

Aflac Incorporated

Third-Quarter Results—Consistency Stands Out, Investment Portfolio Appears to Be Under Manageable Stress

Highlights

> Third-quarter operating EPS (excluding realized investment losses) increased 20%, to \$1.02—\$0.02 above our estimate and consensus. The stronger yen/dollar exchange rate added \$0.04 per share to EPS—there is no economic benefit from the translation. Operating EPS excluding the impact of the yen increased 15.3% in the third quarter. The upside relative to our expectations was driven by higher margins in both Japan and the United States—although not driven by any specific factors. Net income per share was \$0.21, which included \$0.81 per share of net realized investment losses.

> Sales in Japan (70% of earnings) increased only 0.9%, which is a bit of a disappointment versus management's original expectations, although September was a better month than expected. Sales remain a key driver of long-term earnings growth and the stock is highly sensitive to sales trends, although sales have little impact on current earnings given that greater than 90% of earnings are driven by renewals. Management stated its 3% to 7% sales guidance for the year in Japan will be difficult to achieve—we would say incredibly difficult to achieve given that the company would need to generate at least 11% growth in the fourth quarter to hit the bottom of the range, a result that has not been achieved in more than five years. We estimate 1% to 3% sales growth in the fourth quarter, aided by bank distribution, which would put growth at only 0.6% for 2008 after two years of consecutive sales decline. Sluggish growth is being driven by heavy competition, a more mature market, and a weaker economy putting pressure on discretionary income. We estimate in force premium growth (the total block of business) of 3.7% in 2008, which we believe would be the slowest growth rate in Aflac's more-than-35-year history in Japan.

> Bank sales contributed 4.6% of sales in the third quarter in Japan, nearly double last quarter, although management's expectations were higher. Banks were allowed to sell Aflac's products at the end of 2007. Management's original guess had been that banks could contribute as much as a tenfold increase by the fourth quarter relative to the first quarter as the bank program ramps up. Management stated that regional banks, which contributed about one-third of bank sales during the quarter, appeared to be distracted by dealing with current customers concerned about the massive sell off in equity markets. By the end of September, 196 banks out of 402 had selling agreements, up from 154 at the end of June and 90 at the end of March. Stand-alone medical sales declined a bit due to a slightly more difficult comparison given that Gentle EVER, a nonstandard medical product, was introduced in third quarter 2007. A sales decline relative to the first quarter of even a partial comparison with a new product launch highlights the sluggishness of the sales environment in Japan, in our opinion. We continue to believe that banks sales will take share from the company's core distribution channels, although quantifying the impact is difficult.

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Financial | Insurance

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Stock Rating: **Market Perform**
Company Profile: **Established Growth**

Symbol: AFL (NYSE)
Price: \$38.87 (52-Wk.: \$33-\$69)
Market Value (mil.): \$17,734
Fiscal Year End: December
Long-Term EPS Growth Rate: 14%
Dividend/Yield: \$0.96/2.5%

	2007A	2008E	2009E
Estimates			
EPS Q1	\$0.82	A\$0.98	NA
Q2	\$0.82	A\$1.01	NA
Q3	\$0.85	A\$1.02	NA
Q4	\$0.78	\$0.97	NA
FY	\$3.27	\$3.98	\$4.55
CY		\$3.98	\$4.55
Valuation			
FY P/E	11.9x	9.8x	8.5x
CY P/E		9.8x	8.5x

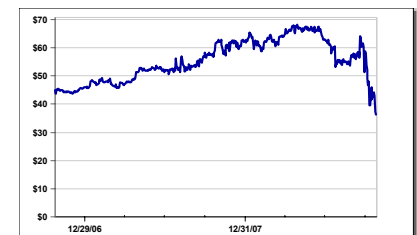
Trading Data (Thomson Financial)

Shares Outstanding (mil.)	476
Float (mil.)	461
Average Daily Volume	4,752,468

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	16.9
Book Value Per Share (MRQ)	16.6
Enterprise Value (mil.)	17,886.1
EBITDA (TTM)	2,713.0
Enterprise Value/EBITDA (TTM)	6.6x
Return on Equity (TTM)	21.7

Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

> There have been no changes in the outlook from Japan Post. In mid-November 2007, the company announced that Aflac had been selected by Japan Post Network Co., Ltd., a subsidiary of Japan Post Holdings Co., Ltd., as the exclusive provider of cancer insurance for distribution through the nationwide postal office network. Japan Post Network Co. is one of four separate postal entities that began operating in October 2007 as a part of the postal privatization process set forth under laws enacted in 2005. Japan Post Network Co. operates approximately 24,000 post office locations throughout Japan and the program began slowly with about 300 locations on October 1, 2008. We expect this relationship to take time to ramp up, similar to the banks, but the potential could be meaningful.

> Management stated it does not have an interest in buying AIG's (AIG \$1.70) Japanese life insurance operations, which is Aflac's main competitor in the accident and health market. While there was some initial confusion regarding AIG's troubles in mid-September that caused problems for many life insurers, management does not believe AIG's woes are creating any lingering adverse impact on other life insurers, including Aflac. However, and importantly, Aflac could certainly benefit competitively over time from AIG's divestiture of its Japanese life operations. It is difficult for us to believe that any company that buys AIG's operations will be able to run them in a noticeably better fashion than AIG has for the past several years. The normal distractions that accompany a sale should also work to Aflac's benefit.

> Management does not believe the company needs any capital despite deterioration in the credit environment and its own investment portfolio. While Aflac has already completed its planned share repurchase activity for 2008 (and more with 23.2 million shares purchased), management did state its intention to pursue its normal goal of repurchasing 12 million shares in 2009. The board also has already approved a 16.7% increase in its quarterly dividend effective in first quarter 2009, highlighting management's confidence in its balance sheet and its continued commitment to increasing its dividend at a rate in excess of the company's expected earnings growth rate. The company's risk-based capital (RBC) ratio was estimated to be 495% as of September 30, 2008, compared with 574% as of December 31, 2007, and management's 350% minimum target—the difference between 350% and 495% is roughly about \$1.2 billion, everything else equal. The yen has been particularly strong since the end of the quarter and management stated that a 10% strengthening in the yen would cut the RBC by about 50 basis points.

> Aflac's credit quality is much better than the average life insurer in our view given that the company does not invest in equities, commercial real estate, structured credit products, or any type of below investment grade securities—nearly the entire portfolio with the exception of Japanese government bonds is investment grade corporate bonds. However, Aflac is not immune to credit deterioration and is significantly more leveraged (invested assets to equity at 9.3 times) than the average insurance company because its liabilities are so long. Couple this with the fact that Japan does not have a well-developed long-term bond market, and one major concern regarding Aflac is its investment concentration. For example, 4 of Aflac's top 10 investment holdings are triple-B credits and range on an after-tax basis anywhere from 6% to 9% of total shareholders' equity (\$600 million to \$900 million pretax positions). Current guidelines limit investment positions to about \$225 million—obviously management is concerned about its concentration risk as well.

> In the third quarter, realized investment losses were \$0.81 per share, or \$389 million—sales of Lehman Brothers and Washington Mutual and an impairment on Ford (F \$2.01) were nearly 50% of the total. The company expects to take a \$110 million after-tax loss in the fourth quarter given its exposure to the Icelandic banks. The company also took a \$191 million after-tax loss on changing the accounting for certain perpetual debentures (nearly \$8 billion) to equity impairment accounting from debt accounting—the former has less subjective rules. The unrealized loss on its investment portfolio that runs through equity increased by less than \$700 million, which is significantly less than generally expected. However, another unique factor regarding Aflac's investment portfolio is that because the company's liabilities are so long and therefore its intent is to hold long-dated assets to match these liabilities, 34% of its total cash and investments (\$20.6 billion) are classified as held to maturity in lieu of available for sale. Therefore, Aflac is not required to run any realized gains or losses through shareholders' equity despite the fact that the \$20.6 billion held to maturity portfolio included an embedded net unrealized loss of \$1.7 billion.

> U.S. sales increased only 0.9%, were disappointing, and compared with our 6% growth estimate. The weaker economy is playing a larger-than-expected role and Hurricane Ike had some modest

negative impact. Sales in the first nine months were up 1.8% and the company will not be able to achieve its original goal of at least 8% growth for 2008. As mentioned last quarter, lower per employee insurance purchases can explain some of the weakness, as the total number of new payroll accounts actually increased 6.4%. Aflac also continues to make investments in future growth, as recruiting increased 4.9%, down slightly from the first half, but still better than last year. The number of weekly average producers also increased 3.7%, to 11,100, after 6.3% last quarter and only 0.2% in the first quarter. Management believes that the weaker economy has helped boost recruiting in the first half, as it has in the past.

> Management increased its operating EPS growth goal for 2008 to 15% from 14%-15% and reiterated its 13%-15% EPS growth goal for 2009 excluding currency translations. Our fourth-quarter EPS estimate remains \$0.97 per share and we are increasing our 2008 EPS to \$3.98 from \$3.96 given the outperformance this quarter. We are increasing our 2009 EPS estimate to \$4.55 from \$4.50 given the recent strength in the yen relative to the dollar (our estimate includes a 102 exchange rate). Our EPS estimates represent 15% and 14% growth excluding currency translations, respectively. A 1 yen/dollar change in the exchange rate alters our annual EPS estimate by about \$0.017 per share.

> Our rating remains Market Perform, although Aflac is as attractive as it has been on an absolute basis in a long time and should continue to be much more stable than the average insurance company in this environment. However, Aflac's capital position is not immune from broader deterioration in credit markets and its multiple still sits well above any peer group measure on a relative basis. The shares trade at less than 9 times our 2009 EPS estimate—the lowest level in recent history, at 2.85 times reported book value per share, and 2.51 times book value per share excluding unrealized gains on investment securities (as of Separately 30, 2008). The life insurance peer group we track as a whole is under book value currently on a reported book basis. However, we estimate that Aflac will generate nearly a 23% return on equity in 2008 (including unrealized gains on investment securities) with better visibility than the overall life insurance group that is experiencing more significant credit deterioration and dilution at several large companies from recent capital issuance.

William Blair & Company, L.L.C. is a market maker in the security of Aflac Incorporated and may have a long or short position.

Additional information is available upon request.



Current Rating Distribution (as of 09/30/08)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	60	Outperform (Buy)	5
Market Perform (Hold)	39	Market Perform (Hold)	2
Underperform (Sell)	1	Underperform (Sell)	1

*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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