September 2013

Aflac

Price: $62

Research Report By
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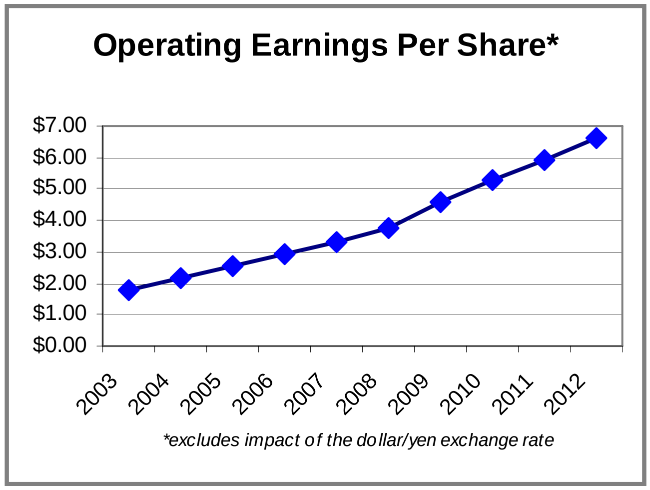


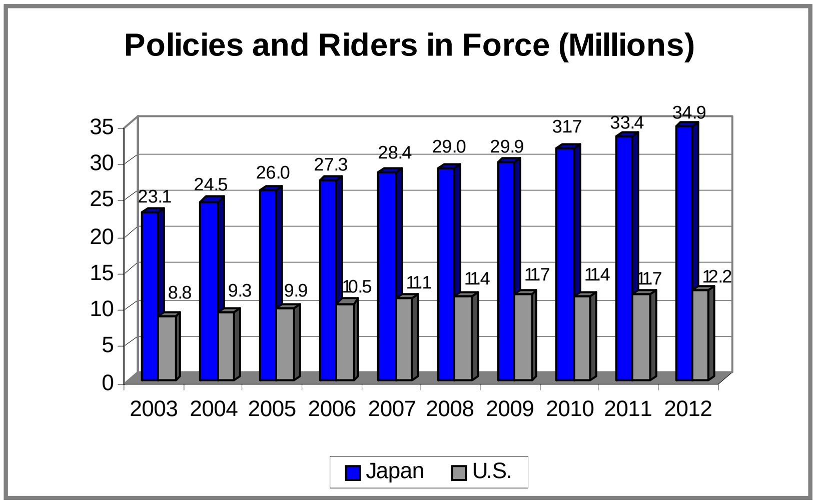
Aflac (AFL) was founded in 1955 by John, Paul, and Bill Amos. The three brothers had little insurance experience, yet, in their first year of operations, AFL sold *6,426* policies. Several years later, the Amos's father died of cancer, and the brothers experienced firsthand how that disease can financially burden a family. From this unfortunate event was born the idea of supplemental cancer insurance. The model is simple: Customers pay a small premium, and in return they receive a lump-sum cash payment (if the policyholder falls ill with cancer) that can be used for expenses ranging from extra medical care to family members' hotel rooms. In addition to pioneering supplemental insurance, Aflac revolutionized the method of distribution. Instead of selling the product door-to-door, the Amos brothers decided to sell policies to employees at their worksites and deduct premiums directly from payroll. This distribution approach has proved to be shrewd, as Aflac now covers 50 million people in the U.S. and Japan.

Aflac Financial Data	2008	2009	2010	2011	2012
Premiums	$14.9B	$16.6B	$18.1B	$20.4B	$22.1B
Net investment income	$2.6B	$2.8B	$3.0B	$3.3B	$3.5B
Realized investment gains (losses)	($1.0B)	($1.2B)	($0.4B)	($1.6B)	($0.4B)
Net earnings	$1.3B	$1.5B	$2.3B	$1.9B	$2.9B
Combined ratio	97.9%	96.4%	95.0%	94.4%	95.1%

AFL has a market capitalization of $28B. Its initial asset base of $50,000 has since grown to over $130B. In 2012, Aflac generated revenue of $25.3B with net income of $2.9B. And operating earnings-per-share (excluding currency effects) have increased 15% annualized over the past decade. Given the firm's low-cost business model, unmatched distribution channels and strong brand awareness (92% name recognition), Aflac is able to consistently sell its insurance products at an underwriting profit. Last year its combined ratio was 95%. ("Combined ratio" includes benefits and claims paid plus operating expenses, divided by earned premiums. A ratio above 100% indicates an underwriting loss, while a ratio below 100% signifies a profit.) Consequently, Aflac is able to achieve returns on equity (19%) that far exceed its peers.

In light of Aflac's remarkable success in the United States and Japan, many ask why AFL has not expanded into additional global markets. The reason is that in 1990, when Dan Amos became CEO, his first initiative was to close down Aflac's underperforming (often money-losing) international operations. He then focused the company entirely on the U.S. and Japan, where more life insurance is purchased than in the rest of the world combined. Ironically, the money saved by shuttering the floundering international businesses was reallocated to a nationwide U.S. advertising campaign to increase name recognition. This led to the Aflac "duck" commercials that ultimately made Aflac a household name.

Aflac Japan



Aflac is headquartered in Columbus, Georgia, but the vast majority of its business is conducted in Japan. In 1970, AFL co-founder Paul Amos visited the Osaka world fair. While there, he noticed that everyone was wearing white surgical masks to keep from getting sick. He concluded that if the Japanese were so health-conscious, they would probably buy supplemental health insurance—and he was right. Today, Aflac is the leading insurance company in Japan (gauged by policies in force), covering over 35 million people, roughly 25% of Japanese households. And the number of policies in force has increased every year for 38 years. Hence, Japan now accounts for 80% of total AFL profits.

The lifeblood of Aflac's product portfolio is supplemental cancer and medical insurance. In 1974, Aflac introduced them to Japan. Today, despite increasing competition, AFL remains the leading provider by a wide margin (72% marketshare). This coverage is more pertinent today than ever before: Last year, one of every three deaths in Japan was related to cancer, making it the number-one cause of death in the country (exceeding numbers two and three—heart attack and stroke—combined). Furthermore, selling supplemental coverage is extremely attractive because it is less cyclical and vulnerable to economic downturns than other insurance products, as evidenced by steady policy growth throughout the recent global financial crisis. An argument can be made that Aflac products actually become *more* viable during times of economic uncertainty because households face an increased probability of less income or even no income. So Aflac provides customers with an extra layer of protection, adding financial stability and peace of mind in an otherwise uncertain environment.

In general, insurance is a commodity business driven solely by price. (A commodity business sells products or services indistinguishable from those of competitors.) Aflac, however, has created a small niche within the insurance industry by selling its supplemental health insurance directly to employees through their employers. The company covers more than 140,000 small businesses in Japan and 90% of the firms listed on the Tokyo Stock Exchange. This gives Aflac a significant competitive advantage over competitors. Approximately 98% of AFL's policies have premiums deducted directly from employee paychecks, and policies can be transferred between jobs. Given this convenience, plus the relatively low cost for supplemental coverage (as little as $14 per month), customers very rarely switch from Aflac after initiating a policy. This explains Aflac's industry-high persistency rate of 95%, which means lower customer acquisition costs. A low-cost distribution model and high customer-retention rates have kept AFL's expense ratio below that of half its closest competitors. That's why Aflac consistently underwrites its policies at a profit and generates substantial returns on shareholders' equity.

While supplemental insurance has historically been Aflac's primary business, the firm has expanded beyond traditional health-related lines to include various life and annuity products. Aflac's "WAYS" product, for example, has led Aflac Japan's recent sales growth—contributing 65% of new sales in 2012. WAYS is a hybrid whole-life policy that allows much of the life coverage to be converted to a fixed annuity, medical coverage or nursing-care benefits when the policyholder reaches a predetermined age. Much of WAYS' success stems from AFL's strong distribution channels. Aflac sells life insurance and annuity products through approximately 20,000 sales agencies, including 90% of Japanese banks. Marketing via banks greatly enhances the firm's access to customers and has multiplied opportunities for selling different products to them.

Aflac Japan Premiums	2010	2011	2012
Cancer	**$6.85B**	**$7.54B**	**$7.54B**
Medical and health	**$4.57B**	**$5.16B**	**$5.24B**
Life insurance (WAYS)	**$2.06B**	**$2.92B**	**$4.37B**
Total Premiums	***$13.48B***	***$15.62B***	***$17.15B***

Aflac continually works to strengthen its distribution network. The company recently announced a major distribution partnership with Japan Post Holdings (JPH), the world's largest insurance company (in terms of total assets). JPH also provides universal postal services and sells a variety of financial products throughout Japan. This new agreement significantly broadens the original (2008) partnership. Now, JPH will increase from 1,000 to *20,000* the number of its postal outlets offering Aflac cancer products. Additionally, Japan Post Insurance (Kampo) has contracted to dispense AFL's cancer insurance products at all 79 Kampo sales offices. While Aflac has typically sold its products in metropolitan areas—such as Tokyo, Osaka and Yokohama—this new agreement extends distribution into more rural areas, where post offices are essentially the sole provider of insurance and financial services. Perhaps most important, this partnership ends concerns that Japan Post would compete with Aflac by creating its own supplemental cancer product. To quote CEO Dan Amos, "This is a game changer."

Aging population and declining birth rate

Japan faces a demographic predicament: Its population peaked at about 128 million in 2010 and has decreased every year since. Japan's current birthrate is 1.39, far below the estimated 2.08 level needed to stabilize the population size. According to the national census, Japan's population will consequently drop below 100 million by 2048. Furthermore, a large percentage of the population is entering retirement age. Today, roughly 30 million—nearly 25%—of the Japanese population is over 65. Hence, government healthcare costs are expected to rise considerably, as Japan has a universal healthcare system. Many believe that the government will be forced to increase out-of-pocket expenses—and the scope of coverage may be reduced too. This scenario has already begun to play out. When Aflac entered the Japanese market in 1974, most citizens were required to pay nothing for healthcare. Now, copayments for people over 70 are 10% (30% for those under 70). And, in an attempt to ease the system's financial burdens, government officials are considering raising copayments for the elderly to 20%.

These factors should lead to rising interest in Aflac products, particularly supplemental health insurance. The government will cover fewer healthcare expenses, therefore patients will bear an increasing proportion of medical costs. Given Aflac's #1 marketshare in supplemental insurance, which pays for costs not covered by universal healthcare, AFL is poised to benefit as Japanese patients seek additional coverage.

Aflac U.S.

Aflac U.S. shares many of Aflac Japan's competitive advantages. It does not participate in crowded, low-margin, commoditized insurance-product markets. Instead, it focuses on supplemental voluntary insurance. This is a market Aflac U.S. has dominated for several decades and to such a degree that its marketshare is greater than that of its next four competitors combined.

Aflac U.S. Premiums	2010	2011	2012
Accident/disability	$2.10B	$2.19B	$2.21B
Cancer	$1.24B	$1.26B	$1.28B
Other health	$1.03B	$1.06B	$1.26B
Life insurance	$0.22B	$0.23B	$0.24B
Total Premiums	*$4.59B*	*$4.74B*	*$5.00B*

The economic environment in the U.S. remains challenging. Uncertainty regarding healthcare reform and a weak jobs market have made it difficult for AFL to grow revenues. Furthermore, voluntary insurance markets are shifting away from individual polices (Aflac's mainstay), as more businesses are offering employees group coverage. Over the past ten years, group policy sales have increased from 35% of total worksite sales to 56% and suppressed individual policy sales. In 2009, Aflac responded by significantly expanding its product portfolio to include group coverage. The addition of group products has increased access to larger businesses, which should result in more sales. In the U.S., businesses with 500+ workers number nearly 17,000 and employ a total of 57 million people. This "new" market represents considerable opportunity, as Aflac previously sold individual polices exclusively through small businesses. Aflac's expanded product portfolio also allows businesses to offer employees a more valuable and comprehensive selection of coverage options.

Given the insurance arena's tough competitive environment, what truly separates Aflac from competitors is *distribution*. Like Aflac Japan, Aflac U.S. sells its products via worksites on a payroll-deduction basis. Its distribution team includes over 76,000 commissioned independent sales associates who work with hundreds of thousands of small businesses. Thus, 90% of AFL's U.S. polices are sold through this channel. Because this method of delivering coverage is so cost-effective, Aflac competitors have long tried to implement similar strategies of their own—but experienced little success. In fact, some competitors have attempted to buy sales distribution channels to mimic AFL, but none have been able to replicate Aflac's model on a major scale.

While Aflac's U.S. segment enjoys competitive preeminence, it is less dominant than in Japan. For instance, the U.S. business boasts a persistency rate of 76%, versus 95% in Japan. This largely results from *group* benefits in the U.S., which cannot be transferred between jobs. A lower persistency rate indicates higher policy turnover, meaning AFL must pay more upfront costs (i.e., commissions to brokers, underwriting, bonuses, etc.) as it seeks new customers. Consequently, U.S. deferred-policy-acquisition costs are 52% of annual premiums in force, but only 39% in Japan. And operating margins in Japan are almost 20%, compared to 18% in the U.S. For obvious reasons, Aflac prefers *persistent* business to less-profitable business that lapses.

The U.S., however, offers more growth potential than mostly saturated Japan. A recent study revealed that just 6% of the U.S. population has access to Aflac products, but 20% say they would buy Aflac products if given the opportunity. Because the Census Bureau says there are 111 million full-time employees in the U.S., the "6%" figure signifies that over 100 million workers now have no access to AFL products at their workplace. Yet Aflac's recent expansion into group coverage (and large businesses) should facilitate far greater employee access to AFL products. Furthermore, Aflac's 92% brand name recognition means virtually all of these workers are familiar with Aflac and therefore inclined to choose it over an unknown competitor.

Healthcare in transition

There is concern regarding how recent changes in U.S. healthcare policy might affect AFL's business model. The Affordable Care Act, or "Obamacare", mandates that all Americans have comprehensive major-medical health insurance. Aflac policies do *not* provide major medical coverage. Instead, they provide additional coverage for illness-related out-of-pocket expenses—paying for mortgages, utilities, groceries, etc.—that are not covered by major medical insurance. Moreover, because Japan has given its citizens universal healthcare insurance for years, Aflac already knows how to operate in this kind of environment. AFL management said this: "*One thing we know from our nearly four decades in Japan is that even with a national healthcare system, consumers still bear significant out-of-pocket expenses, making our products very relevant to consumers. We believe a more uniform healthcare system in the United States actually presents Aflac with opportunities, as consumers become better aware of the financial protection Aflac products help provide.*"

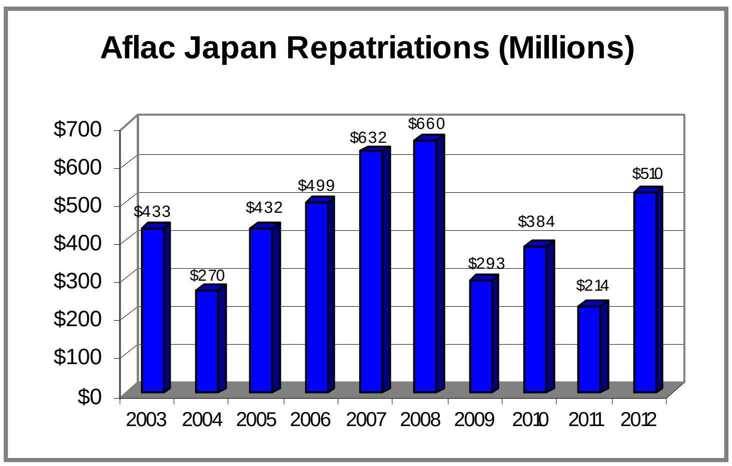
Investments / Business Model Risk

Management emphasizes that its greatest challenge remains investing the massive cashflows that Aflac Japan generates and finding appropriate investments that meet or exceed its pricing and policy-reserve assumptions. Aflac holds cash and investments worth approximately $103B. The bulk of these assets is invested in fixed-income securities, including $35B in long-term Japanese Government Bonds (JGBs). Because bond prices are extremely sensitive to interest-rate change (higher rates reduce bond prices and lower rates increase bond prices), Aflac is prone to major swings in the value of its portfolio—which consequently affects its capital ratios.

Like all insurance companies, Aflac is governed by various state, federal and international regulatory bodies. These agencies closely scrutinize its capital levels to ensure that the firm can adequately repay its financial obligations. There are several financial metrics that insurance regulators monitor. The two most significant are risk-based capital (RBC) and, in Japan, solvency-margin ratio (SMR). These two measures differ in one major respect: SMR takes into account unrealized gains and losses on investments that are classified as "available for sale"; RBC does not.

This poses some challenges for Aflac. Because the vast majority of its portfolio is invested in JGBs and other yen-denominated bonds, a spike in Japanese interest rates slashes the value of the portfolio. That these losses are largely unrealized does not matter; Aflac's SMR still falls. To illustrate: A 100-basis-point increase in 10-year JGB interest rates results in a 200% drop in Aflac's SMR ratio. At year-end 2012, the firm's SMR was a very comfortable 669%, but subsequent jumps in U.S. and JGB interest rates (from April to June, 10-year JGB interest rates rose from 0.60% to 0.85%) reduced its SMR to 585%. Also, AFL shareholders' equity decreased—falling from $16B to 13.7B. (Aflac began 2013 with an unrealized *gain* of $2.6B in its bond portfolio, but after ensuing interest-rate increases, the company has an unrealized *loss* of $200M.) The Japanese Financial Services Agency (FSA) requires that insurance companies maintain an SMR above 200%. If the ratio falls below this threshold, regulatory action is triggered. In this event, the FSA may not allow Aflac Japan to repatriate profits to Aflac U.S. or could insist that Aflac Japan raise additional capital.

In 2009 and 2011, Aflac recorded sizeable realized investment losses. Resultantly, repatriations from AFL Japan to AFL U.S. decreased significantly (see chart at right), as AFL Japan retained capital to support its SMR. Please note that these profit repatriations from Aflac Japan are paramount in funding AFL's dividend and share repurchase program. Another spike in rates could reduce the SMR considerably and challenge Aflac's ability to fund its capital initiatives.



Possibility versus probability

A significant rise in interest rates, particularly in Japan, is seen by many well-respected investors as not just likely but certain. David Einhorn, famed value investor known for shorting Lehman Brothers before the 2008 crash, said: *"Over the last few years, Japanese savers have been willing to finance their government deficit. However, with Japan's population aging, it's likely that the domestic savers will begin using those savings to fund their retirements. The newly elected DPJ party that favors domestic consumption might speed up this development. Should the market re-price Japanese credit risk, it is hard to see how Japan could avoid a government default or hyperinflationary currency death spiral."* Indeed, Japanese savers have been more than willing to fund government spending, as Japanese debt is 92.7% domestically owned. Thus, savers becoming consumers would prove problematic. The Japanese government is discouraging domestic consumption to avoid such a scenario. It recently raised the consumption tax rate to 8% (effective 2014) and will increase the rate to 10% in 2015—*if* the economy is strong enough to handle the hikes. This tax is expected to slow consumption *and* provide additional revenue to help balance the budget. Japan is currently the world's most indebted developed country, with a debt-to-GDP ratio of 214%—which fails to account for the trillions of yen that the government will spend on entitlement programs for its aging population, including universal healthcare costs and social security.

The Bank of Japan is now compounding this risk by executing a bond-buying program (quantitative easing totaling 60-70 trillion yen) in an attempt to double the money supply over the next two years. This type of program, also being used by the U.S. Federal Reserve and Bank of England, keeps interest rates artificially low. Eventually (perhaps sooner rather than later) this government bond-buying will stop, and there is much uncertainty regarding how high rates might climb, in light of there having been no true price discovery in these markets for several years.

The solution

In anticipation of further U.S. and Japanese interest-rate hikes, Aflac has put together a systematic plan to reduce its portfolio risk and strengthen its capital position. The initiative has three major components:

1) Aflac will decrease exposure to JGBs and purchase more U.S. corporate bonds. Beginning in 2012, two-thirds of cashflow has been allocated to U.S. corporate bonds and one-third to JGBs. To further reduce risk, this program employs a hedging strategy ensuring that dollar investments may be converted to yen in the future, at fixed exchange rates. U.S. corporate bonds now comprise roughly 12% of the total investment portfolio. (Given the increase in U.S. interest rates during Q2 2013, management has temporarily shifted this strategy. In Q3 2013, cashflows will be allocated to JGBs, unless/until market conditions shift again.)

2) Aflac is changing the way it accounts for the bonds on its balance sheet, switching from "available for sale" (AFS) to "policy reserve matching" (PRM). PRM accounting has been adopted by the majority of Japanese financial institutions because, unlike with AFS, prices are not marked to market. PRM is thereby less vulnerable to wide swings in bond prices that may negatively affect capital levels. Management states, *"Our objective is to reduce [interest rate] sensitivity, but the overriding objective is to keep the SMR within the 500%-to-600% target at various interest-rate scenarios… So, to mitigate interest-rate risk to the end market, it is our plan to move a number of our JGBs from the existing AFS into PRM."* Accounting standards prohibit reclassification of bonds as PRM from AFS—management must classify the bonds when they are acquired. So Aflac must sell its available-for-sale JGBs and then repurchase them to "reclassify" the bonds as PRM. Note that the cost to execute this strategy is minimal, roughly one-to-two basis points.

3) Aflac has recently entered into a five-year senior unsecured credit facility (essentially a corporate line of credit) for 50 billion yen. In the event of rapidly rising interest rates, access to these funds will help bolster capital levels and strengthen the balance sheet. While only a short-term fix, this would provide additional time for management to implement a more durable solution. A reinsurance deal, for example, would be a potentially effective tool that management might execute in this "distressed" scenario.

Impact of the Yen/Dollar exchange rate

Yen/Dollar Exchange Rate	Operating Earnings Per Share	Yen Impact
79.81*	$6.86 - $7.06	$0.00
85	$6.60 - $6.80	($0.26)
90	$6.37 - $6.57	($0.49)
95	$6.17 - $6.37	($0.69)
100	$5.99 - $6.19	($0.87)

**Actual 2012 weighted-average exchange rate*

Confusion abounds regarding Aflac's exposure to currency fluctuations. Here are the facts: Aflac collects the vast majority of its premiums in yen, pays benefits and expenses in yen, and ordinarily invests in yen-denominated securities to match its yen-denominated liabilities. With the exception of an annual repatriation from AFL Japan to AFL U.S. (hedged to reduce risk), Aflac does not convert its yen into dollars. Therefore, from an economic standpoint, Aflac is barely impacted by minor changes in the yen/dollar exchange rate. However, for GAAP accounting purposes, Aflac must translate its AFL Japan financial statements from yen to dollars (using the average exchange rate), which does affect Aflac's reported financial results. In years when the yen appreciates against the U.S. dollar, growth rates are magnified. Conversely, if the dollar strengthens against the yen, growth rates appear weaker.

Aflac does not hedge exchange-rate conversions to embellish financial reporting. However, the firm *does* hedge economic transactions, like profit repatriation. In July, for instance, Aflac Japan repatriated 76.8B yen ($771M) to Aflac U.S. To reduce exchange-rate risk, Aflac hedged its currency exposure via options and foreign-exchange forward contracts, yielding an additional $24M from the transaction. The yen/dollar exchange rate fluctuated between 78 and 125 (currently 99.45) over the past decade, yet Aflac's operations still managed to prosper. Barring any abnormally high devaluation of the yen, exchange-rate fluctuations are unlikely to materially affect Aflac's intrinsic value. The table above shows how different yen/dollar values will change management's projected 2013 earnings-per-share figures.

Management / Capital Allocation

Aflac is led by Chairman and CEO Dan Amos (son of co-founder Paul Amos). Dan joined Aflac in 1973 and became CEO in 1990. Under his stewardship Aflac has thrived; he has met or exceeded AFL's operating-earnings-per-share objectives for 23 consecutive years. Furthermore, Amos is focused intently on growing shareholder value: *"As CEO, it is my job to manage our business in a way that generates value for those who have put capital at stake and invested in our business – our investors."* Amos thinks and acts like an owner because he personally owns 8,238,768 shares (2% of shares outstanding), worth approximately $478M. Other members of the Amos family own additional shares valued at over $250M.

Aflac maintains a disciplined capital-allocation strategy focused on dividends and share repurchases. Last year marked the 30th consecutive year with an increased annual dividend, now exceeding $600M. Moreover, Aflac will buy back roughly $600M worth of stock in 2013 and plans to repurchase up to $900M in 2014. Aflac very rarely makes acquisitions. The reason:

When analyzing a potential acquisition, management compares the expected rates of return from buying the new company versus simply repurchasing AFL stock. In most cases, repurchasing Aflac shares promises the higher return. Investors can expect more of the same, per Dan Amos: *"As we have said for many years, when it comes to deploying capital for the benefit of our shareholders, we still believe that repurchasing our shares and growing the cash dividend are the most attractive means, and that is something we will continue to pursue."*

While Dan Amos, 61, has no plans to retire, it is widely speculated that his son, Paul Amos II, is being groomed to succeed him. Starting in July 2013, Paul began to serve as Aflac President, working directly with AFL Japan President Tohru Tonoike and Chief Investment Officer Eric Kirsch. Following eight years as acting Aflac U.S. President, Paul's new role will further expand his ability to operate and manage all key aspects of the business.

Valuation

Aflac stock now sells for $62 per share. Given expectations of 2013 earnings-per-share between $6.86 and $7.06, shares are trading (at the low end) at a price-to-earnings ratio (P/E) of just 9 times forward earnings. At the current price, Aflac pays investors a dividend yielding 2.25%.

Over the past decade, Aflac's valuation has averaged approximately 15 times earnings. However, some of AFL's recent P/E compression *is* warranted. Premium growth has slowed markedly, and future growth expectations range from flat to a mild increase of 5%. As detailed above, the firm may also face severe challenges in a quickly rising interest-rate environment. Nonetheless, Aflac is making the adjustments necessary to preserve its capital levels. Thus, it should be able to survive an interest-rate crisis relatively unscathed. On the plus side, premium growth may receive a boost from: 1) an aging Japanese population saddled with an increasing portion of healthcare costs, 2) U.S. insurance-portfolio expansion that includes more supplemental group coverage, opening the door to tens of millions of possible customers, and 3) the Affordable Care Act, exposing more U.S. consumers to Aflac products and the financial security they offer.

At the current AFL valuation of 9 times earnings, shareholders enjoy an earnings yield (inverse of the P/E ratio) of 11.1%. Given the alternatives—an S&P 500 yielding 6.5%, corporate bonds yielding 4.5% and 10-year government bonds yielding 2.7%—Aflac offers prospective long-term investors an attractive entry point.

[See "Executive Summary" and footnotes on next page]

Executive Summary: AFL

POSITIVES	NEGATIVES
• **#1 marketshare in supplemental cancer and medical coverage**	• **Saturated Japanese insurance markets; slowing growth**
• **Industry-high persistency rates (strong customer relationships)**	• **Uncertainty regarding U.S. healthcare reform and weak employment**
• **Consistently profitable insurance-product underwriting**	• **Tepid Japanese economy**
• **Strong distribution system**	• **Challenging interest-rate environment**
• **New partnership with Japan Post (20,000 more distribution outlets)**	

[See footnotes below]