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CNO - Q1 2020 CNO Financial Group Inc Earnings Call

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MAY 06, 2020 / 5:00PM, CNO - Q1 2020 CNO Financial Group Inc Earnings Call

CORPORATE PARTICIPANTS

Eric Ronald Johnson *CNO Financial Group, Inc. - CIO*

Gary Chandru Bhojwani *CNO Financial Group, Inc. - CEO & Director*

Jennifer Childe *CNO Financial Group, Inc. - VP of IR*

Paul Harrington McDonough *CNO Financial Group, Inc. - CFO & Executive VP*

CONFERENCE CALL PARTICIPANTS

Daniel Basch Bergman *Citigroup Inc, Research Division - VP*

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

Humphrey Lee *Dowling & Partners Securities, LLC - Research Analyst*

Randolph Binner *B. Riley FBR, Inc., Research Division - Analyst*

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

Operator

Ladies and gentlemen, thank you for standing by, and welcome to CNO Financial Group's First Quarter 2020 Earnings Call. (Operator Instructions)

I would now like to hand the conference over to your first speaker today, Jennifer Childe, Vice President of Investor Relations. Thank you. Please go ahead.

Jennifer Childe - CNO Financial Group, Inc. - VP of IR

Thank you, operator. Good afternoon, and thank you for joining us on CNO Financial Group's First Quarter 2020 Earnings Conference Call. Today's presentation will include remarks from Gary Bhojwani, Chief Executive Officer; and Paul McDonough, Chief Financial Officer. Following the presentation, we will also have several other business leaders available for the question-and-answer period.

During this conference call, we will be referring to information contained in yesterday's press release. You can obtain the release by visiting the Media section of our website at cnoinc.com. This afternoon's presentation is also available in the Investors section of our website and was filed in a Form 8-K yesterday. We expect to file our Form 10-Q and post it on our website on or before May 11.

Let me remind you that any forward-looking statements we may make today are subject to a number of factors, which may cause actual results to be materially different than those contemplated by the forward-looking statements. Today's presentations contain a number of non-GAAP measures, which should not be considered as substitutes for the most directly comparable GAAP measures. You'll find a reconciliation of the non-GAAP measures to the corresponding GAAP measures in the appendix.

Throughout the presentations, we will be making performance comparisons. And unless otherwise specified, any comparisons made will be referring to changes between the first quarter of 2019 and first quarter of 2020.

And with that, I'll turn the call over to Gary.



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Gary Chandru Bhojwani - CNO Financial Group, Inc. - CEO & Director

Good afternoon, everyone, and thank you for joining us. Today's call is going to run a little differently from our usual format. I'll begin with comments on the current environment, the actions we're taking to address the pandemic and provide a brief overview of our first quarter business performance. Then Paul will provide more detail on our first quarter results, our balance sheet and our outlook.

I'd like to start with some remarks on the COVID-19 crisis. First and foremost, I hope that you and yours are keeping safe and healthy. Second, every one of us at CNO would like to extend our gratitude to the health care professionals, first responders and many others who are providing essential services that keep our country running. We also extend our deepest sympathies to the families who have lost a loved one to the virus or are ill and recovering. Our thoughts and prayers are with you.

I'd also like to take a moment to thank our many associates who literally worked night and day to mobilize our remote work capabilities and keep our infrastructure running smoothly. I'm incredibly proud of how our associates and agents have responded and adapted to these challenges. They have been working tirelessly to support our customers during this difficult period.

Most states consider our business to be essential under the stay-at-home orders because of the critical protection products that we provide. Never before have we been so forcefully reminded of the importance of the service provided by a company and industry. We pay claims when our customers are in need. We protect what people have spent a lifetime building. And we help people live their lives with a little less worry and a little more financial dignity.

Every business is navigating unprecedented economic fallout from COVID-19. Some economists are forecasting unemployment and GDP estimates that signal a recession unseen since the 1930s. We are truly in uncharted territory, but we will get through this. Thankfully, CNO is operating from a position of strength.

There are 5 key takeaways I highlight for you. First, our capital and liquidity remain strong. Even under our severe stress scenario, we expect to maintain our dividend and have the capacity to resume share repurchases should that make sense as conditions evolve.

Second, our investment portfolio is solid. In earlier periods, we benefited significantly from investment earnings in favorable credit environments. Early in 2019, we proactively reduced the risk profile of our portfolio, positioning it for an eventual change in the credit cycle with a bias towards steady and predictable results. This portfolio repositioning decreased our short-term profits in 2019. But more importantly, it allows us to exit 2019 more conservatively positioned. The recent events suggest that the decision to trade near-term returns in 2019 for safety in 2020 was a prudent decision.

Third, though the pandemic will pressure sales in the near term, our growth engine remains intact. In fact, demand for some of our products, especially our direct-to-consumer life insurance, has increased meaningfully. We believe our performance during the crisis will demonstrate the strength of our business model and the value proposition of our broad suite of products.

Fourth, the business transformation we announced in January positions us well for an increasingly digital world. Across all industries, the COVID crisis is accelerating the transition of more services to a digital and virtual format. Our transformation was developed to capitalize on changing customer expectations. The groundwork laid by our transformation enables us to now accelerate virtual selling, digital service, and lead sharing between channels to support consumers in response to the crisis.

Fifth, we delivered record operating earnings per share in the first quarter, but generated a nonoperating loss, largely due to the GAAP mark-to-market treatment of various assets and liabilities. The majority of the loss reflects noncash impacts. Paul will discuss this in further detail in a few moments.

At CNO, we take the long view. Over the past several years, we've put in the work to strengthen our financial foundation and earn our investment-grade ratings. Our recent transformation puts us on the right path to respond more quickly and effectively to the changing needs of our customers. As an outcome of the crisis, we are further reexamining the way we do business and intend to accelerate our strategic plans in certain areas. In doing so, we are balancing expense discipline with investments targeted at technology, innovation, distribution enhancements and improvements to the way we prospect and reach customers.



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Turning to Slide 4. I'd like to address what CNO has done to navigate through this challenging environment. First and foremost, we're focused on the health and safety of our associates and agents and the continuity of service to our policyholders. I share our approach by our 3 constituencies: Our associates and agents, our consumers and our communities.

Starting with our associates and agents. In mid-March, we instituted a work-from-home mandate in both our corporate and sales offices. Within 10 days, we successfully transitioned 70% of our associates to remote working arrangements. For those business-critical associates whose roles do not allow them to work remotely, we have taken significant steps to safeguard their health and safety at the office.

Many customers prefer to meet with our agents in a face-to-face setting. To assist, we deployed enhanced technology tools and training for our exclusive agents to allow them to serve consumers through virtual consultations and digital insurance applications. Although we cannot predict what the long-term holds, it was important to reaffirm our commitment to our workforce. Last month, we communicated that there would be no associate reductions due to COVID-19 for at least the balance of this year. We also introduced financial support programs for our exclusive agents who have seen their businesses disrupted and their livelihood challenged.

In response to COVID-19, numerous health and well-being resources were made available to eligible associates, which you can see on the slide. Our exclusive agents, financial advisers and customer care centers remain fully engaged and available for our more than 1.3 million policyholders.

We are also working with consumers who may be experiencing financial difficulty. We provide an extended period of time to make premium payments without the risk of losing their benefits during these difficult times. It is precisely in situations like these that our exceptional client service is so important.

For our communities, CNO committed to maintaining our 2020 budgeted donations for corporate philanthropic partners. Associates are participating in virtual volunteering opportunities offered through our team CNO volunteer program. CNO and senior leaders also donated \$300,000 to 2 financial assistance funds to support agents and associates within the CNO family that have been impacted by COVID-19 or other personal financial hardships.

The actions we are taking to respond to the pandemic are consistent with our core values and our commitment to social responsibility. We realize that our long-term success is tied to the collective well-being of our customers, our associates, our agents and our communities. It is our privilege and duty to support these constituents. We embrace this role.

I'd like to now dig more deeply into the -- our businesses and the impact from the pandemic. I was very pleased with our first quarter operating progress and record results. We successfully implemented our business continuity plan with minimal disruption and no significant loss of operational capacity. Today, all key operational functions are running smoothly. This includes our call centers, underwriting, claims processing and other shared services. Our service levels remain strong. We also implemented additional cybersecurity precautions to ensure that associates working remotely have systems that meet our rigorous security standards.

Turning to Slide 5. The first quarter was divided into 2 distinct periods. Our sales performance through early March was solid and then slowed meaningfully in the last 2 to 3 weeks of the quarter as states and consumers responded to the pandemic. As a result, our first quarter sales reflect a blend of those 2 periods. From an operating earnings perspective, we felt very little impact of the crisis in the first quarter.

Operating earnings were up 28%, and operating earnings per share were up 41% to a record \$0.58. Even if we exclude the outperformance from our non-allocated investment income and the benefits from a slightly lower tax rate, our operating earnings per share were still up a strong 20%. This was due to growth in fee income, a reduction in our corporate expenses and a lower share count due to our share repurchase activity. Paul will cover all of this in more detail during his prepared remarks.

Both insurance policy income and insurance product margin were up year-over-year, reflecting both the diversification of our business and its resiliency in the face of continued interest rate headwinds.

I'd also like to note that our expenses decreased by \$4 million or 2% year-over-year as we captured efficiencies in certain areas while continuing to invest in growth.

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Turning to our growth scorecard on Slide 6. Despite the COVID-19 impact on our sales in the second half of March, our top line results were still strong for the quarter. We had growth in 4 of our 5 scorecard metrics. Life and health sales were up 7%, our seventh consecutive increase. Annuity account balances were up 8%. As expected, in the context of continued low interest rates and resulting pricing actions, annuity sales were down 7%.

Turning to our Consumer business on Slide 7. For the full quarter, life and health sales were up 8%. Our Consumer business entered the quarter with good momentum. Life and health sales were up 14% from February. Towards the end of the quarter, as many parts of the country started to shelter in place and face-to-face meetings slowed, we saw a steep decline in sales. As a result of previous investments in technologies such as electronic applications and CRM tools, we were able to quickly transition both our field and telesales agents to work remotely. Agents are conducting virtual sales presentations and using digital and voice signatures. This has allowed our exclusive agents to regain sales traction, albeit at lower levels.

Direct-to-consumer life sales are surging, and this channel serves as a key lead source to our exclusive agents. We are encouraged by the demographic makeup of our in-force book. A disproportionate number of our life, health and annuity policyholders are over age 65. For those that are retired, they may not be as impacted by the economic disruption. At the same time, the crisis underscores the crucial need for insurance and financial protection products and the peace of mind our suite of products provides.

Annuity sales, as I mentioned, were down 7% in the first quarter as compared to 25% growth in the comparable 2019 period. Knowing that our sales would be affected, we took additional pricing action during the quarter. We continuously manage the participation rates on our annuities in order to balance sales growth and profitability in the current low interest rate environment. As has been the case in prior periods, we will accept lower sales when market conditions warrant. This ensures that we are putting business on the books that meet our return threshold. We remain comfortable with this trade off and will continue to employ the same discipline in similar circumstances.

Agent recruiting and retention continues to be strong. Our producing agent count was up 2% in the first quarter on top of 3% growth in the same period last year. Initially after the shutdown began, our efforts to license new agents were stymied by the closure of state insurance testing centers. More recently, many states have agreed to issue temporary licenses, and in some areas, testing centers are reopening. Consistent with our experience in prior periods of job disruption, we expect the current environment to create a tailwind for our new agent recruiting efforts. Through our national network of offices, we have the ability to create new insurance agent jobs in communities across the country.

With stay-at-home orders in place across much of the country during Q1, the health crisis is hastening the movement to digital purchasing of more products and services, including insurance. Since physical distancing guidelines went into effect, we have seen a significant increase in our website traffic and digital sales.

Recall that in January, we announced our business transformation that consolidated our 3 segments into 2 divisions, Consumer and Worksite, to enable cross-channel efficiencies and better serve our customers. I'm pleased with the initial progress we've made to reduce the barriers between our businesses. For example, in late March, when our exclusive agents were increasingly unable to meet with prospects face-to-face, we ramped up our direct-to-consumer advertising spend and accelerated the lead sharing with our exclusive agent force. This translated to higher lead conversion rates and higher premiums per sale. This ability to flex resources across channels demonstrates the value we can unlock under our new structure. We have a number of other cross-channel collaboration programs underway.

Turning to Slide 8 in our Worksite business. Our Worksite business also began the year very strong. Through the bulk of the first quarter, we were on track for another double-digit quarter. Worksite producing agent growth was up a healthy 13% in the first quarter, sales were up 12% through mid-March. In the back half of March, sales decreased sharply. Responding to the pandemic, employers diverted their attention to crisis response, limited office visitation, and in most cases, closed their offices altogether. We ended the quarter with total Worksite sales down 1%.

Web Benefits Design, or WBD, our benefits administration technology platform, performed well with fee revenue up 8%. The integration of WBD remains on track, and we're seeing solid progress in our cross-selling efforts. Approximately 6% of worksite insurance sales this quarter were attributable to WBD-related relationships in the quarter.



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We expect a steeper path to recovery within the Worksite business than in Consumer business given its greater reliance on face-to-face sales at worksite locations. That said, we have armed our agents with virtual sales tools, and they are actively engaging with current customers and existing employer clients to drive sales.

The demographic breakdown of our employer groups is also encouraging. More than 70% of our covered employee base are employed by state and local governments, primary and secondary schools, utilities, and other public service-oriented organizations less likely to be impacted by the pandemic.

Turning to Slide 9. We returned \$99 million to shareholders in the first quarter, including \$83 million in the form of share repurchases. In mid-March, as financial markets began to deteriorate due to the uncertainty surrounding the ultimate severity and duration of the pandemic, we suspended our share repurchase activity. Paul will provide more detail in a few moments.

Before I turn it over to Paul, I'd like to make a few comments on our outlook. From where we sit today, it is too soon to predict when the country would return to normalcy and what that path will look like. But you can be assured that we remain laser-focused on delivering value to our customers, our communities and our shareholders as we navigate through these unprecedented times.

Despite these significant short-term challenges, our franchise remains healthy and our strategies and priorities remain consistent. We are benefiting today from the actions we've taken over the last several years to diversify our business, strengthen our balance sheet and manage risk in our investment portfolio.

In the tragedy and economic crisis brought on by COVID-19, we recognize and embrace our duty to help those that count on us. Nothing is more important than ensuring our ability to keep the promises we make with every product we sell. We know the responsibility that rests with us and we take it very seriously. We are well positioned to weather what is ahead of us, and I am confident that we will exit this crisis as a stronger and more resilient company.

And with that, I'll now turn it over to Paul.

Paul Harrington McDonough - CNO Financial Group, Inc. - CFO & Executive VP

Thanks, Gary, and good afternoon, everyone. I'll begin by providing a bit more detail on our first quarter results and then share our outlook for the balance of the year.

Turning to the financial highlights on Slide 10. As referenced at our Investor Day in February, we have adopted a new reporting framework this quarter, which we think provides better transparency and also better illustrates the value drivers of our business. As Gary mentioned, the pandemic had no material impact on our first quarter operating earnings, which were up 28% from the prior year period. This was driven primarily by significant outperformance in variable investment income. It also reflected growth in insurance product margin and fee income and a decrease in expenses. As Gary mentioned, on a per share basis, operating earnings were up 41%, benefiting from our strong free cash flow, which funded share repurchase, reducing our share count by 4% sequentially and 10% year-over-year.

The pandemic-related investment climate at quarter end with its lower treasury rates, wider credit spreads, lower equity valuations and higher equity volatility did have a significant impact on our nonoperating earnings, resulting in a net loss for the quarter of \$21 million. This was driven by mark-to-market changes to certain investments and on the embedded derivative in our fixed index annuity reserve. The change in the allowance for credit losses required under a new accounting standard also contributed. It's worth noting that over half of the credit allowance on our balance sheet, as of March 31, relates to the securities held by variable interest entities that we consolidate under GAAP, but for which we have limited economic exposure. Our results for the quarter included a \$34 million tax benefit related to a provision in the CARES Act, which I'll touch on in further detail in a moment.

Operating return on equity, excluding significant items, was 11.1% in the first quarter of 2020 compared to 10.5% in the prior year period, both on a trailing 12-month basis. Given the challenging operating environment, we are keeping a close eye on our overall level of discretionary spend.



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Allocated expenses increased by less than \$1 million, roughly half of 1%, due to increased expense on mandatory spending. Expenses non-allocated products decreased by \$4.3 million, driven by declines in legal and other corporate expenses.

As we think about transitioning from the current environment, we are already reconsidering both how and where we work, and if previous levels of business travel still makes sense. Ultimately, this could have significant ramifications for our physical footprint and fixed cost base, opening up opportunities for incremental expense reduction.

Turning to Slide 11. As reflected on this slide, we benefit from a diverse product offering with each product contributing meaningfully to earnings. In the first quarter, total insurance margin was up modestly over the prior year period with growth in the annuity, long-term care and life margin, offset by a decrease in the health margin. This reflects growth in the reserves and related invested assets, offset by a decline in the yield on those investments.

Turning to Slide 12 and our investment results. Investment income allocated to products increased by \$2.3 million or 1%, reflecting a 4.9% increase in net insurance liabilities, partially offset by a 19 basis point year-over-year decline in the average yield on those investments to 4.97%. Sequentially, the average yield declined 5 basis points.

Investment income not allocated to products increased year-over-year by \$14.1 million driven by an increase in income from alternative investments, call and prepay income and trading income, offset by lower COLI performance. Recall that we record our alternative investment results on 1 quarter lag. Our new money rate of 4.46% was up 8 basis points year-over-year and 38 basis points sequentially, reflecting opportunistic investments and high-quality securities during the market dislocation in March.

Turning to Slide 13 and an overview of our investment portfolio. Our up-in-quality trade last year positioned our portfolio to perform well through this new phase of the credit cycle. In early 2019, we significantly reduced our exposure to higher risk sectors including BBBs, equities and high-yield bonds.

For the quarter, average invested assets were \$22.6 billion. At March 31, 86% were fixed maturity. Approximately 91% of our fixed maturity portfolio is investment grade rated with an average rating of A. The low investment grade corporate bonds were 2.7% compared to 3.3% a year ago. We are underinvested in sectors generally considered to be high risk in the context of the pandemic including energy, airlines, gaming, hotels, nonessential retail and restaurants. On a consolidated basis, our investments in these sectors comprised 3.9% of our general account.

Approximately 6.7% of our assets are invested in commercial mortgage loans. We are underweight relative to most peers. We are well diversified by product -- property type and geographic concentration. 100% of our investments are first mortgages, 97% are rated CM1-2, the weighted average loan-to-value ratio is 51%, and the weighted average debt service coverage ratio is 1.96x. Our loan portfolio is resilient with conservative stress test assumptions.

Approximately 9% of our assets are invested in residential mortgage-backed securities, 99.9% of which are rated NAIC 1 or 2, 76% of which were purchased at discounts to par value. Our RMBS portfolio is loss-remote using conservative stress test assumptions.

CLOs comprised 1.7% of our assets. This includes equity in the CLOs that we manufacture of \$114 million and third-party debt CLOs of \$400 million. Our CLO debt portfolio is comprised entirely of AAA to single A-rated assets with significant cushion against various stress scenarios.

According to our stress testing, credit conditions would have to deteriorate well beyond those of the great financial crisis before any principle would be at risk. You will find further detail on our investment portfolio in the appendix to our presentation.

Turning now to Slide 14. The CARES Act included a provision that allows NOLs created after 2017 to be carried back and repeals the 80% limitation for utilization of NOLs created after 2017. This lines up perfectly with our circumstance as we generated losses in 2018 related to our LTC transaction, and we paid cash taxes in 2017 and a bit in 2016. As a result, the provision allows us to accelerate the utilization of \$480 million of life NOLs and restores \$165 million of non-life NOLs. In addition, the tax rate differential between the current 21% rate and 35% rate in the carryback years results in a \$34 million permanent tax benefit that, as I mentioned previously, we recorded in our first quarter nonoperating earnings.

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Turning to Slide 15. We continued to generate strong free cash flow to the holding company in the first quarter with excess cash flow of \$82 million or 98% of operating income. As Gary mentioned, we returned \$99 million to shareholders in the quarter including dividends of \$16 million and share repurchases of \$83 million.

Turning to Slide 16. At quarter end, our consolidated RBC ratio was 406%, down slightly from 408% at year-end 2019 and modestly above our targeted range of 375% to 400%. This reflects adverse impacts on RBC as a result of the pandemic-related investment climate, offset by favorable impacts related to the CARES Act tax provision and a change in reserving methodology for our fixed index annuities.

Our leverage ratio at 23.8% remains within our targeted range of 22% to 25%. Our Holdco liquidity at \$168 million was above our target minimum of \$150 million. We also had \$314 million of operating company cash and cash equivalents at quarter end.

As a reminder, we have an undrawn \$250 million credit facility with a \$100 million accordion feature and we have no debt maturities prior to 2025. Following a review of our capital and liquidity in the context of various pandemic-related stresses, Fitch recently affirmed our investment grade rating with a stable outlook.

Turning to Slide 17 and our outlook for the remainder of 2020 and beyond. Given the enormous amount of uncertainty surrounding how the COVID-19 pandemic will play out and the continued economic impact it will have, we are suspending the guidance we had previously provided regarding earnings per share growth and share repurchase capacity in 2020. The potential impact of the pandemic on our results is largely driven by 3 things: Number one, the impact of social distancing on our sales volumes; number two, changes in mortality, morbidity and persistency or lapse rates impacting insurance product margin; and number three, the resulting severe economic recession, driving lower NII through lower interest rates, the impact of credit deterioration on invested assets and capital and potential impacts to reserves and DAC resulting from lower interest rates.

To develop a sense for the range of potential outcomes across these 3 dimensions, we've modeled 2 scenarios, which I'll call our base case and Alt case. These scenarios were based on the IHME model that the White House Coronavirus Task Force has frequently cited in its press briefings. Our base case assumes social distancing practices continue through the end of June, after which economic activity slowly but surely picks up. In this scenario, we assume 80,000 deaths from the virus in the U.S.

In our Alt case, we assume the same as our base case initially, but then a second wave of the virus hits in late July, resulting in an additional 40,000 deaths in the third quarter. And we resume social distancing through the early part of next year. In both cases, we assume certain levels of various macroeconomic variables, including GDP, unemployment, interest rates, ratings migration, among others. In the Alt case, most of these metrics approximate levels seen in the great financial crisis of 2008 and 2009. Some metrics such as unemployment levels are worse.

With respect to the impact on sales volumes, we expect our consolidated second quarter results to be challenged. In April, Consumer Division, life and health NAP was down 24%, and annuity collected premiums were down 19%. As the economy continues to reopen and as our customers and agents become more accustomed to virtual transactions, we expect to gradually return to our prior growth trajectory. Direct-to-consumer channel inside the Consumer Division outperformed in April with life NAP up 28%. This was a record month, and we expect this momentum to continue.

As Gary mentioned, we expect the path to the recovery within our Worksite business to be more difficult. In April, Worksite life and health NAP was down 75%. We expect Worksite sales will remain challenged through the third quarter and begin to stabilize in the fourth quarter in conjunction with open enrollment periods.

With respect to changes in mortality and morbidity, we expect [COVID-19] to have an adverse impact on our full year insurance product margin of approximately \$20 million to \$30 million across the 2 scenarios. It's worth noting that our product suite creates a natural hedge. While higher mortality claims unfavorably impact our life margins, they can benefit our health and long-term care margins through the release of reserves.

With respect to persistency, through April, we did not see any material change in loss rate. Based on our experience during the great financial crisis in '08, '09, we do believe there is a possibility that high unemployment in the current crisis could translate to an increase in lapse rates in the coming



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months. If that does occur, it would benefit current period earnings, but hurt out-year earnings as the base case of invested assets would then, of course, be lower.

Regarding our investment portfolio, we have carefully evaluated a range of potential impacts from the pandemic, including impacts on credit migration, levels of defaults, NII and capital. We used a range of assumptions which are market consistent or in line with [downturn assumptions to] rating agencies and consistent with past financial crisis. We paid particularly close attention to COVID-19 impacted sectors such as real estate, airlines, retail, hospitality and energy, among others.

With respect to the collective impact on earnings, we expect second quarter operating earnings to be meaningfully depressed relative to the prior year period. This is driven by the likely impact of alternative investments which again are reported on a 1 quarter lag and due to the impact of COVID-19 claims on insurance product margin.

Earnings for the balance of the year will likely be pressured by lower interest rates and possible increased pressure on insurance product margin related to COVID-19. Depending on how the virus plays out, these unfavorable impacts could potentially offset a favorable earnings impact with higher lapse rates.

Earnings could also be impacted by a decision to reduce interest assumptions for reserving purposes. We did not believe that was necessary or appropriate as of March 31, but it may be appropriate in subsequent quarters. The impact of the earnings is dependent upon the interest rate assumptions used. As an example, an immediate and permanent reduction in the money rate of 3% would have a relatively modest impact on earnings in the range of \$16 million to \$20 million.

With respect to capital, we expect credit migration to reduce RBC levels by 20 to 30 points across our 2 scenarios, which translates to a reduction of approximately \$100 million to \$150 million in associated capital, all else equal. But this is before the favorable impact on our capital from lower sales volumes, which will reduce capital strain and our in-force book would continue to generate earnings and capital.

Even at the low end of our range of estimated outcomes, which assumes the least favorable assumptions across the 2 scenarios and incorporates additional stress impacts such as lower interest rate assumptions for reserve purposes, we expect to be able to maintain our target RBC levels, debt leverage and minimum holding company liquidity, maintain our quarterly dividend to shareholders, not have to raise capital and have the capacity to resume share repurchases should that make sense as conditions evolve.

And with that, I'll turn it back over to Gary.

Gary Chandru Bhojwani - CNO Financial Group, Inc. - CEO & Director

Thanks very much, Paul. We are navigating through unprecedented times and profound challenges. As a country, this crisis may last longer and be tougher than we expected. But I know we will weather the storm together.

My confidence in the long-term outlook for our company is Steadfast. Our franchise remains strong and our financial position is robust. We have a strong track record of execution and delivering on our promises. Prior to 2017, we were in a de-risking and turnaround mode. Between 2017 and 2019, we pivoted to growth. And going forward, we are focused on maintaining our growth momentum while optimizing profitability as we transform our business to a more customer-centric distribution model.

Turning to Slide 19. We are differentiated by our exclusive focus on middle-income consumers, our diverse distribution channels, and the combination of health and wealth and insurance and security offerings. Nearly 65% of our insurance earnings are generated from our life and health products, and 90% of our revenue is generated from renewal business. We have ample capital, liquidity and reserves, enabling us to absorb shocks while still meeting our commitments.

Our cash flow yield and conversion rates continue to be among the highest in the industry, and we remain disciplined in its deployment. Our investment portfolio is well positioned for both the current cycle and a low-for-long interest rate environment.



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I end by reiterating my gratitude to all of our associates, agents and leaders. They are doing an amazing job of supporting each other and serving our clients during this very challenging time. I couldn't be prouder of this organization and everyone in it. To everyone on the call and to all of our shareholders, please stay healthy and stay safe. Thank you for your interest in and support of CNO Financial Group.

We will now open it up for questions.

Before I hand it over to the operator, I wanted to make just 1 side comment. I know that when Paul was speaking, there were times the audio broke up a little bit, at least for me, that may have been the case when I was speaking as well. So if you need us to restate something or if there was a number you didn't hear, please, of course, feel free to ask, as you can imagine, we're all in separate locations right now trying to navigate this as best we can.

So with that, I will turn it over to the operator.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Ryan Krueger from KBW.

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

In regards to buyback, I guess, can you just give us a sense of kind of what you'd want to see in the external environment before you'd consider resuming it?

Gary Chandru Bhojwani - CNO Financial Group, Inc. - CEO & Director

Yes. I'm going to go ahead and let Paul speak to that, and then I'll jump in if necessary.

Paul Harrington McDonough - CNO Financial Group, Inc. - CFO & Executive VP

Ryan, I would say that we don't have a bright line. What I would emphasize is that based on all the modeling that I just described, in the low end of the range that comes out of that modeling and stress testing, that we have the capacity to buy back shares, and we'll decide whether and when to do that as things continue to evolve.

Gary, would you add anything to that?

Gary Chandru Bhojwani - CNO Financial Group, Inc. - CEO & Director

Yes. I think the only perspective I'd give, I think about buybacks and have this discussion with our Board pretty regularly. I think about it across 3 dimensions: First is, do we have the capacity, and we feel quite confident in our capacity. We're very pleased with how the business are performing. We look at the valuation. We think that the stock is at a very compelling valuation. And the third and final factor are the external factors. And I think we're at a time and a place right now where there's a lot more wisdom in trying to conserve cash and make sure things develop as we expect. So we think there'll come a time and a place, but we think right now, it's smarter to watch the situation unfold.



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

Understood. And then on any -- I guess, any changes on your expense expectations if we -- from the Investor Day in the current environment?

Paul Harrington McDonough - CNO Financial Group, Inc. - CFO & Executive VP

Ryan, it's Paul. I'd say, in general, no. We continue to be very focused on expenses. You'll recall the 2 actions that we took at the end of last year, beginning part of this year, one relating to outsourcing of IT, the other relating to our transformation, both translating to some meaningful expense reductions. We continue to be disciplined just in general and focused on identifying ways to take out costs and be more efficient, some of which we expect to flow through to earnings, some of which we would use to fund our continued growth. As we mentioned back in February at the Investor Day, we do expect that to translate to a reduction in expenses year-over-year.

The one thing that I would say is new is that and I mentioned this in my prepared remarks, as we think about transitioning back to work, not working from home, we are beginning to reimagine what that may look like and, certainly, this is being covered well in the media. We're not the only ones doing it, but we think that, that may very well translate to a lower cost base just in terms of our physical office footprint. So I'd point to just those 2 things, Ryan.

Operator

Your next question comes from Randy Binner from B. Riley FBR.

Randolph Binner - B. Riley FBR, Inc., Research Division - Analyst

I guess I'd like to focus on the kind of the sensitivity and the scenario analysis you laid out on Slide 17. And Paul, actually, for part of that explanation, when you went through RBC impacts that I was not able to hear that because of the phone connection. So could you first review the RBC part of the scenario walk you did? And then on the claims side, I just wanted to understand what I think you said was that, it's more of a lapse rate assumption rather than mortality as being the COVID impact?

Paul Harrington McDonough - CNO Financial Group, Inc. - CFO & Executive VP

Okay. Randy, so with respect to the impact of the current environment on investments, we've modeled an RBC impact of 20 to 30 points across the 2 scenarios. In addition to that, we've also modeled a meaningful earnings impact, so lower NII, some of which would flow through allocated to products, lower assets because of the decline in sales on the margin and potentially lower new money rate from lower interest rates.

With respect to claims, again, our underlying assumption is that there would be between 80,000 and 120,000 deaths in the U.S. And the mortality impact of that across our products, primarily life with a very modest offset in long-term care and supplemental health, would result in an adverse earnings impact between \$20 million and \$30 million across the scenarios. We do not expect any net impact from morbidity. We expect that we'll have some COVID-19 morbidity cases, but that will be offset by a decline in services on long-term care and health and so forth. And I think that covers your questions, Randy. Does that...

Randolph Binner - B. Riley FBR, Inc., Research Division - Analyst

Yes. So then lapse rates specifically are not...

Paul Harrington McDonough - CNO Financial Group, Inc. - CFO & Executive VP

I'm sorry, lapse rate.

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Randolph Binner - *B. Riley FBR, Inc., Research Division - Analyst*

If mortality is what is driving the \$20 million to \$30 million, then -- what part of the \$20 million to \$30 million would be lapse driven?

Paul Harrington McDonough - *CNO Financial Group, Inc. - CFO & Executive VP*

Yes. So as I mentioned, as we thought about how to model potential lapse rates, we went back to our experience in the 2008-2009 financial crisis, where we observed between 0% and 3% increase in lapse rates depending on the product. In this instance, for modeling purposes, we assumed a bit higher than that across the 2 scenarios. But importantly, in building the low end of our range for earnings and free cash flow/capital, we assumed no increase in lapse rates because the impact to earnings and capital from a shock lapse in the first year would actually be favorable.

Randolph Binner - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. And then actually, I'm just going to do one more back to Ryan -- Ryan's question on expenses. So kind of netting everything out, you're going to have a smaller office footprint, but aren't -- I think you also mentioned in your opening comment that you're accelerating some strategic initiatives including what I thought I heard to be IT spend. So kind of going back to the expense goal, wouldn't that accelerate expenses this year?

Gary Chandru Bhojwani - *CNO Financial Group, Inc. - CEO & Director*

So Randy, this is Gary. There are certain areas, and we did some of it in Q1. If you take a look at, as an example, we saw really strong lift from accelerating the time frame when we hand Colonial Penn inbound leads off to Bankers Life agents. So we actually spent more on advertising in the first quarter in order to ramp up that production because we thought that was really working quite well. So there are different categories of expense that we would look to accelerate. And we're trying to constantly walk this balance between doing things like that and other investments that are really going to be important in a new world order. We're walking that balance against the operating. So is it true that in certain categories, we'll accelerate expenditures? Yes, that's absolutely true. Is it true that there won't be anything else to net that out against? I can't say that yet, we're still working through how to balance these things.

Operator

Your next question comes from Erik Bass from Autonomous Research.

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

I want to go back to your stress test comments on the investment portfolio, and I apologize if I missed this. I got the RBC impact, but did you talk about kind of what you're assuming for impairments or credit losses in the different scenarios?

Paul Harrington McDonough - *CNO Financial Group, Inc. - CFO & Executive VP*

Yes. So we haven't given those specifics. We obviously did make specific assumptions. I would say, generally speaking, that the assumptions that we made were in line with what that experience was broadly during the financial crisis.

Eric, I don't know if you want to provide any other -- any additional color here?

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Eric Ronald Johnson - CNO Financial Group, Inc. - CIO

No. Two points -- well, two points. First point. Some of our assumptions you'll see reflected to a degree, in the allowance for losses, which was taken in the quarter, which was developed as a pretty granular asset class level that -- so that's one reflection of it. And I guess I'll just add that one point.

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

Got it. Okay. And then on the kind of the capital ratios overall, you've been in the process of sort of bringing down your targets a little bit for RBC and the Holdco liquidity. How are you thinking about that now? And I'm assuming you're still keeping the same long-term targets, but would you intend to run it a little bit higher buffer to that in the interim just given the uncertainty?

Gary Chandru Bhojwani - CNO Financial Group, Inc. - CEO & Director

So we're changing our targets. So RBC, if (inaudible) as we ran our modeling, we essentially [stalled] for 385 RBC. So within a range, distributing capital of (inaudible) RBC. And paying our dividends and that generates the amount of free cash flow that's available. So it's in that context that we say at the low end of the range of our estimates. [I think there] can be least favorable solution across the scenarios and across the stress testing that we have share repurchase capacity. So we don't see a need to [relax] the requirements in the context of how we see this playing out.

Operator

Your next question comes from Alex Scott from Goldman Sachs.

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

So I guess the first one, I just wanted to get a feel for when I think through Colonial Penn and sort of the surge in interest there, what you've seen so far in April for life and health -- life and health sales, I was just interested in if you could provide any kind of sensitivity we should think about for just the premium level? And how that could trend when we kind of think about those different pieces and the lapses that you mentioned?

Paul Harrington McDonough - CNO Financial Group, Inc. - CFO & Executive VP

Sure. Alex. So as I mentioned in April, our direct-to-consumer life sales through Colonial Penn were up 28%. We expect that momentum to continue. Not sure, Gary, would you offer any additional color there?

Gary Chandru Bhojwani - CNO Financial Group, Inc. - CEO & Director

No. I like the results we've seen in April. I'd like us to continue those. We think there's more opportunity as consumers themselves get more comfortable interacting online, on the phone and so on for these types of products. So we like what we're seeing, and we think there's reason to believe it will continue.

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

Got it. And then maybe as a follow-up on free cash flow generation. I think you talked about \$300 million to \$350 million in the past before deployment. Just be interested in when we kind of look through some of the impacts that you're expected around alternatives and COVID-19 and so forth, would you expect any kind of ongoing impact to those levels? And is there any offset from new business strain that maybe helps offset some of the impact from lower revenue growth and some of the onetime impacts?



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Gary Chandru Bhojwani - CNO Financial Group, Inc. - CEO & Director

Alex, I'm going to have Paul answer that question in just a moment. I just want to come back and add to that last response I gave you because I think there was part of it that maybe got glossed over in our explanation. We've -- for a long period of time, we've had lead sharing between Colonial Penn and Bankers Life. What was different after our transformation in January, we started experimenting with sorting those leads in different ways and sharing them at an earlier point in time with Bankers Life's "physical agents." And we were really very pleasantly surprised by the pickup in sales, the average case size going up and that the sale was taking less time and turning quicker by making some tweaks to which types of leads we share from Colonial Penn to Bankers and the number of days that we lag and so on.

So the point I want to emphasize there, in addition to just consumers being more responsive to that direct-to-consumer advertising and other things we're doing to drive demand, we're also seeing higher close rates, higher average sale, quick return and so on. And that collaboration, as we get better at sifting through the leads and figuring out which ones are more effective and how all that works, we expect that to continue to accelerate. So I don't want to give you the impression this is only about running more ads and getting consumers to be more responsive. There are a number of other things we're doing to bring the collective expertise of our overall consumer channel together. And that's what's got us excited and believing that there's really potential to invest and build new skills and really get more success. So -- I did a bad job answering that question on the first go, and so I wanted to add to that.

Now I'll turn it to Paul to speak to the cash flow question you just asked.

Paul Harrington McDonough - CNO Financial Group, Inc. - CFO & Executive VP

Alex, on the free cash flow, again, that's essentially the output of all of our modeling is when you stress the statutory balance sheet and earnings, how much capital is available to dividend up to the Holdco. And after you tell your expenses and your quarterly dividend, how much would remain? And that's -- so that's net of certainly some capital being freed up relative to our prior expectations on sales. It's net of the most adverse assumptions across the scenarios relative to mortality and RBC impacts. We did not -- as I mentioned before, we did not include an assumption of an increase in lapse rates for the purpose of defining the lower rent range for earnings and capital because higher lapse would actually have a favorable impact to earnings and capital in the current year. So it's net of all those things that we conclude that we have free cash flow that translates to share repurchase capacity. And again, whether and when we decide to do that, we'll determine as things evolve.

Operator

Your next question comes from Humphrey Lee from Dowling & Partners.

Humphrey Lee - Dowling & Partners Securities, LLC - Research Analyst

A question for Paul or maybe Eric Johnson. Looking at kind of interest rate right now and [that would be] kind of how the yield and the spread have developed since your Investor Day, is the thinking in terms of kind of new money yield and spread compression throughout the enterprise still kind of unchanged? Or how should we think about it at least in the near term?

Eric Ronald Johnson - CNO Financial Group, Inc. - CIO

Yes. Humphrey, this is Eric. And what I would say is that the expectations that I came into the year with, with respect to new money rates are not different today. I think we did something in the middle of 440s in the first quarter, which was ahead of that expectation, largely because not only have we been -- I think we've done a good job playing defense, but we also played offense. And where there's opportunities to generate some excess spread and, therefore, margin for the products, we're looking to do that too, reflected in the first quarter. I think -- while the market opportunity isn't as diverse and obvious as we're now into the second quarter, there's still opportunities to play the same pattern of offense. And I would think that when you get at the end of the year, net-net, there's -- it's really uncertain what conditions will be, but I'm comfortable today that we'll achieve



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in 2020 what we thought we would achieve going into the year in some slightly different ways, but we have a lot of skills and tools here, and we'll pull out the ones that we need as conditions warrant.

Humphrey Lee - *Dowling & Partners Securities, LLC - Research Analyst*

Just to follow-up on that. So like I think previously you indicated that you have some appetite to take some of the capital. And then like you said, play some offense and invest in some of the higher yielding assets, given kind of the macroeconomic concern and all that, has that appetite changed?

Eric Ronald Johnson - *CNO Financial Group, Inc. - CIO*

Not at all. I think one word I would insert into your sentence was selectively. We think we have a good quality portfolio and we want to keep it that way. But on several market conditions, there are times where you can buy good risks at good value. And when people are throwing out babies with bathwater, we'll let the bathwater go, we'll take the baby. We can be patient and pick our spots. And I think we did that very effectively in the first quarter, and we're going to continue to do that as conditions warrant through the rest of the year.

We have a tremendous amount of expertise in certain fixed income credit markets. And the market sometimes give us the opportunity to use those skills to understand and take risks that while the market at the moment isn't valuing them properly, we can, and then things go pretty well for us down the line. So we have to play defense and have a good quality earnings stream for the company. But there's no EPS unless we play offense too. We have to get -- keep those in proper proportion. I think we've been doing that. We'll be disciplined when we have to, witness what we did last year. We'll be smart when we need to, witness what we did in the first quarter of this year.

Operator

Your last question comes from Dan Bergman from Citi.

Daniel Basch Bergman - *Citigroup Inc, Research Division - VP*

I know you touched on this in the prepared remarks, but I just want to see if there's any more color you could provide on what portion of your sales typically involve face-to-face interactions? And how we should be thinking about both your ability and customers' receptivity to instead transact digitally or electronically? Just any kind of color on how that breaks down across your products and segments would be great.

Gary Chandru Bhojwani - *CNO Financial Group, Inc. - CEO & Director*

Sure. Thanks, Dan. This is Gary. The short answer is the majority of our sales involve some type of face-to-face connectivity. Now we've seen a lot of that change here in recent years. We've been very pleased with how Colonial Penn has worked, and we've been very pleased with what Web Benefits brings and the ability to enroll consumers over the telephone. We think that will accelerate. And in the earlier longer response I gave to Alex about seeing some early success where we accelerated the ad spend and a little bit of technology spend with Colonial Penn and then handed those leads off. And then those "face-to-face agents," they were interfacing with consumers on a more personal basis whether it was over the phone or over a local computer or what have you. So they weren't necessarily truly physically face-to-face, but they're in their community making contact. And I think that's what's going to start to happen, meaning I continue to believe there's great value in the distribution footprint we have and the local advice we can give. And I think we have the ability to leverage that so that we can provide that type of guidance and counsel and so on without having to be physically there. Now there will become a time when we're able to do that as well. But right now, we think we can navigate the best of both worlds.

But to come back to your question, the short answer is, the vast majority of our sales involve some type of "face-to-face." We just think that the character of that is going to continue to change.



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Daniel Basch Bergman - Citigroup Inc, Research Division - VP

Got it. That's really helpful. And then maybe just quickly shifting gears. I think one of your competitors recently announced a sizable statutory long-term care reserve build following a regulatory review, I think, given some mandated changes to interest rates and some morbidity mortality assumptions. So I just wanted to see and check if there are any comparable reviews by the state regulators for your LTC book that are either in process now or expected? Just any quick thoughts would be great.

Gary Chandru Bhojwani - CNO Financial Group, Inc. - CEO & Director

Okay. I'll let Paul take that one.

Paul Harrington McDonough - CNO Financial Group, Inc. - CFO & Executive VP

Sure. So Dan, we -- I think you probably noted that, that charge by Unum came at the end of a sort of typical 3- to 5-year financial exam. We're at the tail end of ours, and we've certainly not experienced anything like that. And then I guess I would just emphasize the nature of our book. I'd refer you to Slide 25 in our earnings call deck, which just emphasizes the very much lower risk profile of our LTC reserves. And I think I'd leave it at that.

Eric Ronald Johnson - CNO Financial Group, Inc. - CIO

Yes. I think the only thing I would add to that, look at the track record we've had relative to reserves and the absence of charges. And then I try and remind everybody every chance I get. The very fact that we were able to consummate a reinsurance deal with a reputable reinsurer suggests that the book was never as bad as everybody feel. They were able to quantify it and measure the risk and so on. And then we feel that what's left is some of the best parts of the book. So we believe we're in a very different place than the vast majority books out there.

Paul Harrington McDonough - CNO Financial Group, Inc. - CFO & Executive VP

Yes. It's Paul again. I'd add 1 other thing, and that's just a conservative nature of the assumptions that we use in setting our reserves. So for instance, we don't assume morbidity or mortality improvement, nor do we assume new rounds of future rate increases.

Operator

We have no further questions. I turn the call back over to the presenters for closing remarks.

Jennifer Childe - CNO Financial Group, Inc. - VP of IR

We would like to thank everyone....

Gary Chandru Bhojwani - CNO Financial Group, Inc. - CEO & Director

I want to -- go ahead, Jennifer.

Jennifer Childe - CNO Financial Group, Inc. - VP of IR

We would like to thank everyone for joining us today. We look forward to speaking with you again soon.



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Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.

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