

Equity Research

FINANCIAL
Insurance

October 24, 2007
Research Note

Ticker: AFL
Market: NYSE
Price: \$61.72
52-week: (\$43-\$59)

Stock Rating:
Market Perform

Company Profile:
Established Growth

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Aflac Incorporated

Very Solid Third-Quarter Results, No Big Surprises

FINANCIAL SUMMARY

Fiscal Year Ends:	December	Dividend/Yield:	\$0.82/1.3%
Long-term EPS Growth Rate:	14%	Market Value (mil.):	\$28,869

ESTIMATES*

FYE	Q1	Q2	Q3	Q4	Annual	P/E
2006A	\$0.72	\$0.75	\$0.72	\$0.66	\$2.85	21.7x
2007E	\$0.82 A	\$0.82 A	\$0.85 A	\$0.81	\$3.30	18.7x
2008E	NA	NA	NA	NA	\$3.77	16.4x
Cal2008					\$3.77	16.4x
Cal2009					NA	NA

* Estimates reflect the adoption of FAS 123R.

- Third-quarter operating EPS increased 18%, to \$0.85, \$0.04 ahead of our estimate and \$0.03 ahead of consensus (no impact on EPS from currency translations). The upside relative to our estimate was driven by a higher margin in Japan and stronger revenue growth and a higher margin in the United States.
- Sales in Japan increased 2.2%, compared with our 0.0% estimate. This quarter was up against an easy comparison (-12%), and the growth was driven by continued strong in cancer sales in front of a price increase on September 1 and the August 1 launch of a new version of the company's market-leading stand-alone medical product. Management continues to expect a 0% to 4% increase in the second half. Sales through banks should help drive sales growth in 2008, as the Financial Services Agency in Japan (insurance regulator) has decided to fully deregulate the sale of insurance products through banks in late December after the ruling Liberal Democratic Party approved the plan earlier this week.
- U.S. sales increased 11%, compared with our 8% estimate. Execution continues to be better and growth by product was broad. The number of weekly average producers increased 5% in the third quarter, down 7% from the first half. Management's sales guidance in the United States for 2007 remains 6%-10% sales growth given a very difficult fourth-quarter comparison.

- Management reiterated its 15%-16% operating EPS growth goal for 2007 excluding currency translations and its 13%-15% growth goal for 2008. We are increasing our 2007 EPS estimate to \$3.30 from \$3.25 and our 2008 EPS estimate to \$3.77 from \$3.75, respectively—our 2007 estimate remains 15% growth excluding currency translations and our 2008 estimate is 14%, compared with 15% previously, given stronger growth this year.
- Our rating remains Market Perform. Aflac's franchise is fully in tact, the economics of its business remain compelling, and sales in Japan appear to have bottomed in the near term, but the market environment within its major businesses is not overly robust and we do not find valuation compelling at a 12% premium to the S&P 500 based off of 2008.

Earnings Ahead of Expectations; In Line With Guidance Year-to-Date

Third quarter operating EPS increased 18% to \$0.85, \$0.04 ahead of our estimate and \$0.03 ahead of consensus (no impact on EPS from currency translations). Net EPS including realized investment gains/losses and FAS No. 133 adjustments was also \$0.85 per share. Operating EPS excluding currency translations for the first nine months of 2007 was 15%, squarely in line with management's guidance. The upside relative to our estimate this quarter was driven by a higher margin in Japan and stronger revenue growth and a higher margin in the United States. There were no major surprises in the results, sales in Japan continue to show signs of modest improvement, and stronger growth in sales in the United States over the past several quarters continues to drive better premium growth domestically. While the sales environment in Japan remains challenging, Aflac continues to grind it out with continued margin expansion in Japan (75% of earnings) due to a lower benefits ratio that is helping to drive mid-teens EPS growth excluding currency translations for the whole company. The benefits ratio improved a full 240 basis points this quarter, much higher than in any recent quarter. We expect the benefits ratio to continue to drive margin expansion in Japan given a more favorable product mix shift and favorable claims experience, but the degree of improvement this quarter was somewhat extraordinary. The company repurchased another 2.0 million shares in the quarter, bringing the total in the first nine months to 9.1 million in the first half--the goal is 12 million for year--up 20% compared to 2006.

Japan Sales Sluggish, but Show Modest Improvement; Bank Distribution Set to Open in Late 2007

Sales in Japan increased 2.2%, compared with our 0.0% estimate. This quarter was up against an easy comparison (-12%), and the growth was driven by continued strong in cancer sales in front of a price increase on September 1 and the August 1 launch of a new version of the company's market-leading stand-alone medical product. Cancer sales, which represent approximately one-third of total sales, increased 22% in the quarter after strong growth in the first half. Stand-alone medical sales, Aflac's top-selling product in Japan and approximately one-third of total sales, were basically flat given some benefit from the new product, but were up against a nearly 20% negative comparison. Management continues to expect a 0% to 4% increase in the second half, with the new stand-alone medical product offsetting an expected decline in cancer sales after the price decline. Sales through banks should help drive sales growth in 2008, as the Financial Services Agency in Japan (insurance regulator) has decided to fully deregulate the sale of insurance products at banks in late December after the ruling Liberal Democratic Party approved the plan earlier this week. However, management stated that it expects the impact to be gradual, as not all banks are set to launch immediately and it will take time to refine the selling process. In addition, bank sales could pressure sales growth in Aflac's independent agent channel. Management expects to provide sales guidance on its fourth-quarter conference call in late January 2008.

The new product launched on August 1 is called Gentle EVER, which is the "EVER" stand-alone medical product with limited underwriting requirements—more of a nonstandard policy. Gentle EVER contributed about 11% of new stand-alone premium sales—about 4% for Japan overall. Management stated that it believes that about 30% of the market would fit into this category, which represents a pretty large opportunity. It would appear that Aflac would be well positioned to capture some sales growth from this new product given its brand advantage and the cheapest price in the industry. But

other competitors are in the market already selling this product with success. The product is about twice the premium level of the core EVER product with a similar profit margin. However, Aflac has not had tremendous success extending the EVER franchise, in our opinion, and recent product introductions have either sputtered after an initial boost or failed to drive any meaningful improvement in aggregate sales—including EVER Half, EVER Bonus, and WAYs. Salespeople also tend to take the path of least resistance and new products tend to cannibalize existing product sales because salespeople focus on selling new products, in our opinion. Management believes that the cannibalization impact may be less this time given that many clients that were turned away for underwriting purposes will now be able to buy insurance, which should ultimately improve Aflac's hit rate and improve overall sales productivity.

The industry environment in Japan has not changed meaningfully, in our opinion. The combination of intense competition and continued pressure within the affiliated corporate agency channel has contributed to the sales weakness over the past several quarters (six consecutive quarters of sales declines before this quarter). Importantly, the continued scrutiny of poor claims-paying practices within the life and nonlife insurance industries that led to sanctions against certain companies starting in the second quarter 2006 also continues to have an adverse impact on sales for the entire industry—although this impact is difficult to quantify and could also prove temporary. Management now expects the FSA-related overhang to be resolved some time around year end, which is longer than original expectations. The FSA (Japan's insurance regulatory entity) required all third sector companies to analyze and submit findings by mid-April of certain claims-paying practices over the past five years after it found irregularities in certain practices among certain companies in 2006 stemming from its regular regulatory review process. The FSA is now analyzing the data to better improve comparability and then it plans to meet with all the life insurers in Japan separately--about 35 companies. Aflac released the results of its own internal review of its claim-paying practices and the issues identified looked to be relatively immaterial and lower than other companies that were actually sanctioned in the market.

U.S. Sales In Line; Continuing to Push Training/Productivity Emphasis

U.S. sales increased 11%, compared with our 8% estimate. Management's sales guidance in the United States for 2007 remains 6%-10% sales growth given a very difficult fourth-quarter comparison (21%) because of the signing of a large account. Margins were up slightly given stronger premium growth, contributing to 12% pretax operating earnings growth in the United States. While there may be some modest opportunities to improve margins over time, sales growth needs to expand at double-digit percentage rates for earnings to track at double-digit percentage rates.

Solid sales results within the United States continue to benefit from the myriad well-documented changes that have taken place domestically over the past three years, primarily management changes and better execution, as well as increased emphasis on improving training and productivity. Growth by product was broad, with double-digit percentage growth for accident/disability, cancer, and hospital indemnity (over 80% of sales combined).

U.S. recruiting continues to decline as expected, as the emphasis this year has been on improved training, agent retention, and productivity. Unlike last year, when sales management bonuses were tied to recruiting, this year sales management bonuses are tied to the average number of weekly producers. The number of weekly average producers increased 5% in the third quarter, down 7% from the first half. Over the long term, continued growth in recruiting is essential to drive sales growth, and we expect management will reemphasize recruiting after near-term productivity goals are achieved.

Increasing Estimates a Bit; Rating Remains Market Perform

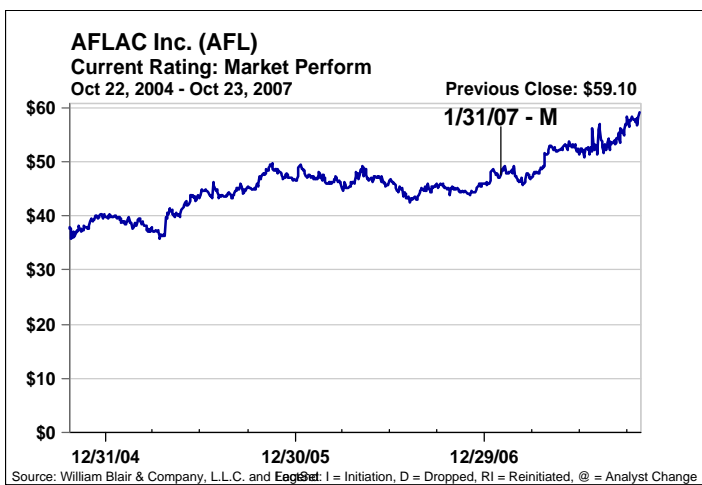
Management reiterated its 15%-16% operating EPS growth goal for 2007 excluding currency translations and its 13%-15% growth goal for 2008. We are increasing our 2007 EPS estimate to \$3.30 from \$3.25 and our 2008 EPS estimate to \$3.77 from \$3.75, respectively—our 2007 estimate remains 15% growth excluding currency translations and our 2008 estimate is 14%, compared with 15% previously, given stronger growth this year. CEO Dan Amos's personal goal remains 15%

operating EPS growth excluding currency translations for his first 20 years as CEO, which extends through 2009. Our estimates include a yen-to-dollar exchange rate of 118—currently at 115. A 1 yen/dollar change in the exchange rate alters our annual EPS estimate by about \$0.012 per share, although a weak yen has no material economic impact on Aflac, given that Aflac Japan is a self-contained operation with all assets, liabilities, revenues, and expenses in yen. The stock has actually outperformed significantly in the past during periods of time when the yen has been weak.

Our rating remains Market Perform. Earnings visibility remains high, Aflac's franchise is fully intact, the economics of its business remain compelling, and sales in Japan appear to have bottomed in the near term, but the market environment within its major businesses is not overly robust in our view and we do not find valuation overly compelling. The stock has performed well in 2007 given that sales in Japan seemed to have bottomed and Aflac is a very defensive name within a volatile and uncertain period for financial services stocks as a group. The company also continues to manage capital aggressively.

The shares now trade at a about a 12% premium to the S&P 500 based on 2008 EPS estimates—well above average from a historical perspective. The shares trade at about 3.6 times reported book value per share and nearly 4.0 times book value per share excluding unrealized gains on investment securities (as of September 30, 2007), which represents more than a 50% premium to the life insurance peer group we track as a whole on a reported book basis. Aflac still has a significant unrealized gain in its Japanese investment portfolio given the significant decline in interest rates in Japan over the past several years, and the company plans to hold these investments to maturity and not realize any current investment gains. We estimate that Aflac will generate nearly a 20% ROE in 2008 (including unrealized gains on investment securities) with better visibility, compared with 14% for the life insurance group; this is the main driver of the price-to-book-value-per-share premium multiple. The ROE excluding the unrealized gains on investment securities is about 22%.

Additional information is available upon request.



Current Rating Distribution (as of 10/1/2007)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	60	Outperform (Buy)	12
Market Perform (Hold)	39	Market Perform (Hold)	5
Underperform (Sell)	1	Underperform (Sell)	1

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