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Prudential Financial, Inc. (PRU)

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Prudential First Quarter 2018 Earnings Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. [Operator Instructions] As a reminder, this conference is being recorded.

I'd now like to turn the call over to our host, Mr. Mark Finkelstein. Please go ahead, sir.

Alan Mark Finkelstein

Senior Vice President & Head-Investor Relations, Prudential Financial, Inc.

Thank you, Brad. Good morning and thank you for joining our call. Representing Prudential on today's call are John Strangfeld, CEO; Mark Grier, Vice Chairman; Charlie Lowrey, Head of International Businesses; Steve Pelletier, Head of Domestic Businesses; Rob Falzon, Chief Financial Officer, and Rob Axel, Principal Accounting Officer. We will start with prepared comments by John, Mark and Rob, and then we will answer your questions. Today's presentation may include forward-looking statements. It is possible that actual results may differ materially from the predictions we make today.

In addition, this presentation may include references to non-GAAP measures. For a reconciliation of such measures to the comparable GAAP measures and a discussion of factors that could cause actual results to differ materially from those in the forward-looking statements, please see the section titled forward-looking statements and non-GAAP measures of our earnings press release, which can be found on our website at investor.prudential.com. And with that, I will hand it over to John.

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you, Mark. Good morning and thank you for joining us. We had a good start to the year. Earnings were solid and the underlying momentum across our businesses remained strong. In my remarks, I will cover three main topics. I'll provide a high-level perspective on earnings, discuss our business fundamentals, and then cover capital deployment. And after that, I'll hand it over to Mark and Rob to go through the specifics.

I'll start my comments on the results for the first quarter. Adjusted operating earnings of \$3.05, which excludes a \$0.03 benefit from market-driven and discrete items, exceeds the \$2.76 we reported in the prior year quarter. Annualized return on equity on the same basis was very good, in the mid-13% range, which is above our near to intermediate term target of 12% to 13%. There were a number of moving parts at the segment level that Mark will walk through, but at a high level, earnings are benefiting from solid core growth in our asset-based businesses, including Investment Management, Retirement and Individual Annuities. We also saw improved margins in our Group Insurance business and steady underlying results in our international operations.

In addition, tax reform is an incremental positive to results and we experienced lower than normal corporate expenses in the quarter, which we know will vary. Partially offsetting these items, investment returns and spread income were lower than the prior year and below our normal expectations, due mainly to less favorable non-coupon and prepayment investment results. In addition, year-over-year comparisons are impacted by lower expectations in Individual Life Insurance as a result of last year's second quarter actuarial updates.

I would also highlight that we experienced mixed underwriting results across the segments, which is not uncommon to see in the first quarter. However, the positive and negatives largely offset and the net impact on results was relatively modest. In particular, the adverse mortality experienced in Individual Life Insurance and to a lesser extent our Life Planner business was largely offset by favorable case experience in our Retirement business and good Group Life and Disability experience. While we don't expect this to match precisely every quarter, we manage our mix of mortality and longevity businesses such that they will work well together and contributed to dampening earnings volatility.

Before turning to business fundamentals, I'd also like to observe that net income for the quarter was fairly consistent with operating earnings. Credit losses were muted and a number of the recent actions to reduce earnings volatility are having their intended impact. In addition, our variable annuities hedging program showed good results in a particularly volatile quarter for capital markets. Strong net income is also contributing to solid growth in adjusted book value per share, which is up 15% over the prior quarter. While this increase reflects the impacts of tax reform and accounting changes at the start of 2018, it also reflects strong bottom line results.

I'll now turn to business fundamentals. At a high level, we continue to see solid momentum. While first quarter sales inflows were influenced by the timing of transactions and other episodic factors, looking through those we are pleased with the overall production trends in our operations. In our domestic businesses, we're seeing increasing sales momentum in our Individual Annuities business, with sales up 20% over the prior year and 7% sequentially. Likewise, we're seeing strong sales in our Group Insurance business, which reported growth of 27% over the prior year. This includes the benefits of our financial wellness value proposition as well as success expanding our presence in the premier market or accounts with 100 to 5,000 lives.

Investment Management also had a good growth quarter, although the extent of the strength is not reflected in the published net flow number. Results were distorted by an institutional outflow relating to a very low fee legacy index account. And this large \$6 billion outflow was more than offset by about \$7 billion of higher value new assets. And given the excellent investment performance of our funds, we remain upbeat that net flow story will continue to be a positive one.

We did experience net outflows in our Retirement business. While full service had solid sales in net flows, we did not close any pension risk transfers in the quarter. Pension risk transfer transactions are episodic, and we have seen a recent trend where activity builds throughout the year. So, having said that, we have a healthy pipeline and believe our leading market position and strong execution track record will lead to continued strength in this business.

Our international businesses continue to show good overall momentum. Although sales were down from the prior year, this is mainly due to challenging comparisons, as the first quarter of 2017 benefited from a sales surge in Japan ahead of our repricing of yen-based products. Looking through that impact, sales were solid, led by good Life Planner and Life Consultant productivity, and we continue to see particularly strong sales results in our U.S. dollar products in Japan.

With regard to capital deployment, we returned \$760 million to shareholders, about equally split between dividends and share repurchases. This reflects the quarterly impact of the 20% increase in both our share repurchase authorization and dividend level for 2018. We continue to generate a considerable amount of free cash flow in our businesses and thoughtfully allocate our excess capital between investing in our businesses and returning capital to our shareholders all the while maintaining a strong financial position.

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

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

Thank you, John. Good morning, good afternoon, or good evening. Thank you for joining our earnings call today. I'll take through our results and then I'll turn it over to Rob Falzon who will cover liquidity leverage and capital highlights.

I'm starting on slide 2. After tax adjusted operating income amounted to \$3.08 per share for the quarter compared to \$2.79 a year ago. After adjusting for market-driven and discrete items of \$0.03 per share, which consist of our quarterly market and experience unlockings in the Annuities business, EPS amounted to \$3.05 for this quarter, up from \$2.76 a year ago, and implying an ROE of 13.6% on an annualized basis.

Core performance of our businesses overall was solid in the quarter, with year-over-year comparisons benefiting from higher fees in our Annuities and Investment Management businesses, and continued business growth in International Insurance on a constant currency basis, including the impact of seasonally higher earnings from the elimination of Gibraltar Life's one-month reporting lag. In addition, a lower effective tax rate benefited earnings in the quarter as compared to prior year results.

While underlying business performance was solid, I would highlight that current quarter results included a couple of items that we refer to as trend considerations or items that varied from our average expectations. This includes non-coupon investment returns and prepayment income which were about \$50 million below our average expectations in the quarter. In addition, our Individual Life Insurance business had about \$20 million of reserve true-ups in the quarter. As John mentioned, overall mortality experience was in line with our expectations, as positives and negatives largely offset across segments. The net impact of these items resulted in a negative impact to current quarter earnings of approximately \$0.14 per share. GAAP net income, which included amounts categorized as realized investment gains and losses and results from divested businesses was \$1.4 billion in the quarter and was relatively consistent with our after tax adjusted operating income despite significant market volatility.

Moving to slide 3, which shows the items affecting pre-tax net income that are not included in adjusted operating income. Our current quarter GAAP net income includes pre-tax net realized investment gains of \$64 million and a pre-tax loss on divested business results and other items of \$66 million. Three items to note. Product-related embedded derivatives and associated hedging had a positive impact of \$340 million, largely driven by the noneconomic impact of applying wider credit spreads in the calculation of our non-performance risk related to the annuities living benefits.

The loss of \$269 million from risk management activities was primarily driven by currency hedges, as the U.S. dollar weakened compared to certain other currencies, as well as by losses on derivatives used for asset and liability management and other risk mitigation activities. The \$81 million loss from divested businesses primarily relates to the impact of higher rates on our derivatives used for asset and liability duration management in our Long-Term Care business. Underwriting results were largely as expected.

Moving to our business results and starting on slide 4, I will discuss the comparative results for each segment, excluding market-driven and discrete items. Annuities earnings were \$503 million for the quarter, up by \$54 million from a year ago. The increase was primarily driven by a greater contribution from policy charges and fee income, reflecting a 6% increase in our variable annuity average separate account values and lower risk management costs. Partially offsetting this increase was a lower contribution from net investment spread results

as returns on non-coupon investments and prepayment fees were approximately \$5 million below expectations in the current quarter compared to \$15 million above expectations a year ago.

Annuities return on assets, or ROA, of 121 basis points is down modestly from the fourth quarter, primarily due to lower returns on non-coupon investments and prepayment fees in the quarter. As we have previously stated, our long-term ROA target is about 115 basis points and we expect to exceed this level in the short to medium term. Over time, we expect that higher risk management costs and the aging of our business will cause our ROA to migrate to the long-term target level. I would also highlight that our variable annuity hedging program was well over 90% effective in what was a very volatile quarter.

Slide 5 presents our Annuity sales. Total Annuity sales in the quarter of \$1.7 billion were 20% higher than the year-ago quarter and 7% above the prior sequential quarter. The increase was primarily driven by higher HDI sales as the current interest rate environment enabled us to increase the attractiveness of our products.

Turning to slide 6, Individual Life had a soft quarter as earnings of \$36 million were \$82 million lower than the year-ago quarter and well below our expectations. I'll focus my comments on items in the quarter that deviated from what we would ordinarily expect. There were three items I will highlight, each having a negative impact on current quarter results.

First, our claims experience, inclusive of reinsurance, associated reserve updates and amortization was approximately \$45 million less favorable than expected. While we typically experience higher claims in the first quarter, claims this quarter were higher than typical seasonality. Notably, we experienced a higher frequency of claims in older age bands. Second, we experienced adverse impacts from reserve true-ups of \$20 million. In any given quarter, we could make modest positive and negative adjustments as we reconcile actual experience to actuarial models. The adjustments this quarter were larger than normal and skewed to the negative side. And finally, returns on non-coupon investments and prepayment fees were about \$10 million below expectations. We believe that after adjusting for these items results would be representative of our quarterly earnings power.

Turning to slide 7, Individual Life sales based on annualized new business premiums of \$125 million, were \$21 million lower than the year-ago quarter. As expected, guaranteed universal life sales declined and were partially offset by higher variable life and other universal life sales. This reflects our product diversification strategy and specific distribution, service, and product actions that we have taken.

Turning to slide 8, Retirement earnings were \$317 million for the current quarter compared to \$397 million a year ago. The decrease reflects a lower contribution from net investment spread results and higher expenses, partially offset by more favorable case experience. The contribution from net investment spread results was \$80 million lower than the year-ago quarter. Current quarter returns on non-coupon investments and prepayment fees were about \$20 million below expectations compared to \$65 million above expectations a year ago.

In addition, while we continue to experience some spread compression, this was mitigated by an increase in the average spread-based asset balances. Current quarter results also reflect particularly strong case experience, which was about \$55 million more favorable than our expectations. This modestly exceeded the prior year, which also benefited from very good case experience.

Turning to slide 9, total Retirement gross deposits and sales were \$10.6 billion for the current quarter, relatively consistent with the year ago. Results reflect solid full service plan sales offset by light institutional investment product sales. Net outflows for the current quarter of \$2.4 billion reflect a few items I will highlight. First, there were no pension risk transfer transactions that closed in the quarter. As we've mentioned, these transactions can

be lumpy, particularly given our focus on larger cases. However, we have a robust pipeline. Second, we experienced net outflows in our investment-only stable value business, driven by higher net participant withdrawals. Finally, these two items were partially offset by positive net flows in full service with good planned sales activity in the quarter, as noted previously. Total Retirement account values were \$428 billion, up by 8% from a year earlier. This increase reflects the benefit from market appreciation as well as about \$7 billion of positive net flows over the past year.

Turning to slide 10. Group Insurance earnings were \$55 million for the quarter as compared to \$34 million a year ago. The increase primarily reflects more favorable underwriting results, partially offset by a lower contribution from net investment spread results and higher expenses. The current quarter total benefits ratio of 85.6% was slightly better than our long-term target range of 86% to 90%, reflecting more favorable Group Life experience, partially offset by modestly less favorable Disability experience. We continue to be pleased with the underwriting results in our Group Insurance business.

Turning to slide 11, most of our Group Insurance sales occur in the first quarter, reflecting calendar year effective dates. Current quarter sales based on annualized new business premiums of \$383 million were 27% higher than the year-ago quarter. This increase reflects higher sales in both Group Life and Disability.

Turning to slide 12. Investment Management earnings were \$232 million for the quarter, compared to \$196 million a year ago. The increase in earnings was driven by higher asset management fees, net of related expenses, which reflects a 9% increase in average assets under management, driven by fixed income net inflows and equity market appreciation. Fee rates on our assets under management have remained very consistent.

In addition, results reflect a \$16 million higher contribution from other related revenues, which totaled \$45 million in the quarter as a result of stronger strategic investing earnings and higher transaction fees. This is about \$12 million above the quarterly average over the last three years. I would also highlight that earnings, excluding other related revenue, were below the prior sequential quarter. This is mainly due to the seasonality of certain revenue and expense items, including first quarter cost associated with our long-term incentive plan.

The Investment Management business reported about \$800 million of net positive unaffiliated third-party flows in the quarter, excluding money market activity. Net retail inflows of \$1 billion, driven by fixed income strategies, were slightly offset by institutional net outflows of \$200 million. As John mentioned, we had a large client withdrawal of about \$6 billion tied to a very low-fee index strategy that is inconsequential to earnings.

Moving now to International Insurance and turning to slide 13. Earnings from our Life Planner business were \$416 million for the quarter compared to \$408 million a year ago. The increase was driven by continued business growth with constant dollar insurance revenues up by 8% from a year ago, partially offset by a lower contribution from net investment spread results and higher expenses. The current quarter contribution from net investment spread results included returns on non-coupon investments and prepayment fees approximately \$5 million below our average expectations, in comparison to \$10 million above expectations in the year-ago quarter. Claims experience was approximately \$15 million less favorable than expected in both the current and prior period.

I would also highlight that a concentration of annual mode revenues results in an earnings pattern that favors the first quarter. We estimate that this benefited current quarter results by about \$25 million in relation to the quarterly average.

Turning to slide 14, Gibraltar Life earnings were \$440 million for the quarter, compared to \$391 million a year ago. This increase reflects seasonally higher earnings, which were previously reported in the second quarter, now

reflected in the first quarter due to the elimination of the one-month reporting lag. We would estimate that the benefit to current quarter earnings from a shift in the concentration of annual mode revenues was about \$25 million.

In addition, current quarter results benefited from more favorable policy benefits experience and business growth, primarily from strong U.S. dollar product sales in all channels. These increases were partially offset by a lower contribution from net investment spread results with returns on non-coupon investments and prepayment fees, approximately \$10 million below expectations, in comparison to \$5 million above expectations in the year ago quarter.

Turning to slide 15, International Insurance sales on a constant dollar basis were \$745 million for the current quarter, down by \$149 million or 17% from a year ago. This decrease primarily reflects lower sales in Japan and is largely tied to the elevated level of sales that occurred in the year ago quarter. You may recall that we experienced a sales acceleration in advance of the repricing of recurring premium yen products a year ago. This decrease was partially offset by an increase in U.S. dollar-denominated sales in Japan, driven by the continued attractiveness of U.S. dollar products in the current environment and the introduction of new U.S. dollar products last year. 79% of sales in Japan were U.S. dollar denominated in the quarter. Sales outside of Japan were lower. This reflects lower sales in Korea as the year ago quarter had large Annuity sales in advance of tax revisions on savings products. This was partially offset by growth in Brazil where business drivers remain strong.

Turning to slide 16, the Corporate & Other loss was \$294 million for the current quarter compared to a \$352 million loss a year ago. The decrease was primarily driven by lower expenses, in particular non-linear items, which can fluctuate including lower cost for employee benefit and compensation plans which are tied to equity market returns. In addition, higher income from the qualified pension plan following our assumption updates at year-end last year was partially offset by lower net investment income. As we've seen in the past, Corporate & Other results can vary on a quarterly basis due to the timing of expense items. We would consider the loss this quarter to be smaller than what we would typically expect.

Now I'll turn it over to Rob.

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Thank you, Mark. Now turning to slide 17, I'll provide an update on key balance sheet items and financial measures.

Our cash and liquid assets at the parent company amounted to \$5.1 billion at the end of the quarter. The increase of about \$700 million from year-end was driven primarily by proceeds from our \$1 billion senior debt issuance in March, partially offset by operating needs within our businesses. Cash inflows from the businesses during the quarter supported approximately \$760 million of shareholder distributions. This was about evenly split between dividends of \$387 million and share repurchases of \$375 million done under our \$1.5 billion board authorization for the year. Our financial leverage and total leverage ratios remained within our targets as of the end of the first quarter.

The year-end 2017 RBC ratios at Prudential Insurance or PICA and PALAC as well as the composite RBC are also shown here. As we have highlighted previously, we manage our Annuity risks using an economic framework that includes holding total assets to a CTE 97 level with the ability to maintain that level through moderate stresses. As a consequence, over time we may see some significant variability in the excess of PALAC's RBC ratio over our target ratio. At December 31, 2017, our domestic and international regulatory capital ratios were

above our AA financial strengths targeted levels and we continued to be well positioned relative to these objectives as of March 31, 2018.

I would also remind investors of two items we communicated in our guidance and during our fourth quarter earnings call that had a positive impact on adjusted book value in the first quarter of 2018 of roughly \$1 billion. First, we implemented the new accounting standard, which impacts the treatment of equity investments and resulted in a reclass of net unrealized gains of approximately \$900 million from AOCI to retained earnings. In addition, we eliminated the one-month reporting lag in our Gibraltar operations, so that Gibraltar's first quarter results reflect January through March activity. This did not result in an extra month of Gibraltar earnings, but instead resulted in an adjustment to opening equity of approximately \$170 million.

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

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thanks, Rob, thanks, Mark. We would like to now open it up for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] First question in queue will come from Erik Bass with Autonomous Research. Please go ahead.

Erik Bass

Equity Research Analyst - Life Insurance, Autonomous Research

Q

Hi, good morning. Thank you. I guess first, given the renewed concerns on Long-Term Care in the industry, can you just comment on the reserve levels and assumptions in your legacy block and the recent claims trends that you've seen?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Sure, Erik, it's Rob. So, a couple of thoughts. One let me sort of just sort of set the stage with the characterization of our block. It is a relatively small block. We've got about 214,000 policies. Our reserves, to the point of your question, are \$6.2 billion statutory, and that's about 7% of our overall statutory reserves. The nature of our book is a relatively recent vintage, and therefore, it benefits from more conservative plan designs than what we've seen in across the industry. Also notable is that two-thirds of our book are group issued, which also tend to have more conservative plan designs, for instance, lower percentages of things like lifetime benefits and inflation benefits. So, when we look at the reserving of that, it's a relatively small book. We feel pretty comfortable with the level of that reserve. And given that our assumptions are consistent with industry peers and generally on the more conservative side. Now, we recognize that only about 2% of our book is in payout, and the industry is also relatively nascent in terms of its experience and the emergence of that experience. So, obviously, as data emerges we and others will have to reflect that data vis-à-vis the assumptions that we're making.

And period results as a result of that as well, any given period you're going to see volatility in that, which we think you saw in 2017 versus what we experienced in 2018. So, our results for 2017 were negative with regard to our underwriting results, but in 2018 in the first quarter, as Mark indicated in his opening remarks, were largely in-line

with our expectations. We update our assumptions every year in the second quarter, so we'll be moving into that process. As I mentioned in the last call, we have about \$0.5 billion of margins in our reserves in that Long-Term Care block. So, given the size of the block, given the composition of the block, given the margin we have, we believe that we're very well-positioned going into the second quarter process to absorb changes, if any, that might come out of our review of assumptions in that period of time.

Erik Bass

Equity Research Analyst - Life Insurance, Autonomous Research

Q

Thank you. That's helpful. And just don't know if you can provide any further drilling down into the assumptions, which you characterized as conservative relative to peers. But any detail you can provide there in terms of whether it's mortality, morbidity, or interest rate assumptions?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

So, we haven't provided any details on that and sort of breaking that out separately, and the way those assumptions work, Erik, calling out any individual assumption without the context of the overall assessment of those assumptions is sort of a very difficult thing to do, but we benefit from industry studies. We look at those studies and we look at our own experience and I think it's very safe to say that we're across each and every one of those dimensions we would consider ourselves to be on the mid to more conservative end of the spectrum of how others have estimated those things.

Erik Bass

Equity Research Analyst - Life Insurance, Autonomous Research

Q

Got it, thank you.

Operator: And our next question will come from Ryan Krueger with KBW. Please go ahead.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hi, thanks, good morning. Somewhat similar but not specific to Long-Term Care, but just as we approach the second quarter actuarial assumption review, anything we should be thinking about in terms of key model updates or anything of that nature that you can help us think about as we move into that?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

So, Ryan, obviously, can't really comment on what's coming into the second quarter, given that that process is just kicking off. The only observations I would make is that we have – as we indicated last year, when we talked about, we did have significant impacts as a result of model changes that we were implementing as a result of what we called our actuarial transformation process that we were undertaking. And that modeling, with respect to valuations, was largely completed during the course of last year. So, we don't have an issue where we're looking at significant outcomes as a result of having done major revamps to modeling. That's probably the only insight I could offer at this point.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

No, that's helpful. Thanks. And then just on the PRT pipeline, I think you mentioned looks pretty good. But can you provide some additional color as we move through the year on PRT?

Stephen P. Pelletier

Executive Vice President & Chief Operating Officer - U.S. Businesses, Prudential Financial, Inc.

A

Ryan, it's Steve Pelletier, I'll answer that question. As Mark mentioned in his opening comments, it's not unusual to see transaction activity build over the course of the year. That's especially true in the very large case market, in which we specialize in that segment of the market, seeing companies develop their approaches and their transaction plans over the course of a fiscal year is not at all unusual, and it's in fact what we've seen over the past few years. But I would echo some of the comments I've made in the immediate past. We see a very robust visible pipeline. That pipeline continues to be driven by some of the considerations we've spoken about. A rising interest rate environment helps improve funding status. And so, across the board, ability of plan sponsors to transact is enhanced. And propensity to transact still remains very strong, driven by considerations like rising PBGC premiums and increased awareness of the longevity risk inherent in their plans.

So, we like what we see in terms of the visible pipeline and we think that we also like our ability to compete within that pipeline and as that pipeline emerges, really driven again by the same considerations that have driven our business in the past. The quality of our overall effort, the ability to bring large and complex transactions to a successful close, and the ability to onboard large populations of annuitants in a very seamless fashion.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Great, thanks a lot.

Operator: Okay. And we will go to the line of John Nadel with UBS. Please go ahead.

John M. Nadel

Analyst, UBS

Q

Hey, good morning, everybody. Two questions. One on PALAC, and the risk-based capital ratio there, Rob, is it fair for us to think that a roughly 1,000% RBC ratio is equivalent to CTE 97? Or would that just be a poor relationship to try to draw?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Well, I get the direction you're going. And what I'd modify on what you said, John, is that the way we manage that block is not just to a CTE 97, but the phrase we've used is through the cycle.

John M. Nadel

Analyst, UBS

Q

Understood, yeah.

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. So it's our ability to maintain that not only today but through an adverse economic cycle, equity markets being down like 17%, interest rates popping up. So, if you think about that, it's that CTE 97 under a level of duress.

John M. Nadel

Analyst, UBS

Q

Okay. So, in a more benign environment, it's above CTE 97?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yep, absolutely.

John M. Nadel

Analyst, UBS

Q

And, so again, around 1,000%, is that the place to think about or is it something below this level?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

No, part of the challenge you have with it, John, is that that is a very volatile measure because, without getting into sort of the inside baseball of how this all works, there's a lot of volatility between capital and reserves because they're calculated differently. And the way that ratio works is that it tends to mute the volatility when you're down around [ph] 350-ish (35:11) or so, but when you're above [ph] 350 (35:15), depending on what's happening in the market, it affects capital differently than it affects reserves. And so you get lots of volatility above that level. So, it's really hard to read too much into the ratio when it's that high. It's much cleaner to look at it when it's actually closer to the sort of the targeted level.

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

A

And the concept is more a total asset requirement, which combines both capital and reserves. And the way the liability side changes in terms of the mix is still supported by the asset position.

John M. Nadel

Analyst, UBS

Q

Okay. I appreciate that color. Thanks. And then I think I have one more for Charlie. I understand the fact that Life Planner sales in Japan in the year-ago period certainly benefited from some accelerated sales ahead of some pricing changes. I was curious about the Life Planner sales outside of Japan or rest of world that were down 12% year-over-year. Was there a similar impact anywhere that affected that comparison?

Charlie F. Lowrey

Chief Operating Officer-International & EVP, Prudential Financial, Inc.

A

There was actually in Korea, there was a similar effect in terms after a surge in anticipation of a tax rate change on variable products. So, you had the same thing happen there. Other than that you had goo sales in Brazil and other places, but there was a similar factor outside and that's what caused the decrease.

John M. Nadel

Analyst, UBS

Q

Okay. Thank you.

Charlie F. Lowrey

Chief Operating Officer-International & EVP, Prudential Financial, Inc.

Yep.

A

Operator: And we'll go to the line of Tom Gallagher with Evercore ISI. Please go ahead.

Thomas Gallagher

Analyst, Evercore Group LLC

Good morning. Just a few follow-up questions on Long-Term Care. Rob, the 8% margin on Long-Term Care, is that for GAAP or stat?

Q

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

The 8% margin...

A

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

The \$500 million on....

A

Thomas Gallagher

Analyst, Evercore Group LLC

Yeah, the \$500 million.

Q

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Oh I'm sorry...

A

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

\$500 million is what he is...

A

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Yeah. So I'm sorry, that's a GAAP cushion, the statutory cushion is in excess of Tom.

A

Thomas Gallagher

Analyst, Evercore Group LLC

Got you. And do you have the stats about differential between GAAP and stat reserves I think you said \$6.2 billion was stat?

Q

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Yes, the statutory reserves are \$6.2 billion, GAAP reserves are about \$5 billion. But recall on the GAAP side you're holding equity in addition to the reserves, so the way that works, if we look at our statutory reserves, we

A

look at the GAAP and the dealt delta has to be filled by equity. So, you've got \$2.5 billion of equity in addition to reserves sitting in GAAP where you have a lower level of equity in your statutory statements.

Thomas Gallagher

Analyst, Evercore Group LLC

Q

Got you. And then can you provide a little bit of color around the increase in incurred Long-Term Care claims in 2017? I know you described it as adverse. It was a fairly big delta, just if you could give some color on what drove it.

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Sure, so a couple of thoughts. I've mentioned before about the size of the book. And so as a result of the size of the book, the size of the claims that you get in any given period in a year are going to be relatively small and therefore volatile as well, Tom, so we had like 1,800, 1,900 claims during the entire year, which represents well less than 1% of our policies outstanding. So, you take underwriting results which can be volatile in and of themselves and then you take a small sample size which can be volatile and you just had a compounding volatility. And so specifically, what we saw last year is that the claims had a disproportionate representation of lifetime benefits or sort of a more generous benefit packages vis-à-vis our book.

So, our book has got less than 10% lifetime benefits. But the claims last year were like 1.5% ex that. So, it's sort of not proportional to what the book would otherwise be. And so if you just think about our incidents, our claim was only up about 7%. That's kind of natural given as the book matures, claims are going to climb over time, but the severity vis-à-vis of prior year was up like – in excess of 20% and that represents that nicks that came through which we don't think is anything systemic. We think that's just – it's just small sampling and volatility just given the profile of our book. And in fact if you look at the first quarter, part of what drove the operating results being profitable in the Long-Term Care book was in fact a movement back toward a reversion to closer to the average that we have in the book as opposed to what we saw last year.

Thomas Gallagher

Analyst, Evercore Group LLC

Q

Got it. That's really helpful. Yeah. Because, when you looked at the incurred claims I think they were up over 50% but the actual incidents was up only 7%. So is the right way to interpret that the way those filings work it's the expectation of ultimate claims so that would be like a claim duration issue because of the lifetime benefit connection, that's what really drove that?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. Absolutely. So, an estimate would be based on the characteristics of the policy and to the extent it's a more generous policy, it's going to have a larger reserve associated with it.

Thomas Gallagher

Analyst, Evercore Group LLC

Q

Thanks, and then one final one. Long-Term Care riders on life insurance policies, is that driving any of the weakness you're seeing on the life insurance reserving and/or claims experience there?

Stephen P. Pelletier

Executive Vice President & Chief Operating Officer - U.S. Businesses, Prudential Financial, Inc.

A

Tom, this is Steve. No, that has no impact on what you saw this quarter with the reserves. Those are true-ups that as Mark said in his opening comments, they all tended to go against us, so a bunch of relatively small items, but in the aggregate we felt it was worth calling them out. Those are items that as recently as last quarter, several of them went in our favor, so they can vary from quarter-to-quarter, but they don't have anything to do with the rider characteristics on our Life business.

Thomas Gallagher

Analyst, Evercore Group LLC

Q

Okay. Thanks.

Operator: And our next question will come from Jimmy Bhullar with JPMorgan. Please go ahead.

Jamminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Hi. First just a question on your variable annuity sales. The sales have been picking up a little bit, but withdrawals have increased as well. And just wondering if that's because of the aging of the book or if there's something else going on and how that affects your views of net flows in the Annuity business over the next couple of years?

Stephen P. Pelletier

Executive Vice President & Chief Operating Officer - U.S. Businesses, Prudential Financial, Inc.

A

Jimmy, it's Steve. I'll address your question first addressing sales. We did have a solid pickup in sales year-over-year. I'd say that's characterized by a couple of things. First of all, there's generally improving sentiment in the distribution markets around Department of Labor fiduciary rule outcomes and that certainly helps on an overall basis. In our particular case, we were also able to make some judicious and measured enhancements to the competitiveness of our products in ways that – especially HDI and PDI, in ways that contributed to first quarter sales.

You will recall that we are pretty unique in our ability to make pricing changes in any direction on a monthly basis. And so, when we saw a rising rate environment over the cusp of the year and we saw the positive impact that that was having on our at-issue returns, we were able to move nimbly. And, like I say, make some measured enhancement to our product competitiveness while still writing the business at very attractive returns. So, that's on the sales side.

In the aspect of the withdrawals, I think part of that is natural to the aging of the book as more of the business moves into payout phase and there's more active utilization of the benefit. I'd also say that we saw increased lapsation in this quarter. And again, that is something that is very much contemplated and anticipated in the way we manage risk in the business, in particular in our dynamic lapse function that we spoke to you about a couple of years ago. We expect to see – and Mark touched upon this in his opening comments, we expect to see rising lapses in a rising rate environment. However, I will point out we're talking about a couple of quarters now that we've seen increased lapsation. It's way too early to call some type of a trend, given the duration of the liability, but the pick-up in lapsation is not inconsistent with the way we approach the business from a risk management standpoint.

Jaminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay. And I had a question for Charlie, as well. On sales in Japan, they've been pressured by the shift in the product portfolio towards non-yen products. Where are you in the whole process of sort of pivoting your product mix? And I guess as you lap through the difficult comps and I'm assuming that sales will begin to recover in the second half, but what's your view on that?

Charlie F. Lowrey

Chief Operating Officer-International & EVP, Prudential Financial, Inc.

A

So, Jimmy, as was said, sales were down 17%, but what we were able to do was to pivot to U.S. dollar product, right. So, sales were down, partly because of the surge that took place and partly because of the repricing of our recurring premium yen-denominated product. So, as you know, we don't really sell – we sell virtually no single-premium yen-denominated product anymore in Japan in any channel. But we do sell some recurring premium product, but we've repriced that significantly. And so, we did see a decrease in sales there, but because of the sophistication of our sales force and the channels in which we sell through, we were able to pivot such that now the U.S. dollar sales are almost 80% of total sales.

So I think Steve used the word nimble before in his answer, I will use the same thing here. We have been able to pivot, both in terms of new product innovation, in terms of new dollar-denominated product, and in terms of the sophistication of the sales force in selling that product. So, we're most of the way through this, I would say, but there will be some continuing decrease in the yen-denominated product that we have. So, I think what you'll see going forward is a continued increase in U.S. dollar sales, but a leveling off of the recurring premium yen-denominated sales as well.

Jaminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay, thank you.

Operator: And we'll go to the next question in queue will come from Sean Dargan with Wells Fargo Securities. Please go ahead.

Sean Dargan

Analyst, Wells Fargo Securities LLC

Q

Hi. Thanks. I have a question about an item from the press release about an \$81 million derivative loss linked to the LTC business. Can you give some color on what that was exactly?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Sean, it's Rob. Yeah. So, the nature of the liability within Long-Term Care is very long, it's got a very long duration. And therefore, in order for us to do proper ALM, we have to use a combination of cash instruments, treasuries, and corporates and complement that with derivatives in order to be able to extend out the duration. So, we are long interest rate swaps in the – so a net receiver interest rate swaps in that Long-Term Care portfolio. Obviously, as interest rates rise, as they did during the course of the quarter, the mark-to-market on that swap is negative. And that's the number that you're referring to. So, it's a negative mark on the duration swaps, which theoretically are being offset by a positive mark on the liability, if you sort of think about the conceptual construct there, right, any change in the value of the asset is going to be reflected in the change in the present value of that

liability as well. So, that's the whole idea between ALM and doing good duration matching. Is that clear or did you have a follow up to that?

Sean Dargan

Analyst, Wells Fargo Securities LLC

Q

No, I think that's clear. Just sticking with hedging, with increased volatility returning, it seems like the hedge breakage was not material on the VA side in the first quarter. Just wondering if you have any qualitative comments about how you viewed slippage in the quarter?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. So, just the remark that you made was sort of on point, which is that it was a very volatile quarter. We had lots of days where volatility was in excess of 1%, which was an anomaly in the quarter vis-à-vis prior periods of time. So, I think it was in excess of 20 days where we had volatility in excess of 1% and that compares to having less than 10 of those days in all of 2017. So, lots of volatility there. We have a very rigorous hedging program.

The implication of that volatility is that they were trading probably twice the level of trades that they do during the day, we'd usually trade a couple of times, rebalance a couple of times during the day. They are probably rebalancing four, five, six times during the course of the day as a result of that volatility. But the end result of that was a high level of hedge efficiency. So, as Mark indicated, it was in excess of 90% and we feel good about that outcome. And so while we had negative hedge breakage, the gross number was around \$149 million for the quarter. We've seen some reversion of that, as well, on actually a significantly lower level of hedge breakage on a cumulative basis from where we sit today. So, we think that program is robust. We think that protects us, not only from volatility but also from a declining equity market. So, we feel good about both the quality and earnings prospects of our Annuities book, given the number of things that we've done over the course of the years to de-risk that book of business.

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

A

Yeah, Sean, it's Mark. Just one additional comment. We have substantial technology and human resources dedicated to this hedging process. And so, when Rob talks about the capabilities that we have to rebalance within a day several times, for example, that reflects a big investment in getting this right.

Sean Dargan

Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you.

Operator: And our next question will come from Humphrey Lee with Dowling & Partners. Please go ahead.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Good morning and thank you for taking my question. Regarding to your Group sales in the quarter, it was really strong. I was just wondering, what were the drivers and are you taking market share in a certain part of the market?

Stephen P. Pelletier

Executive Vice President & Chief Operating Officer - U.S. Businesses, Prudential Financial, Inc.

A

Humphrey, this is Steve. I would say that the strength of our Group sales is very much attributable to the strength of our financial wellness value proposition and how we see that really resonating in the marketplace. You recall we spoke about this extensively at Investor Day last year and our financial wellness effort is really about taking the capabilities that exist across all of our businesses and the digital and data analytics capabilities that we've been investing in significantly over the past few years and using those to deepen and individualize our relationships with people, individuals who come to us via the workplace channels, via our Group business and our Retirement full service business. And we see real progress in the strength of that value proposition.

I'll give you an example. Again, harkening back to Investor Day, last year, we spoke about the Pathways program. You'll recall this is the program by which some of our top Prudential advisors offer financial planning and financial education seminars to individuals who are employees of our Group and Retirement clients. I think the numbers we cited for you last year were that that program was being taken up by 250 companies, who collectively employ 3 million people plus. Today, those numbers are 350 companies who collectively employ 4 million people plus. And so that type of tangible benefit that we're able to offer to individuals and their employers is really resonating in the marketplace. And I'd say that was the major driver of our pickup in Group sales. And we're pleased not just by the overall quantum of that pickup, 27%, but by the composition of it as well, as Mark mentioned. About 40% of our sales growth occurred in the premier market, 100 to 5,000 lives, where we're really trying to build our presence. So, we feel very good about Group results in the quarter.

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

A

This is Mark, just to add on. When we've talked about this in investor meetings, we've said that the first proof point on the wellness initiative will show up in Group sales. And I think from Steve you're hearing good early returns on that proof point.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Got it. And then shifting gear to Investment Management. You talked about you have \$7 billion of high fee gross inflows coming in, but offset by the \$6.2 billion low fee index product. If we were to think about the fee differential between the inflows and the outflows, like how would you describe that in the current quarter?

Stephen P. Pelletier

Executive Vice President & Chief Operating Officer - U.S. Businesses, Prudential Financial, Inc.

A

I would say the differential couldn't be wider, Humphrey, quite frankly given the fact that the fee basis on the single large outflow was absolutely de minimis. This was a legacy, a passive strategy, which we don't do much of at all, that was part of a larger long-standing relationship. But the fee basis on this part of the business was absolutely inconsequential. And as it relates to our inflows, they continue to come from areas such as certain components of our fixed income business and our real estate business where we are able to continually – continue to attract very reasonable fees. All of this put together means that, even in an age where there's secular pressure on the fees inherent in active asset management, we've been able to keep our average fee basis across our entire book of business very, very constant in that 22 basis point range that we've cited to you before.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Got it. Thank you.

Operator: And our next question here will come from Alex Scott with Goldman Sachs. Please go ahead.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Hi. The first question I had was just going back to the Annuities and the total asset requirement. Could you just describe, I guess, given the net outflows and given sort of some of the stuff that's running off might be a little bit more capital intensive, how quickly is that total asset requirement declining and how much would you expect that to contribute to capital deployment?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

So, Alex, it's Rob. I think about it less in terms of sort of that capital ratio and more in terms of the operating earnings that are coming off that business and because we're as well capitalized as we are, our ability to be fairly aggressive about dividending out our earnings in the form of free cash flow out of the business. So, if you look at PALAC in our Annuities business last year, we actually took out over \$1 billion worth of dividends – or dividends and returns of capital from the business. And in the first quarter we took out in excess of \$300 million in dividends from that business as well. And if you sort of look at the run rate of the business on an after-tax basis, that \$300 million compares to around \$400 million or so of earnings that we would report in the quarter. So, we feel very good about the dynamic that occurs on the capital side allowing us to be very aggressive about dividending out earnings.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

And do you have flexibility to be sort of proactive and accelerate any of that to repurchase stock at more attractive share prices?

Robert Michael Falzon

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Well, so that's a different issue, which is how we feel about stock repurchase, so I'll belabor the question by simply saying recall that we increased both our dividend and our stock prices – our stock repurchases by 20% this year, to get us to the \$0.90 quarterly rate on dividends and the \$1.5 billion of stock buybacks. Obviously, we revisit this all the time. As we thought about that, that level of stock buybacks and dividends is sort of calibrated to our free cash flow ratio. We've brought that free cash flow ratio up to around 65% from where it was at 60% before. If you look at the dividends and the buybacks, it represents just under 60% of our earnings in the first quarter. So, you can sort of see we've got some flexibility against where we are, but we like to keep some room in that in order to be opportunistic to deploy some of our free cash flow towards growing the businesses, either organically or inorganically.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Got it. And then can I sneak one last one in? On the International segment, can you give an update on how much of a headwind you'd expect low rates to be there? I mean it didn't appear to be having much of an impact this quarter. Will we start to see that later in the year?

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

No, I don't think so. Recall in Japan that we hedged the currency. And in terms of interest rates, we don't think it's going to be a headwind. The interest rates have been low, they remain low. We've been operating in a low environment for a long period of time. And so, I think we're comfortable with where we are.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Thanks very much.

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

A

Brad, we have time for one more question.

Operator: Thank you. That will come from John Barnidge with Sandler O'Neill. Please go ahead, sir.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Thank you. Given where evaluations have fallen this year in life insurance, as well as asset managers, can you talk about your interest in acquiring blocks, whole businesses, or even a traditional asset manager? Thank you for your answer.

Stephen P. Pelletier

Executive Vice President & Chief Operating Officer - U.S. Businesses, Prudential Financial, Inc.

A

John, this is Steve. I'll address your question as it relates to – as it relates to asset management. We certainly have been very successful in growing our business organically. The business that you see today is virtually entirely the product of organic growth. However, as we've mentioned before, we are open to opportunities for inorganic growth. However, in looking at those opportunities, we're very mindful of the importance of avoiding undue social disruption in the asset management business. And so, I think what you'll see or what we have a greater interest in is opportunities that might fit neatly into our multi-manager model, not necessarily opportunities that call for broad-based integration efforts across multiple asset classes, but rather things that can slot neatly into the overall architecture of our multi-manager model. Matters like this will probably naturally tend to be relatively smaller in size rather than deals of very, very large size, but nonetheless, we feel we can attractively utilize the capabilities that such efforts might bring us.

On the Life basis, we are always looking for ways to continue to bolster the mortality side of the mortality longevity equation that John mentioned in his opening comments. Certainly, our pretty strong sales levels are one way of doing that, but we also look at opportunities on the inorganic front, as well.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Great, thank you for your time.

Operator: And, ladies and gentlemen, that does conclude our conference for today. Thanks for your participation and for using AT&T executive teleconference. You may now disconnect.

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