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Prudential Financial, Inc. (PRU)

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CORPORATE PARTICIPANTS

Darin Arita

Senior Vice President, Head of Investor Relations, Prudential Financial, Inc.

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

Robert Michael Falzon

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

Stephen P. Pelletier

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

OTHER PARTICIPANTS

John Nadel

Analyst, UBS Securities LLC

Thomas Gallagher

Analyst, Evercore ISI

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Erik James Bass

Analyst, Autonomous Research US LP

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for your patience in standing by and welcome to the Prudential Second Quarter of 2018 Earnings Call. At this time, all of your participant phone lines are in a listen-only mode and later there will be an opportunity here for your questions. Just a brief reminder, today's conference is being recorded, and I would now like to turn the conference over to Head of Investor Relations, Darin Arita.

Darin Arita

Senior Vice President, Head of Investor Relations, Prudential Financial, Inc.

Thank you, Justin. Good morning, everyone, and thank you for joining us. Representing Prudential on today's call are John Strangfeld, Chairman and 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 take 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 the materials for today's presentation. These can be found on our website at investor.prudential.com.

You will notice that we made changes to the format of our slide presentation. We hope this provides you with more color on the strategic direction of our company and the key priorities of our businesses. Also, as a reminder, we will be hosting an Investor Day in Tokyo on the morning of September 27. The focus will be on our international businesses with an emphasis on Japan. We hope that you will be able to join us.

And with that, let's turn to slide 2 and I will hand it over to John.

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you, Darin. Good morning, everyone, and thank you for joining us. We are pleased with the momentum of our business in the first half of the year. We continue to bring financial opportunity to more and more customers around the world in new, exciting and compelling ways. I will expand on our U.S. financial wellness initiative in a few moments.

We generated an attractive operating return on equity and double-digit growth in both adjusted earnings per share and adjusted book value per share. And with our strong capital position, we returned approximately \$760 million to shareholders; as well, significantly strengthened our Long-Term Care reserves. We expect to continue a robust level of capital return and to utilize the remaining \$750 million of our share repurchase authorization by the end of the year.

Turning to slide 3, I will provide some additional financial highlights on the second quarter. We produced an annualized operating return on equity of 13.5%, which was above our near to intermediate-term objective of 12% to 13%. Our second quarter adjusted earnings per share of \$3.01 grew significantly from the prior year. This increase was driven by growth in the business, tax reform, and assumption updates. Adjusting for notable items, earnings per share grew 16%. Our current quarter net income was also affected primarily by the significant strengthening of our Long-Term Care reserves, as I noted earlier. Rob Falzon will discuss this in more detail.

Our adjusted book value per share of \$92.60 is up 14% over the prior year. This increase reflects the earnings we generated as well as the impact of tax reform and accounting changes at the start of 2018. Partially offsetting these items were the payment of \$3.30 per share of common stock dividends and about \$1.4 billion of share repurchases over the past year.

With respect to our business segments, here are some highlights from the quarter. PGIM, which is our investment management business, continued to produce positive net flows with \$7.3 billion in the quarter. Our Retirement business had record account values of \$433 billion, including net flows of \$2.8 billion driven by pension risk transfer and full service sales. The third quarter has started well, with our recently announced pension risk transfer transaction with Raytheon totaling close to \$1 billion. Our Individual Annuities business produced sales of \$2.1 billion, which were 37% higher than the prior year and up 20% sequentially. And in International, we continued to produce steady in-force growth.

Now, turning to slide 4, I'm extremely excited about our potential to accelerate earnings growth as we continue to unlock value through our unique business model. Not only does our model allow us to manage risk and deploy capital in a way that is attractive to shareholders, our model and business mix also allows us to design and deliver integrated solutions at scale to bring financial security more into reach for a growing base of customers. By combining our competencies across disciplines, we generate outcomes that other companies simply cannot replicate.

There are three key points I'd like to make regarding our financial wellness initiative in the United States. First, we have built up significant experience since launching this initiative three years ago and have continued to innovate. Second, we believe our integrated holistic solutions, which are available in person or online, provide meaningful differentiation in the market. And third, our value proposition is resonating with employers and individuals and this is resulting in commercial success.

We view financial wellness as a way to help people drive behaviors that allow them to effectively manage their day-to-day finances, achieve their most important financial goals and protect themselves against key risks. As a reminder, we launched financial wellness with the introduction of Prudential Pathways and, in this program, our Prudential advisors provide education for employees of our workplace clients. Should these employees want more information and solutions for their needs, they can follow up with our advisors. Customers can also receive education and solutions in digital form, since the launch of our digital financial wellness platform. Employers also find significant value in this digital platform as they can better understand the financial wellness of their overall employee population.

We have critical ingredients to deliver integrated solutions that address the holistic financial needs of individuals, and these include our own financial advisors, workplace access to over 20 million people via our Retirement and Group insurance businesses, income and protection solutions via our Individual Annuities and Individual Life businesses, and Investment Management solutions [ph] via (7:30) PGIM. All of this is built on our own technology platform.

This integration creates value in several ways. First, institutional customers only need to work with one party. Second, we can enhance customer experiences and solutions, and these experiences are personalized with solutions tailored to each person's needs. We have the flexibility to adapt and refine the experiences and solutions by having all of the capabilities I previously mentioned. And this is further enabled by our digital and data analytics expertise. And third, having all the parts of the value chain will allow us to deliver sustainable value to our shareholders.

Our solutions that I'm describing are resonating. Since launching financial wellness, over 350 employers representing more than 4 million employees have signed up for Prudential Pathways. When people attend the education seminars, many schedule follow-up meetings with our financial advisors. And the types of employers that have signed up represent a broad spectrum and include several well-known brands from amongst the largest and fastest growing companies in the country. Also, approximately 200 employers are using our digital financial wellness platform.

We're very excited about how our business has come together to make a meaningful difference in the financial health for people. And innovations like Prudential Pathways and our digital financial wellness platform don't happen without an inclusive, empowering culture that promotes internal partnerships. We've witnessed the power of bringing together different perspectives, experiences, and technical expertise to gain deeper insights, develop new offerings, and enter new markets. Our own pension risk transfer business was born from this type of a entrepreneurial culture and partnering capability, and financial wellness is another great example. I continue to believe that Prudential's culture is a competitive advantage and I'm excited to see how our talented people continue to push the company into new areas for growth, areas that are consistent with our mission and our purpose.

With that, I'll turn it over to Mark, who will provide an update on how our businesses are executing on key priorities. Mark?

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

Good morning, good afternoon, and good evening. Thank you, John. I'll be going through comments on each of our businesses in a few minutes, but let me start off by reminding you that we've often talked about ourselves as a very good story around developing thoughtful strategies, executing well, building good business fundamentals, and realizing attractive financial results. And, in fact, we often start our earnings calls by talking about the attractive business fundamentals reflected in sales and flows, for example, that we're experiencing in our businesses

So, under that umbrella of the themes, strategy, execution, fundamentals, and results, I'm going to make a few comments on each of our businesses. I won't be going through that whole equation for everything we do everywhere, but there are things that are worth highlighting in the context of each of our businesses.

Before I get into a business-by-business discussion, though, let me mention a few common themes that run across our businesses, and these are themes that are not necessarily so visible. These are things that are in the heart of our execution processes that are making differences to us in our markets and with our clients.

The first common theme, and it's part of a lot of what John talked about, is the notion of enhancing our value propositions. And the practical consequence of that is that we are able to compete on a basis other than just price because of the attraction of the value proposition that we've put in front of our clients. Importantly, this is not a theoretical aspiration for us. We're seeing real results in the marketplace, reflecting differentiation and reflecting the attraction of a value proposition that goes beyond price competition.

The second common theme that runs across our businesses relates to what we're doing to impact the front end, our customer-facing activities. And almost everywhere, we're doing things that are changing our client experiences, folding into the notion of enhanced value propositions and, again, having concrete results with respect to either individual or institutional businesses.

And then finally, technology runs across so many of the things that we're doing that it's worth highlighting the idea of digital, mobile, and data in a number of aspects of our businesses. John mentioned how important technology is to the financial wellness proposition, but technology runs through a lot of the things that we're doing in the context of that front-end impact and also in the context of the enhanced value proposition. So, big deal there. And each of these impacting what we do in the markets every day are things that are driving the attractive business fundamentals that you're seeing.

I want to now comment on the individual businesses. I'm going to start with slide 5. This one is titled PGIM. And again, I'm not going to go through the whole equation for everything everywhere, but I want to make some points that tie things together around our themes. But with respect to PGIM, our headline for a while has been net flows. Every year, we've counted one more year of consecutive positive flows, up now to 15 years of consecutive positive net flows in our Institutional business, 13 consecutive years of positive net flows in our Retail businesses.

But the story isn't just arithmetic. These net flows tie specifically to the key priorities that are mentioned on the right-hand side of this slide. I guess, if there's a leading indicator of future flows, it's the first bullet under key priorities, which is investment performance. And you see metrics there that provide extremely attractive messages and signals about the prospects for future flows in this business. As our performance ages, we'll see three-year records becoming five-year records and five-year records becoming 10-year records, and you see very attractive

performance relative to benchmark. And that has been one of the anchors over time, driving our flows in the Institutional and Retail Investment businesses.

Then, you see some strategy bullets, and we've talked about these: leveraging scale; realizing the benefits of operating leverage, especially as we've highlighted in public fixed income; but also, expanding our global footprint. We are getting mandates from around the world. We are receiving recognition as an asset manager in publications in Europe, for example, and in publications in Asia, for example. So, the global footprint story really is working. I think the PGIM brand has been very helpful to us in that regard; and then, diversification with respect to products and capabilities. And so, we've talked about strategy initiatives and I've highlighted PGIM over and over as a great story over the past five or six years that relates strategy execution and results. And so, those flows do tie back to exactly the things that are listed under priorities to grow.

I'd comment finally that, in the lower right-hand side of this, our overall fee rate is holding up very well in PGIM. And we've talked about the mix changes that are helping to offset some of the dynamics of product changes within Asset Management, and those mix changes continue to serve us well.

Turning to the next slide, that's on Retirement. The big story here, I think, is probably across-the-board flows. You see on the bottom Institutional Investment product flows and Full Service net flows in Institutional Investment products. We did about \$1 billion of PRT deals in the second quarter. John mentioned a big deal that's been done since then. And we did about \$2.4 billion in two jumbo longevity swaps during the quarter. So, we continue to see robust business flows on the Institutional side. On the Full Service side, in the first half of the year, we had \$16 billion in sales and deposits, and that resulted in a \$3 billion net positive Full Service flow for the first half of the year.

On the point I made earlier about differentiated value proposition, I would highlight the first bullet under key priorities to grow, which is the potential impact on our Retirement businesses, especially Full Service, of things that we're doing in financial wellness and how important that can be as part of our value proposition to clients. And as I said, it's not just a theoretical aspiration; it's happening. We see business coming in because of what we can do in the wellness arena.

Turning to the next slide, Group Insurance, I guess the highlight here is to tie, again, back to the idea that our value proposition is resonating. We're closing, as John's slide mentioned, marquee business, not just on the basis of price, but on the basis of the wellness proposition and other dimensions of service. Under key priorities here, we mention financial wellness, again, but the third bullet also mentions improve organizational and process efficiencies. And we're doing things there that are impacting our customer experience and impacting our value propositions. And these things are paying off. So, the way in which we're approaching customers goes beyond the inclusion of the wellness initiative in our overall package to some specific aspects of how we deal with and how we treat clients; how we service customers, both at the individual level as beneficiaries, for example, but also at the Institutional level as Group Insurance clients.

Turning to the next slide, Individual Annuities, I want to highlight three things. On the bottom left, you see that sales are growing. And what I'd say – what I would say about sales is that they're growing, they're well diversified, and we're selling at prices that are achieving or exceeding our target returns. So, it's a good solid attractive sales picture, reflecting efforts we've made in the product arena, but also reflecting our pricing discipline with respect to meeting profit targets.

Second thing I want to highlight is on the bottom right, and that is the flow of dividends from our Annuity business to PFI. We have promised you, as we restructured and talked about the potential in this business, that we would

generate healthy cash flows from our Variable Annuity business to the parent and we are realizing that, as you see in that slide.

And then, finally, the third bullet under key priorities to grow reflects part of what Variable Annuities can do to be part of the integrated solutions that John mentioned that we're delivering across businesses, particularly with respect to secure retirement income in the workplace as it relates to Individual Annuities. We've launched a product called Guaranteed Income for Tomorrow. The short phrase for that is GIFT, and this is a specific extension of secure retirement income products into the workplace market in a way that we feel is very attractive and is an important complement to what we're doing overall in financial wellness.

Let me turn, now, to Individual Life in the next slide. And I want to talk about two things here. One is the broad sales picture, which we would describe as very solid, but then this is an area where we're doing things that are impacting value proposition and impact on our client interfaces that are extremely important. We've added a capability that we call PruFast Track, which is an end-to-end solution that can bind policies in as quickly as 48 hours. This compares to a traditional issue process that may take several weeks. This process eliminates the need for health examinations. And this capability is unique in the marketplace coming from Prudential in several dimensions. One is we're selling our own products and our binding. We offer a broad array of products, including Term, Variable Universal Life, Fixed Universal Life, and Indexed Universal Life. We sell face amounts up to \$1 million for age ranges between 18 and 60. We anticipate fully rolling this out in our third-party channels by the end of August, and we're optimistic that processes like this, which make life easier for people to do business with an insurance company, can have a significant positive impact on sales. The analogy generally is the whole digital world, where things are just easier, and we're making things easier in our Individual Life business.

Let me turn, now, to International, and there are two slides. And I want to highlight common themes, and then a couple of specifics on each. There are three drivers of our International story at this point, and they're probably familiar. One is the importance of dollar products overall, but particularly in Japan. Our ability to sell dollar products, because of the quality of our sales forces, has allowed us to maintain strong sales results and strong profitability even in an environment in which some of the local currency products, again, especially referring to yen, have been challenged in terms of both attractiveness in the marketplace as well as profitability. So, headline number 1 is the importance of dollar products, and you see graphs of sales mix by currency on both of the pieces of the International picture.

Second key bullet, the management of our Life Planner and Life Consultant forces. This includes growth. It includes quality. And I just reference quality in talking about dollar sales. And it also includes productivity, all of which are strong and improving for us and terrific assets in terms of the way we do business.

And then, finally, a new one for us to talk about in International, which is digital, mobile and data analytics initiatives. And I would describe this as something below the level of total International, thoughtful market-by-market, tailored to the circumstances in our individual markets, but a package of initiatives that we'll be talking more and more about as we mature, both in terms of our front-end initiatives and in our back office and other capabilities.

So just quickly on Life Planners, we've been through a couple of experiences, which we've talked about, where we've had a blip in sales manager growth followed by better results in terms of Life Planner growth. And we're kind of nearing one those blips right now. We have appointed a lot of sales managers and we're anticipating that there will be some reflection of that sales manager growth in Life Planner hiring over the next couple of years. It doesn't happen the next day, but there's a strong basic dynamic around the second bullet under priorities, which

is Grow Life Planners. And that important dynamic relates to appointing sales managers. And then, I mention sales mix by currency just to highlight that on the bottom of that slide on the right.

And then, turning to Gibraltar Life, two comments here. One is the currency results and, again, how important U.S. dollar products are and tying that back to the quality of our sales force and what they can do in the market that many others can't do. But I also want to highlight the multi-channel approach that's reflected in Gibraltar's results. Looking at the sales mix on the left, where you see Distribution, we have Life Consultants. We also have Independent Agents; and, we also have the Bank channel. And so, we continue to optimize across those channels with respect to both product design and, ultimately, volume and price. So good attractive results there.

So that's it. As I said, I've highlighted some pieces under the strategy execution fundamentals and results equation. Good stories everywhere for us and some things that may not have been so visible that we're happy to be able to talk about.

And with that, I'll hand it over to Rob.

Robert Michael Falzon

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

Thanks, Mark. I'm going to pick it up beginning on slide 12 by highlighting the notable items which have impacted the current quarter adjusted operating results. We have combined what we previously called market driven and discrete items with trend considerations into a single list of notable items. These items consist of the impact on results from our annual reviews, including assumption updates and other refinements, the quarterly updated estimate of Individual Annuities profitability driven by market performance, and the impact attributable to variances from our expectations for selected variable revenues and expenses. We highlight these items because their contribution to current quarter results may not be indicative of future performance.

This year's Actuarial review included economic and insurance assumption updates and other refinements and resulted in a net unfavorable pre-tax adjusted operating income impact of \$160 million on our ongoing businesses. We expect no meaningful change to our run rate earnings across our businesses from these updates and refinements. Current quarter returns on non-coupon investments and prepayment fees were about \$10 million below our long-term expectations. In addition, the current quarter underwriting experience was approximately \$85 million better than our average expectations, including favorable pension risk transfer case experience in Retirement.

And finally, our Group Insurance business incurred elevated expenses in the current quarter, including the costs to terminate a third-party underwriting service provider contract. These services will be performed internally, which should reduce future underwriting costs. In total, these notable items reduced earnings by \$102 million, or \$0.19 per share. Excluding these notable items, earnings per share would be \$3.20, up 16% from the year-ago quarter.

Turning now to slide 13, I'll spend a few minutes discussing our Long-Term Care business. We entered the Long-Term Care business in the 1990s and actually issued our first individual Long-Term Care product in 1999. In 2012, we discontinued all sales of Long-Term Care products, classified this business as a divested business, and strengthened reserves by \$700 million. We currently have approximately 211,000 policies in-force, with about 2% of these policies currently generating claims. We have been actively managing our Long-Term Care block by enhancing our claims management programs, optimizing our cost structure and successfully pursuing rate increases. Our experience of applying for and receiving approvals for rate increases is consistent with the assumptions in our reserves. Included in our reserves is \$1 billion of combined future rate increases and benefit reductions in lieu of rate increases which have not yet been approved.

During the quarter, we strengthened our GAAP reserves by \$1.5 million as a result of updating our Actuarial assumptions. We removed our morbidity improvement assumption of 1% reduction in claims cost per year over a 20-year period, which increased our best estimate reserve by \$1.4 billion. In addition, there were a number of other changes to our assumptions, the net effect of which was largely offset by the margin in our reserves that existed prior to the update. These changes align our assumptions with experience and industry data.

Although, we removed our morbidity improvement assumption, we retained our mortality improvement assumption. If we also removed this latter assumption, our best estimate reserve would have been reduced by about \$850 million. While strengthening our reserves, we continue to maintain a strong capital position and do not anticipate any change to our capital deployment plans, including the level of dividends and stock repurchases.

For additional detail, we have included the key assumptions and sensitivities to changes in these assumptions in the appendix of this slide deck. We've also included in the appendix, additional details about the block. Here are a few of the highlights from that data. Our average attained age is 65 years old, which is relatively young and, therefore, likely to provide more time to collect premiums. About two-thirds of our book is group issued, which tends to have lower benefits than individual policies. And, as a result, less than 10% of our total policies have lifetime benefits, and less than 30% contain compound inflation features.

Now turning to slide 14, I will provide an update on key balance sheet items and financial measures. Our cash and highly liquid assets at the parent company amounted to \$4.7 billion at the end of the quarter. The sequential quarter decline of about \$400 million was driven primarily by our redemption of high coupon junior subordinated note, partially offset by cash inflows which were in excess of shareholder distributions during the quarter.

Shareholder distributions included dividends of \$382 million and share repurchases of \$375 million. The share repurchase authorization for the remainder of the year was \$750 million as of June 30.

Our domestic and international regulatory capital ratios are above our AA financial strength targeted levels and our financial leverage and total leverage ratios remain within our targets as of the end of the second quarter. In addition, we do not expect material impacts to capital from the proposed Variable Annuity statutory framework changes adopted by the NAIC Variable Annuities Issues Working Group last week.

So, in summary, we are executing on our strategies and generating strong returns in growth in our adjusted earnings per share and adjusted book value per share while maintaining a robust capital position.

Now, I'll turn it to the operator for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] First we'll go to the line of John Nadel of UBS. Your line is open.

John Nadel

Analyst, UBS Securities LLC

Q

Hey, good morning. So, this has been a long day and there's a lot going on. I guess the first question I have is, when I think about the morbidity improvement and the removal of that assumption from your Long-Term Care reserves, was that something that was an internally-motivated decision? Or was there any external influence on that decision, whether from regulatory bodies or rating agencies or any other constituents?

Robert Michael Falzon

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

A

John, it's Rob. That decision was entirely an internally-motivated decision. It was done with the benefit of consulting with industry experts and others in the industry from which we were able to glean insights as to trends that were occurring within the industry, but was not done in reaction to any regulatory stimulus.

Sort of, if I expand on that a little bit, perhaps, and perhaps a little redundant with what I might have said in my opening remarks, but we discontinued the business back in 2012 and we took a \$700 million strengthening of our reserves at that point in time. As I mentioned, we incorporated our reserve estimates for the morbidity improvement, which means people living healthier, which reduced our required reserves, as well as mortality improvement, which meant that people living longer, which conversely increases our reserves.

John Nadel

Analyst, UBS Securities LLC

Q

Yes.

Robert Michael Falzon

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

A

Given the lack of the statistically significant experience in our book at that point in time, we relied on guidance from consultants, academic research, and industry practice. Since then, neither our experience, which has now, has sort of more statistical significance associated with it, or any of that consultation or survey with industry has indicated that there's been any morbidity improvement trend. So, at the same time, we're seeing the mortality improvements in this business and in other businesses.

John Nadel

Analyst, UBS Securities LLC

Q

Yes.

Robert Michael Falzon

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

A

So, based on that, we elected to – based on looking at that data and that industry experience, we elected to remove the morbidity improvement assumption, and that gave rise to that \$1.4 billion charge while maintaining the mortality improvement assumption. And as I indicated in my remarks, that's about an \$850 million addition to

reserves – or attribution to reserves as a part of our assumption update process. Recognizing that that's a more conservative approach that others in the industry have taken, but it's consistent with our updated view of best estimate.

John Nadel

Analyst, UBS Securities LLC

Q

Got you. And that's really helpful. I really appreciate that. And then, just second, or following up on that, does that change apply to both the Individual and the Group Long-Term Care block? Did you have that assumption in both places? And if so, can you give us an estimate on how to allocate that piece of it?

Robert Michael Falzon

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

A

So, yes, the assumption was – pertain to both blocks of business, Group and Individual, in the old assumption and in the update. So, it's been removed by both.

The impact on either of those blocks in any given assumption, actually, is going to be variable, so there's not a consistent rule of thumb that you can use. With regard to this particular assumption, John, roughly what I would say is about 60% of it would have been driven from the Individual block and about 40% of it from the Group block.

John Nadel

Analyst, UBS Securities LLC

Q

Okay. And then, just one quick follow-up on an actual business question. Within Investment Management, or PGIM, results really stepped up in terms of the pre-tax operating income contribution. Looks like that was – I mean, revenues were sort of in line. You continue to grow very nicely. It looked like the biggest part of it – the biggest driver of the jump was the reduction in expense or spending. Is that sustainable? And if so, sort of what's driving that? Is it just sort of the runoff of some of the investment spending you've been making?

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. There's going to be some variability in relation to timing of expenses. For example, on a sequential quarter, our first quarter expenses would ordinarily be elevated by how we account for our long-term incentive compensation in the Asset Management business. And you're not seeing that show up in the same way in the second quarter. Also, as you note, looking at a longer-term time trend, some of the investments that we've been making in the business are reaching maturity and are yielding very, very significant benefits.

But I would say that the main drivers, looking at a year timeframe or a multi-year timeframe in the Asset Management business and the growth in earnings there, have been continuing to attract very strong and robust flows, attracting those flows into areas where we already have existing strategies; so, therefore, we're able to onboard the flows in a very effective way and expand our margins and our ability that we've spoken about before, which we think is pretty distinctive in the industry, to maintain a stable average fee structure across the entire book of business at about 22 basis points. So, all of those factors, together, we see as really being the underpinning of positive earnings flow – positive earnings trends in PGIM.

John Nadel

Analyst, UBS Securities LLC

Q

Thank you very much.

Operator: Next, we have the line of Tom Gallagher of Evercore. Your line is open.

Thomas Gallagher

Analyst, Evercore ISI

Q

Good morning. Hey, Rob, first just to follow-up to John's question, the – removing the morbidity improvement assumption with only 2% of your book now on claim, I mean, do you really have enough experience in terms of your own data to make that – to see that you're not seeing the emergence of morbidity improvement, or did you have to rely pretty heavily for that assumption change on the third-party consulting advice as well? Or was it a mix? Or – any help on that would be appreciated.

Robert Michael Falzon

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

A

Yeah, so Tom, I would say it was a balance between the two. I would say when we initially took this, we had very little experience. We've now got five, six years' worth of experience that statistically you would call significant. As we look at that data, there's noise. And it clearly – as you would think given it still is a relatively shorter measurement period and, as we indicated, the number of claims that we have is relatively small to the overall book and to the population of claimants that are across the industry.

So, we complemented that with looking externally and talking with consultants that we know have insights into what's happening across the industry to confirm that what we're seeing isn't any different than what others are experiencing across the industry. And based on what we got from those conversations and looking at our own book, felt that there was no discernible trend toward morbidity change. And so, our best estimate, therefore, recognizing that it could go either way, so something that you're trying to get as a mid-point is that there is no morbidity improvement occurring in our book or across the industry that would cause us to think that our book would ultimately behave in a different way than it has been.

And let me – if you don't mind, let me just sort of add on just some sort of further thoughts on that. I think that this was, as we noted, it was somewhat unusual vis-a-vis peers in the industry. We recognize that. But – and while the charge associated with it, at \$1.4 billion, is in excess, I think, of what Street expectations might have been as we were beginning to look at this – but, I would emphasize that we have a very strong capital position and it is largely unaffected by our across-the-board second quarter assumption updates. We continue to have the flexibility to finance our growth, including investments in our new business initiatives, while redeploying capital, including as I mentioned in my opening remarks, to our shareholders through dividends and stock repurchases, completely consistent with our existing plans. And all of that, incidentally, includes absorbing fully the impact of the Tax Act while maintaining our targeted AA solvency ratios, currently still at a 400% FICO ratio and remaining within our targets for liquidity and leverage as well.

Thomas Gallagher

Analyst, Evercore ISI

Q

Thanks for that. And then, just a question about the trends you're seeing in the Long-Term Care block. I know, in 2017, there was sort of this spike in incurred claims up around 50%. Has that trend continued into 2018? Was that also part of the upsizing of the charge here or has that calmed down in terms of the actual trend?

Robert Michael Falzon

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

A

So, let me try taking a stab at that this way, Tom. When we did our assumptions, our assumptions now reflect our full historical experience through 2017. And based on that, our actual to expected is running at 100% over that period of time. And as we look at our 2018 experience as it's emerging, it is entirely consistent with those revised set of assumptions. And so, you sort of think about that as an average over that period of time, and 2018 being reflective of what that average is, recognizing that in any given period, be it quarter or year, you can get noise as we've expressed we saw during 2017.

Thomas Gallagher

Analyst, Evercore ISI

Q

Thanks. And then, just one other quick one. Did you – the statutory charge you took, the \$600 million...

Robert Michael Falzon

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

A

Yeah.

Thomas Gallagher

Analyst, Evercore ISI

Q

Did that – was that just on claim reserves or did you adjust active life reserves at all?

Robert Michael Falzon

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

A

There was a – well, the – no, that was the ALR. That was the active life reserve adjustment, Tom. So, the \$600 million, there was small adjustments in GAAP and stat for the Disabled Life, the claims. The driver in both statutory and in GAAP was on our active life reserve. The \$600 million was significantly less than the GAAP reserve because we had more margins in our reserves on a statutory basis relative to GAAP. But the same set of assumptions are used in the adjustments that we made in GAAP and stat, with the only difference being that stat – that you can see in the total reserves, they're slightly larger as a result of the pads that you have in stat relative to our GAAP results.

Thomas Gallagher

Analyst, Evercore ISI

Q

Okay. Thanks.

Operator: Next, we have the line of Suneet Kamath of Citi. Your line is open.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Thanks. Just wanted to go back to the morbidity improvement, that you've removed the 1% assumption. But could that go the other way? In other words, if claims costs go up by 1% over 20 years, would that essentially, based on your sensitivities, require another \$1.4 billion of reserves?

Robert Michael Falzon

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

A

So, let me try, Suneet, to answer that question this way. We removed the morbidity improvement assumption, as you indicated. We did provide to you sensitivities with regard to claims costs. And so, if you think about the potential variability in our claims costs, we said a reasonable sort of stressed kind of sensitivity around that, we

put in there at plus or minus 5%. So, if our assumptions are that morbidity improvement – not only is there not morbidity improvement, but that we experienced some level of morbidity deterioration, if there was a 5% deterioration – not a 5% per year for forever, but a 5% holistic deterioration in that, that would be about a \$500 million adjustment to our reserves, recognizing over the fullness of time with health innovation, et cetera, there might be an upward bias to that; but, if it were to be downward, that would be the order of magnitude to that. And we've provided similar assumptions to the – across the rest of what we believe to be the primary drivers to the reserves that we hold for this business.

And I think I would characterize what we've done and the sensitivities being provided there, Suneet in the following way. One, it is comprehensive. And so, we've looked holistically at all the assumptions underlying our business and tried to reflect in those assumptions the experience that we've been seeing and what we can glean from what's happening across the industry. The – our desire was to put this issue to bed in the eyes of investors and to allow investors to focus on the strong fundamental and growth that we have in our operating businesses.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Okay. Got it. And then, just on the same Slide 21, if we look at the \$1 billion of future rate increases assumed in your reserves, so is that the same number for GAAP and stat? And separately, what was the prior assumption? In other words, what did you have built in before you did your second quarter of 2018 reserve review in terms of benefit from future reaction?

Robert Michael Falzon

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

A

So, first part of your question, yes, the same assumption being used in both GAAP and statutory reserves, as I'd indicated before. Second question, let me try approaching that a little differently, Suneet, to see if I can actually get at what I think you want to understand with respect to that \$1 billion. Think about that as being in three tranches. The first is – about 10% of that we've already filed before.

First, actually, let me also start with – put that in the context of we've actually already received about \$0.9 billion worth of rate increases on this block over time from the point at which we impaired it back in 2012. So, hopefully that adds some perspective in terms of balancing this \$1 billion against almost \$1 billion that we've already achieved to date. And the assumptions driving this – the \$1 billion that we have in there, are consistent with our experience in the first rounds of price increases that we sought and, incidentally, are subject to very robust underwriting in order to quantify that number to begin with.

And so, going back to sort of thinking about those in buckets, 10% that's already been filed. About 30% of that actually represents instances where we've already had filings with the states where we've implemented a price increase, but where the – where we have agreed to come back to the state and do it in multiple steps as opposed to do it in a single rate increase. So, we implemented a rate increase, but we've agreed to come back and seek approval for a further rate increase in order to make it a more palatable outcome for consumers at the end of the day.

And then, the remaining 60% would be new filings. And within those new filings, I would – that would represent both some of our legacy adverse experience that we've had as well as the new adverse experience that we updated as a result of this update. And think about that as being roughly evenly split between where we expect to get price increases and where we expect to actually – to come out in the form of benefit reductions in lieu of price increases.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Got it. And then, just lastly on the same topic, the assumption to get rid of the morbidity improvement, I mean, it seems like that's what your third-party actuarial consultants are recommending as a best practice, right? And I'm assuming – just trying to think through where the ranges of these assumptions are across different companies.

Robert Michael Falzon

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

A

Well, to be very clear, Suneet, we did not engage any consultants in the evaluation and the process that we went through. We consulted with outside parties, but there's no consultant that recommended to us this as a best estimate. Obviously, our accountants, who have actuarial expertise, have weighed in on this and they have confirmed that they believe that our approach to this is a reasonable approach to take with regard to establishing a best estimate.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks, Rob.

Operator: Next, we have the line of Alex Scott of Goldman Sachs. Your line is open.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Hi. So, my question is around just the cash flows. And, Rob, I think you mentioned that you absorbed – you were able to absorb a good amount here and still had the ability to kind of maintain the capital deployment plans. So, could you talk about what is driving – what are the parts of the business that are driving better free cash flow? And as we kind of think out to next year and beyond, I mean, is there upside as maybe you have some of these things that have been a drag fall away and kind of have continued acceleration in cash in some of the businesses, like Variable Annuities and maybe others?

Robert Michael Falzon

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

A

So, Alex, yeah, a couple of thoughts on that. First, as I mentioned before, we start from a position of having a very robust capital structure that's able to absorb a lot of the changes that are going through in the industry. So, you have the 2Q assumption updates that we've been through. You have the impact of the tax law change. You'll also have certain regulatory changes occurring that are occurring at the NAIC that are, I think, net chewing away at the RBC ratios of companies. And despite all of that, where we are at the end of the day is, pro forma for all of it, including sort of the full-year anticipated impacts of the Tax Act, we're able to maintain above our currently targeted RBC ratio of 400%. So, we start out in a very strong position.

We also have the benefit of continuing to generate strong cash flow and capital. And so, in the course of the second quarter, just by way of example, while the statutory charge for our Long-Term Care business was – the increase and the strengthening of reserves in our Long-Term Care business was about \$600 million. In other parts of RBC calculation, we actually generated incremental capital that almost entirely offset that reserve strengthening. And we see that dynamic.

And so, if you look at sort of the fullness of this year and even what we've experienced to-date this year, what you're going to find is we have diversified businesses each of which provide robust cash flow and diversified sources of cash flow. So, in the current year, while we're strengthening PICA's reserves in order to respond to the impact from the tax law changes, we are getting from our International business significant free cash flow. We are getting from our PGIM business a very high free cash-flow ratio relevant to the strong earnings that we're generating from that. And as we've highlighted in the deck through the bar charts that we provided, our Annuities business at the current levels of sales is throwing off a significantly high level of free cash flow. And so, we're able to continue to generate free cash flow through the portfolio of businesses that we have and absorb the variety of reserve-strengthening initiatives that we and the industry are facing during the course of this year.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

That's very helpful. Thank you. And then, maybe just to follow-up on the 12% to 13% ROE. How should I think about that near to intermediate-term ROE just in light of maybe the move up in interest rates and sort of the environment? I mean, are we at a point where maybe you could sort of revert back to the 13% to 14% that you guys have targeted historically? Or sort of where do we need to get in terms of rates to achieve that?

Robert Michael Falzon

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

A

Well, I think about it this way. I think, first, as you've seen in our results and observe in the market, interest rates have been rising and that's been beneficial to us and to others in the industry. If you look at what I'll call our adjusted portfolio yields, so adjusting it for taking out the impact of alternatives and for where we've invested in Treasuries as we've waited to take the premiums and reinvest them into Corporates, in the first quarter, our portfolio yield was about 4.3%. If you look at our new money rates in the first quarter, it was about 4.25%. So, we're at the point in time, now, where we're investing is crossing over to our portfolio rate, whereas in the past you would have seen a very large gap between those two numbers.

And so, I think the interest rate environment is rapidly ceasing to be a drag and will be pivoting over toward being actually a positive to earnings growth on a go-forward basis. Now, it took a compounding of several years for it to drag us down from 13% to 14% to our intermediate range of 12% to 13%, and we'll need to see some compounded period of being in that better interest rate environment before you'd expect, on a sustainable basis, our ROE to be in a 13% to 14% range. I would note that if you look at our ROE this quarter, on the sort of – adjusted for the notable items that we've called out, it's 13.5%. So, while we provided guidance of 12% to 13%, the reality is, in this current environment with the robust performance we're getting out of our businesses, we are actually exceeding that range that we've provided.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Perfect. Thanks.

Operator: And next, we have the line of Ryan Krueger of KBW. Your line is open.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hi. Good morning. On the annuity ROA, it's been 121 basis points for the last two quarters. How much more near-term downside do you expect from the additional hedging actions, or are we mostly complete with that at this point?

Stephen P. Pelletier

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

A

Ryan, this is Steve. Maybe I'll jump in and Rob can add on. If you look at Annuities ROA on a year-over-year basis, there was a decline. I'd attribute that to three factors, consistent with what we've spoken about before: first, lower non-coupon earnings driving lower spread results; second, the aging of the book of business and fee compression that gradually results from that; and finally, amortization of hedging costs, as you mentioned. The first of those three factors varies from quarter to quarter. The second and the third, I would say – there are, obviously, real impacts, but they emerge very, very gradually over time, over an extended time period. So, if you're talking about near-term ROAs, I would say there's sustainability of our ROAs for the near term at our current level. Rob?

Robert Michael Falzon

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

A

The only thing I'd add to that – and, Ryan, this may be obvious by virtue of how you asked the question, but just to make sure that it's very clear is that our expected hedging costs are entirely in AOI today. And so, that's built into our AOI. We include the cost of hedging in that.

Secondly, that when we have variances against that expected hedging, so what we call hedge breakage, that works its way into our benefit ratios and, therefore, also is amortized into our AOI. So, full cost of hedging is reflected in AOI over time. And that hedge experience has been generally on the positive side, but call it around neutral. And what you're seeing as a result of that is still a robust level of ROA, as Steve just walked through.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. And then, the Corporate segment, I know, is volatile, but it's been pretty favorable for a couple of quarters. Has anything changed there or should we expect it to revert back to a higher loss over time?

Robert Michael Falzon

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

A

So, our guidance for that, Ryan, has been that – think about it as being – and what we said in the past is an average of \$350 million a quarter, subject to seasonality. So, obviously, we get the fourth quarter seasonality that we've walked through a number of times in the past.

If you look at the actual average of the last four quarters, it's been slightly below that. So, it averages out around \$340 million. And in the first and second quarters driving that because they've been below our run-rate expectations. Each of those quarters benefited by somewhere in the range of \$15 million to \$20 million of lower than expected compensation costs, both long-term and deferred, that are associated with market experience including, incidentally, our own stock price performance. The remainder of the variance came from lower net expenses across sort of a whole variety of activities.

So, I think, while that experience – we can – it can be sustained, we don't believe that that experience would change our view going forward of what the run rate and seasonality would be. So, we've benefited from it, but not to the point where we would take a different view toward what we've stated in the past with regard to sort of the going forward run rate of the business [indiscernible] (57:35).

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Got it. Thanks a lot.

Q

Robert Michael Falzon

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

Okay.

A

Operator: And our last question comes from the line of Erik Bass of Autonomous Research. Your line is open.

Erik James Bass

Analyst, Autonomous Research US LP

Hi, thank you. I guess, following up on Alex's question, if we look at the dividends paid from PALAC year-to-date, it's been about 70% to 75% of AOI. So is this a reasonable way to think about the sustainable cash generation of the Annuities business, and how sensitive is this to the level of sales volumes?

Q

Robert Michael Falzon

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

So, I would say that the Annuities business is a positive contributor to our overall targeted free cash flow. So, think about our free cash flow, as we've articulated, as being around 65% of our earnings. And at current levels of sales we would expect the Annuities business actually to be reasonably materially in excess of that; and, we believe that that's a sustainable level.

A

The volatility – we don't believe that it's particularly volatile on a go forward basis, either. The changes that would occur there would be, as Steve has expressed before, things that would be reflected over a fairly long period of time. We're very well capitalized within that business, and so changes in market conditions and/or other drivers to the reserves would not alter the level of distributions from free cash flow that we anticipate and are currently getting from the business.

Erik James Bass

Analyst, Autonomous Research US LP

Thank you. And then, yesterday, Fidelity got a fair amount of press coverage for eliminating fees on certain of its index products. Do you see this having implications for pricing in the Asset Management or Defined Contribution retirement businesses more broadly?

Q

Stephen P. Pelletier

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

Erik, it's Steve. I'll address your question. For some time, we've been very acutely aware of the fact that the most rapid fee compression in the Asset Management business has really been taking place over multiple years within the passive space. And you saw the press coverage yesterday referring to yesterday's move as the race to zero and this being the logical conclusion of it. It's a race that we're not participating in.

A

Several years ago, we made the strategic decision that we were going to – that we were not going to compete in the passive space. But even back then, it was a space well-spoiled for by a handful of competitors. And instead, we would focus on the long-standing value proposition of our Investment Management business, which is alpha generation, alpha that our clients can use alongside the index exposure that they can draw from passive

managers on a cost-effective basis; but, really focusing on our ability to generate alpha through active management.

And the result of that decision, over multiple years, has been that passive assets represent less than 2% of total AUM and well under 1% of total fees. Our fees are based on our generation of alpha, based on the foundation of strong investment performance and strong distribution capabilities, generating attractive flows at stable fee levels, that 22 basis points I mentioned, which has been stable for us now over an extended period of time. And we expect it to remain so.

Erik James Bass

Analyst, Autonomous Research US LP



Thank you. Appreciate the comments.

Operator: At this point, I'll be happy to turn it back to John Strangfeld for any closing remarks

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you very much. I'd just like to bring this back and close it with just a few final thoughts. Bottom line of this whole discussion is our businesses are performing very well. They're supported by a strong balance sheet. We're very confident in our ability to both innovate and execute. And we – our talented employees who embody our purpose-driven culture are ultimately at the core of who we are and what we do. And collectively, we deliver sustainable value for our customers, our community, and our stakeholders. And I'd like to thank you very much for your time and attention today. And have a good day.

Operator: Ladies and gentlemen still connected, that does conclude the presentation for this morning. Again, we thank you very much for your participation and using our Executive TeleConference Service. You may now disconnect.

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