.43</b>	<b>1.27</b>	<b>1.25</b>
PEG	0.51	1.14	0.54	0.62	0.77	1.03	0.96	0.82	0.84

Source for Financial Information: Bloomberg

## Key Points:

- Trading at 5 times earnings, UnumProvident appears undervalued compared to the industry, which is trading at 15 times earnings. However, we feel that the reason for this discrepancy is due to underperformance. UnumProvident has not achieved the expected benefit from being an industry leader following the merger of Unum Corp. and Provident Companies.
- Comparable Valuations:

Current Price	\$12.96
P/B Valuation	\$35.41
P/E Valuation	\$27.06
P/S Valuation	\$37.64
- The comparable valuations and discounted cash flow analysis present UnumProvident in a better light than does the market. We believe that the market has already recognized mismanagement and underperformance with Unum's operations. Furthermore, we assume that the market is skeptical about Unum's increased investment risk, which would cause Unum to have a higher beta. Also, Unum's probable fall from grace into the junk bond status will increase the cost of debt. The compound effect of an increased beta and an increase in cost of debt makes a 9% WACC plausible, which corresponds to a \$11.52 intrinsic value.

## **Valuation Explanations and Financial Reports**

## Discounted Free Cash Flows Valuation

Risk-Free Rate	1.50%		Price	\$12.96
Market Risk Premium	6.50%		Shares Outstanding	241,587,000
Default Risk Premium	1.79%	(BO)	Market Capitalization	\$3,130,970,000
Tax Rate	45.47%	(H)		
Beta	0.98		Short-Term Debt	\$255,000,000
5-Year Growth Rate	8.10%	(M)	Long-Term Debt	\$1,914,000,000
Long-Term Growth Rate	3.00%			
PEG Ratio	0.51			

Weight of Equity	59.08%
Weight of Debt	40.92%
Return (Equity)	7.87%
Return (Debt)	9.79%
After-Tax WACC	6.83%

		2002E			
Net Cash from Operations		\$1,990,700,000.00			
After-tax Interest Expense	+	\$88,549,540.88			
Cash from Operations		\$2,079,249,540.88			
			<b>Future Free C.F.</b>	<b>PV of Future C.F.</b>	
			<b>2003</b>	\$322,299,654	\$301,683,205
			<b>2004</b>	\$348,405,926	\$305,258,750
			<b>2005</b>	\$376,626,806	\$308,876,672
			<b>2006</b>	\$407,133,577	\$312,537,474
			<b>2007</b>	\$440,111,397	\$316,241,664
			<b>2008</b>	\$453,314,739	\$8,496,225,574
Cash from Operations		\$2,079,249,541			
(Net Cash from Investing)	-	(\$1,781,100,000)			
<b>Unlevered Free Cash Flow</b>		<b><u>\$298,149,541</u></b>		<b>PV of All Future C.F.</b>	<b><u>\$10,040,823,339</u></b>

### PV of Free Cash Flows

Total PV of All Future Cash Flows	\$10,040,823,339
(Interest Bearing Liabilities)	(\$2,169,000,000)
Shares Outstanding	241,587,000

**Intrinsic Value \$32.58**

### Sensitivity Analysis

WACC	5.00%	6.00%	6.86%	7.00%	8.00%	9.00%	10.00%
FCF Valuation	\$71.27	\$44.31	\$27.43	\$30.83	\$22.75	\$17.37	\$13.52

### Comparables Valuations

*P/E Valuation:* Industry P/E = 10.70

$$\text{Industry P/E} \times \text{UnumProvident EPS} = 10.70 \times \$2.53 = \mathbf{\$27.06}$$

*P/S Valuation:* Industry P/S = 1.22

$$\text{Industry P/S} \times \text{UnumProvident Sales/Share} = 1.22 \times \$30.85 = \mathbf{\$37.64}$$

*P/B Valuation:* Industry P/B = 1.25

$$\text{Industry P/B} \times \text{UnumProvident EPS} = 1.25 \times \$28.33 = \mathbf{\$35.41}$$

## Financial Statements

### Income Statement

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Net Premiums Earned	\$7,453.10	\$7,078.20	\$7,057.00
Realized Gains (Losses)	(\$239.80)	(\$40.60)	(\$14.60)
Investment Income (Loss)	\$2,085.70	\$2,002.90	\$2,060.40
Income (Loss) Real Estate	\$0.00	\$0.00	\$0.00
Other Operating Income (Loss)	\$389.20	\$354.30	\$329.50
Total Revenue	\$389.20	\$354.30	\$329.50
Insurance Claims/Charge	\$6,582.40	\$6,234.30	\$6,407.50
Underwriting Costs	\$2,215.20	\$2,090.80	\$1,910.10
Other Operating Expenses	\$42.10	\$75.00	\$67.30
Operating Income (Loss)	\$848.50	\$994.70	\$1,047.40
Interest Expense	\$162.40	\$169.60	\$181.80
Net Non-Operating Loss (Gain)	\$0.00	(\$35.20)	\$0.00
Pre-Tax Income	\$686.10	\$860.30	\$865.60
Income Tax Expense	\$312.00	\$278.20	\$301.40
Income Before Extraordinary Items	\$374.10	\$582.10	\$564.20
Extraordinary (Gain) Loss, After-Tax	\$7.10	\$2.90	\$0.00
<b>Net Income</b>	<b><u>\$367.00</u></b>	<b><u>\$579.20</u></b>	<b><u>\$564.20</u></b>
Diluted EPS Continued Operations	\$2.53	\$2.38	\$2.36

Income Statement Source: Bloomberg

### Cash Flow Statement

	<u>Q1-32002</u>	<u>Q42002</u>
Net Income (Loss)	\$272.7	\$124.00
<i>Cashflow from Operating Activities</i>	<i>\$1,183.90</i>	<i>\$806.80</i>
Investments	(\$1,123.60)	(\$328.20)
Other Investing Activities	\$63.00	(\$392.30)
<i>Cashflow from Investing Activities</i>	<i>(\$1,060.60)</i>	<i>(\$720.50)</i>
<i>Cashflow from Financing Activities</i>	<i>(\$135.10)</i>	<i>(\$63.30)</i>
Effect of Exchange Rate	\$0.70	\$0.30
<b>Change In Cash and Cash Equivalents</b>	<b>(\$11.10)</b>	<b>\$23.30</b>

Cash Flow Statement Source: Yahoo! Finance

Balance Sheet

	<u>2002</u>	<u>2001</u>
Short-Term Investments	\$27,704.70	\$24,772.70
Loans and Mortgages	\$3,343.70	\$3,458.20
Fixed Income Securities	\$0.00	\$0.00
Equity Securities	\$27.90	\$10.90
Real Estate Investments	\$37.10	\$51.80
Other Investments	\$38.60	\$30.40
Total Investments	\$31,152.00	\$28,324.00
Cash and Near Cash	\$144.70	\$123.90
Net Receivables	\$6,575.10	\$6,825.30
Net Fixed Assets		
Def. Policy Acquisition Costs	\$2,981.60	\$2,674.80
Other Assets	\$4,406.10	\$4,494.70
<i>Total Assets</i>	<i>\$45,259.50</i>	<i>\$42,442.70</i>
Claims and Loss Reserves	\$1,926.00	\$1,926.10
Premium Reserves		
Life Policy Ben.	\$28,967.00	\$27,511.20
Other Insurance Reserves	\$2,582.80	\$2,585.60
Total Insurance Reserves	\$33,511.80	\$32,022.90
Short-Term Borrowings	\$255.00	\$632.00
Other Short-Term Liabilities	\$0.00	\$19.00
Long-Term Borrowings	\$1,914.00	\$1,534.00
Other Long-Term Liabilities	\$2,435.50	\$1,994.90
<i>Total Liabilities</i>	<i>\$38,116.30</i>	<i>\$36,202.80</i>
Preferred Equity	\$0.00	\$0.00
Minority Interest	\$300.00	\$300.00
Policyholders' Equity	\$0.00	\$0.00
Share Cap and APIC	\$1,111.20	\$1,088.30
Retained Earnings	\$5,732.00	\$4,851.60
Shareholder Equity	\$7,143.20	\$6,239.90
<i>Total Liabilities and Equity</i>	<i>\$45,259.50</i>	<i>\$42,442.70</i>
Shares Outstanding	241.59	242.22

Balance Sheet Source: Bloomberg