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Prudential Financial, Inc. (PRU)

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Prudential Third Quarter 2018 Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. [Operator Instructions] As a reminder, this conference is being recorded. I would now like to turn the conference over to our host, Head of Investor Relations, Mr. Darin Arita. Please go ahead.

Darin Arita

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

Thank you, Tawny. Good morning and thank you for joining our call. 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 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.

Also as a reminder, we will be hosting our 2019 Financial Outlook call on December 6th at 11:00 a.m. Eastern. In the call, we plan to provide our 2019 EPS guidance range. We hope that you will be able to join us.

And with that 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 continued momentum our businesses. During the quarter, we rolled out and expanded initiatives to deliver financial opportunity to more and more people around the world. We produced sustainable returns and strong business growth and maintained a solid capital position while distributing \$755 million to our shareholders via share repurchases and dividends. In addition, we announced leadership succession plans that reflected a thoughtful, multi-year process by our board and our organization's emphasis on talent and culture. I'm confident that our next generation of leadership led by Charlie and Rob alongside our seasoned management team will continue our momentum for many years to come.

We also welcome the Financial Stability Oversight Council's decision earlier last month to rescind Prudential's designation as a systemically important financial institution. We believe this outcome reflects Prudential sustainable business model, capital strength, and comprehensive risk management framework, which have and continue to enable us to fulfill our promises to our customers to deliver consistent performance and to meet regulatory obligations.

Turning to slide 3. I will provide some additional financial highlights on the third quarter. We produced an annualized operating return on equity of 13.5%, above our near-to-intermediate term objective of 12% to 13%. Adjusted earnings per share for the third quarter were \$3.15, up 5% from \$3.01 last year, driven by business growth, tax reform, and capital management.

Net income was higher in the year-ago period, reflecting gains on derivatives. Our adjusted book value per share of \$95.20 is up 12% over the prior year. This reflects the earnings we generated, as well as the impact of tax reform and accounting changes implemented at the start of 2018. These items were partially offset by the payment of \$3.45 per share of common stock dividends totaling \$1.1 billion and about \$1.4 billion of share repurchases over the past year.

Our performance for the third quarter was driven by momentum across our businesses, which worked together to serve the needs of our individual customers, distribution partners, and institutional clients.

Here are a few highlights from the quarter. PGIM, which is our global investment management business continued to produce positive net flows, this time of \$8.7 billion for the quarter. Our Retirement business had record account values of \$447 billion, including net flows of 6 billion driven by our pension risk transfer and full service sales. Our Individual Annuities business produced sales of \$2.2 billion, which were 69% higher than a year-ago quarter, and up 8% sequentially. And we also continued to generate steady growth across our International businesses.

Now turning to slide 4, I'd like to provide an update on Prudential's financial wellness initiatives, which are helping us build deeper relationships that address the changing financial needs of our customers. We're using technology to deliver the full breadth and depth of our collective businesses, so that we can enter new market segments and address an increasingly diverse range of customer needs and financial challenges.

One recent example is the launch of LINK by Prudential, an online experience that helps individuals visualize their financial goals. LINK connects individuals with solutions and financial professionals to help them with their unique goals from investment and retirement, to safeguarding the future of loved ones. One can access LINK via our Prudential.com website or through an employer where LINK is enabled through our digital financial wellness platform.

I'm pleased to note, our digital financial wellness platform available to new and existing workplace clients is growing rapidly. The platform enables individuals to engage in a wide range of financial topics, access multimedia content personalized for their needs, and utilize tools to better manage their financial lives. In addition, employers can better understand the financial wellbeing of their overall workforce.

Today, our digital wellness platform is used by approximately 1,300 organizations covering more than 1.7 million employees. Our goal is to deploy this by early next year to more than 2,500 organizations covering more than 4 million individuals.

And our customers aren't the only ones taking notice. We were honored to be included in Fortune magazine's 2018 Change the World list, which highlights companies making a positive social impact through their core business strategies.

And we continue to build upon our leadership position and commitment to financial wellness through the launch of programs like our State of US brand campaign. This campaign, informed by individual stories and intended to

highlight the financial issues faced by everyday Americans, is currently airing across broadcast, social media and other channels.

To summarize, we are very excited about what our businesses can collectively deliver to make a meaningful difference in people's financial lives, helping them achieve their fullest potential, as we unlock new opportunities to grow our business.

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.

Thanks, John. Good morning, good afternoon, and good evening. Before I touch on strategic and tactical highlights in individual businesses, I want to step up to the higher level of strategy, execution, fundamentals and financial results.

I've often commented that as a company overall and in a number of our individual businesses, we're a great story around the way these things have come together to drive successful business initiatives. And sometimes, they come together in individual businesses or business-by-business, focused on specific things. And we've highlighted there, for example, success in Japan, success in pension risk transfer, the strategy execution and fundamental story in PGIM, all of which play out very well for us.

We're also now emphasizing strategies that leverage and exploit our whole franchise value. And this adds the dimension of cross-business collaborative and unique strategies and unique execution opportunities for us.

So in that context, thinking about strategy, execution and fundamentals, we're pursuing compelling objectives. And I want to highlight four things that run through many of the aspects of the individual businesses that I'll touch on in a minute.

First of all, we're enhancing how we help customers meet their needs. Remember Bring Your Challenges. The language of the company is solutions and outcomes. That's how we talk about our products now. We're focused on new distribution, making it easier for us to access clients and for clients to access us. Headlines there include the wellness platform and the digital initiatives. And we're growing in our existing distribution channels.

Secondly, we're implementing process efficiencies that positively impact clients and their experiences with us. The results reflecting these two aspects of strategy and execution include good growth momentum, as evidenced by sales and flows over time across all of our businesses.

But completing the story, profitable growth at attractive returns, reflecting financial and risk discipline and thoughtful pricing strategies.

So as I go through the individual businesses, think about the way they tie back to meeting client needs, to improving processes and to building growth momentum, as we translate strategy into execution.

I'll start now with PGIM, and this is beginning with slide 5 in the deck. The PGIM strategy is defined by meeting client needs as a strategic partner and across a broad range of asset classes and investment vehicles. And now engagement and dialogue with clients and partners have never been stronger.

It's an interesting time though. Interest rates are higher, equity markets are more volatile, and there is a positive return on cash. And so we would anticipate that this environment will have an impact on client decisions. And the way in which they think about things may result in more variability in the flows that we see. But with the underpinning of very successful execution in the context of thoughtful strategy, we're maintaining very strong business momentum in PGIM.

On slide 5, I want to highlight a couple of things. Under Key Priorities, strong investment performance, ultimately in a way, drives everything. And I want to highlight the five-year performance of AUM versus benchmark. And note that 90% of the assets under management have outperformed their benchmarks over five years.

Shifting to the lower left picture, that investment performance fundamental translates in a nearly linear way into the very strong flows that we realize. And this is the fundamental that we talk about all the time. We had a very strong quarter for Institutional flows. We had record International flows. And we've commented before on 15 consecutive years of positive flows in Institutional businesses and 13 consecutive years of positive flows in Retail businesses.

Just to touch on a couple of the other key priorities to grow earnings: With respect to expanding our global footprint, as I just mentioned, we had a record International flows in the quarter. We also have a record percent of our sales and investment professionals outside the U.S. in PGIM now.

With respect to products, we now have two active fixed income ETFs; launching the second one just about as I speak, and we have established a new alternatives group that will focus on mezzanine finance and direct lending. So, the elements that execute in the context of strategy and strong fundamentals remain very much in place with respect to PGIM.

Let me turn to Retirement now on the next page. And I really just want to highlight the two bottom charts. We are emphasizing flows in Full Service on the right-hand side. Year-to-date \$26 billion of sales and deposits in Full Service across a good mix of clients, between large clients and core clients and that's translated into \$6 billion of net flows year-to-date in Full Service.

We're also doing very well in PRT on the Institutional Investment side. In the quarter, \$5 billion were funded with reinsurance PRT transactions and we announced another \$1.6 billion transaction shortly after the quarter ended and we have a very strong and good pipeline in pension risk transfer as we've mentioned often on these calls.

As I bridge from Retirement to Group, let me highlight again the importance of the wellness opportunity, but specifically as it relates to these two businesses, wellness amplifies our opportunities; it strengthens our sponsor relationships and it provides a meaningful retail potential for us through our Institutional channels. And so as we move into a couple of comments on Group, the first comment, deepening employer and participant relationships with financial wellness programs remains the centerpiece of a lot of what's going on in Group and we've talked about proof points there demonstrating success.

I do want to add, with respect to process efficiencies and making us easier to do business with, that in Group we did launch additional digital capabilities in Disability and these digital capabilities enhance and improve our claim submission and management results.

Let me turn to Individual Annuities. Two quick highlights here. The first is another dividend; and you see in the bottom right-hand chart, \$285 million in the quarter. We have been highlighting free cash flow and attractive returns; that continues to be visible as we pay dividends from our Annuity Business. And then I also want to

comment on the increase in sales. John mentioned it. The editorial on this is that sales in Annuities are broader and deeper, reflecting growth in different products, diversification of products and also strength in our traditional channels.

Before I leave Individual Annuities, just one additional comment, which is, remember, the wellness opportunity for secure retirement income. The Individual Annuity business, as are all of our businesses, has a role in our wellness initiative and the opportunity to put secure retirement income products on our wellness platform is something that we think is very important for us.

Let me move to Individual Life on Page 9. And I want to highlight two things here. I spent some time in the last call discussing a streamlined underwriting process that facilitates binding policies in as fast as 48 hours, and during the quarter we rolled that streamlined underwriting process out to third parties; again, a substantial process improvement for us and something that we believe is a material benefit to our partners and our direct distributors in our Individual Life business.

On the product side, during the quarter we re-launched and improved VUL Protector product in September, continuing our emphasis on matching the right products with the right opportunities and channels. And so we are optimistic about product enhancements as well as process enhancements in Individual Life.

Let me turn to Life Planner and Gibraltar. But before I do, I want to briefly recap messages from our Tokyo Investor Day. We emphasized in our International businesses differentiated business models with superior execution. And you should think of that as distinctive sales capability that drives high return protection solutions in the market for us.

We also talked about sustained growth with strong returns and steady capital generation. And you should be thinking there that part of that growth opportunity is meeting evolving client needs. And then finally, we talked about strategic investments that enhance our long-term prospects.

And so those are the themes that run over both Life Planner and Gibraltar, and so I'm going to highlight a couple of more tactical aspects of where we are there. With respect to Life Planner, very good quarter for sales. Life Planner sales were up 11%. Sales in Prudential of Japan were up 17% and the Life Planner count in Japan and in Brazil has grown to an all-time record level. We had LP growth of about 5% in Japan. So, great dynamics there and I guess I'd emphasize the term we often use in International, which is that the vital signs look absolutely terrific.

Turning to Gibraltar. I want to touch on the three distribution channels here because we have different things going on in each. With respect to the bank channel, our sales were down and this reflects the chronic discipline that we impose with respect to both pricing and product and the fact that we don't chase this market when it's moving in a direction in which we don't want to go. We will see declines in our product sales and so we've seen it recently in the bank channel.

On the other hand, the Independent Agency Channel is up about 9% and we are strategically expanding in the Independent Agency Channel and so that's a gratifying result for us.

And then with respect to Life Consultants, we have been imposing higher standards, and so the emphasis on quality and productivity does result in a decrease in our Life Consultant count. We are down about 4%, but again on the gratifying side, Life Consultant sales are just about flat. So, different stories reflecting the way in which we

are approaching different channels in Gibraltar, but overall a very good, consistent strategic and execution story with respect to what's happening in Gibraltar.

And I will stop there and hand it over to Rob.

Robert Michael Falzon

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

Thanks, Mark. I'll begin on slide 12 by highlighting the notable items which have impacted the current quarter adjusted operating results. As we introduced last quarter, in addition to the impact on results from the quarterly updated estimate of Individual Annuities profitability driven by market performance, notable items include the impact attributable to variances from our expectations for selected revenues and expenses. We highlight these latter items because while their contributions to the current quarter results are economic, they may not be indicative of future performance.

The current quarter unfavorable impact of the market and experience unlockings in the Annuities business was \$36 million. The current quarter returns on non-coupon investments and prepayment fees were about \$35 million below our long-term expectations. And the current quarter underwriting experience was approximately \$65 million better than our average expectations, primarily driven by more favorable mortality experience in Individual Life, reflecting lower than expected large case claims. As an aside, while less favorable than our average expectations, our Retirement business continued to demonstrate positive case experience in the quarter.

In total, these notable items reduced pre-tax earnings by about \$6 million or \$0.01 per share. Excluding notable items, earnings per share would be \$3.16, up 9% from the year-ago quarter.

And speaking about our earnings pattern, I would also note that we have historically experienced higher than average expenses in the fourth quarter. This includes the impact of seasonal items such as annual policyholder communications, employee onboarding and severance, as well as business development, advertising and other variable costs.

Looking back over the past three years, this pattern has produced expenses on average about \$125 million to \$175 million higher in the fourth quarter than the average quarterly level for the respective year. In addition, we have completed the hedging of our expected yen earnings in our International business for 2019, and our hedging rate for the next year will be 105 yen per U.S. dollar as compared to the \$111 for 2018.

Turning to slide 13. I'll provide an update on key balance sheet items and financial measures.

Our cash and liquid assets at the parent company amounted to \$5.2 billion at the end of the quarter. The sequential quarter increase of about \$500 million was driven by proceeds from our \$1.6 billion of junior subordinated notes issue this quarter, partially offset by senior debt maturities of about \$700 million and a capital contribution to PICA to address the impacts of the Tax Act as we discussed on previous calls.

I would also note that we have established a targeted operating range of cash and liquid assets at the parent company of \$3 billion to \$5 billion with the low end of the range equal to approximately two times our annual fixed charges.

Cash inflows from the businesses during the quarter supported the \$755 million of shareholder distributions, which were roughly evenly split between dividends of \$380 million and share repurchases of \$375 million. And our share repurchases authorization for the remainder of the year is \$375 million as of September 30th.

Our domestic and international regulatory capital ratios are above our AA financial strength targeted levels. Further, we do not expect material impacts to target capital levels from the proposed Variable Annuities statutory framework that has been adopted by the NAIC Variable Annuities Issues Working Group. And finally, our financial leverage and total leverage ratios remain within our targets as of the end of the third quarter.

In summary, during the quarter we generated a strong return on adjusted operating equity, double-digit growth in adjusted book value per share and solid sales and net flows across our businesses while maintaining a robust capital position.

Our complementary mix of businesses with leading market positions and integrated solutions for customers are executing on our strategies and producing attractive returns for our stakeholders.

Now we'll turn it over to the operator for questions

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Ryan Krueger with KBW. Please go ahead.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hi. Thanks. Good morning. If I look at your year-to-date run rate EPS and adjust for tax reform, the growth has been on the high end of the 6% to 11% guidance range that you gave last year and your ROE has been above the 12% to 13%. Can you help us think about if there – have there been any major, I guess themes that would have impacted results this year that you wouldn't think would be sustainable going forward? Or is that a reasonable way to think about the kind of growth and ROE power of the company at this point?

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

So, Ryan, I think when we think about our ROE, the guidance that we gave was that in the intermediate term we would continue to expect that to be in the 12% to 13% range, given that we have gone through a fairly long period of sustained low interest rates.

Obviously, interest rates have been moving up. And we've had very favorable equity markets. And the combination of those, plus very strong fundamental performance out of our businesses has resulted in our return on equity being – operating at a range that is at the very high end of that guidance that we provided.

At this point in time, given where we are in the cycle, that's probably to be expected. And we talk about that 12% to 13% as being a return over a cycle.

Over time, we're seeing that the headwinds associated with sustained low interest rates are abating. And we continue to see good fundamental performance in our businesses. So over a longer period of time we would expect that to allow us to sort of return to that more normal long term range of 13% to 14%. But at this point in time, we're not ready to modify that guidance.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay, thanks. And then on PRT, you had pretty good activity in the quarter. You've already announced one deal in the fourth quarter. Can you talk a little bit about how the pipeline and the outlook looks there?

Stephen P. Pelletier

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

A

Ryan, it's, Steve. I'll take that question. I think the pipeline looks very, very robust. Frankly, it looks as robust or even more so than we've seen in recent years.

I think that's a combination of a couple of factors. First of all, the increase in interest rates and what that means in terms of higher funding levels for defined benefit pensions, means that more and more companies are in a position to transact. And propensity to transact continues to be powered by a growing awareness on the part of these companies of the longevity risk inherent in their plans.

So the combination of those two things makes the pipeline look very, very strong. And we also feel very good about our ability to compete in the context of this pipeline. I say that in particular, because we have visibility on a strong pipeline in the large case market, call it \$1 billion plus or minus and above, in which we are particularly well-suited to compete due to the capabilities that we built in the business around ability to bring transactions, to bring large transactions swiftly to an effective close. And the ability to onboard large numbers of participants and give them the type of customer experience that their plan sponsors expect and that the participants deserve.

So again, strong pipeline, and we feel good about our position to compete in it.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Do you tend to see a desire by corporations to get things done before year end?

Stephen P. Pelletier

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

A

There does tend to be a tendency that we've seen for the third and the fourth quarters to be particularly strong in pension risk transfer activity. That's been the case for the past few years now.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay, great. Thank you.

Operator: Thank you. Our next question comes from the line of Jimmy Bhullar with JPMorgan. Please go ahead.

Jamminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Hi, good morning. I had a couple – a few questions just on the International business. First, could you give some color on, your other country sales I think were flat. So which countries are you doing well in? And where might – have sales been weak? And then I have a couple more.

Charlie F. Lowrey

Chief Operating Officer & Executive Vice President, International Businesses, Prudential Financial, Inc.

A

Sure, Jimmy, it's Charlie. Sales in Brazil continue to go up. As Mark said, we have a record Life Planner count and so – and they have a high degree of productivity there. And so we see sales going up there.

Sales in Korea and Taiwan were flat as we continue with our back to the basics strategy. And the number of Life Planners have been decreasing. Interestingly, and one really good thing that's happening in Korea, is that we have shifted a number of Life Planners, in fact a significant number of Life Planners, over to be sales managers. And as you've seen in Japan when we have done that in Prudential of Japan, our Life Planner business there, what happens is, you have about a year lag, but then you start increasing the number of Life Planners. And so I think our transition of Life Planners to sales managers in Korea bodes well for sales in the future.

Jaminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay. And then do you expect an impact on your Japanese business from sort of the expected increase in the consumption tax in 2019?

Charlie F. Lowrey

Chief Operating Officer & Executive Vice President, International Businesses, Prudential Financial, Inc.

A

Not as much. So much of the business we do isn't affected by the consumption tax. Some of it is in, say, the bank channel, but a lot of it is not.

The consumption tax has to do with both where the business is done and also the size of the business. And so it may have a marginal impact. But when the consumption tax went up a number of years ago, we didn't see a significant effect from it.

Jaminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

And then just lastly, I think you mentioned that Life Planner expenses were lower because of either timing of costs or other things. Can you quantify roughly how much that was?

Charlie F. Lowrey

Chief Operating Officer & Executive Vice President, International Businesses, Prudential Financial, Inc.

A

Not really. What happened in the POJ was there were a number of, let's call it, dominoes that all fell in the right direction. And this was throughout actually the businesses in Japan. So it happened with Gibraltar too.

And that was some of the businesses just had sort of ones and twos fall on our direction. And then we had some expense timing things, which will probably fall into the fourth quarter. So we're not going to give you a number. But there were both those factors that led to what we would say an elevated income level this quarter.

Jaminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

Operator: Thank you. Our next question comes from the line of Nigel Dally with Morgan Stanley. Please go ahead.

Nigel P. Dally

Analyst, Morgan Stanley & Co. LLC

Q

Hey, thanks, good morning. So, on the annuity space, somewhat surprising to see the core earning sequentially decline, given the strength of equity markets that you saw last quarter. So, hoping you can provide some color on what drove that and what we should expect for the return on assets, how we should expect that to trend.

Stephen P. Pelletier

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

A

Nigel, it's Steve. I'll take your questions. Thanks very much. This quarter's ROA of 118 basis points reflects a couple of things that we'd mentioned. First of all, why we didn't call them out in our release or anything like that, we did have some one-time costs associated with the systems migration. That reflected about two basis points.

Second, we also had higher variable selling costs which were included in that ROA calculation and that comes with the higher sales that we saw in the business in the quarter. That again, reflected for about another two basis points.

So, if you build those things into the equation, we still see an ROA in the Annuities business that is very consistent with the guidance that we have given before of 120 basis point range give or take.

Nigel P. Dally

Analyst, Morgan Stanley & Co. LLC

Q

That's helpful, thanks. Second question is just on losing the SIFI designation. I know you saw group supervisor in New Jersey but are there going to be some expense saves that you are likely to realize from losing that designation?

Robert Michael Falzon

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

A

Nigel, it's Rob. So what we've expressed before and I think still holds is that as we – if you look last year, our enhanced supervision costs were about \$120 million for the full year. As we think about the – no longer being a SIFI, our expectation is that about a third of those costs go away very rapidly and almost instantaneously, which is a combination of the fees that we are paying for Fed supervision and some consulting expenses that we would no longer need to incur. About a third of those costs are associated with projects that were in the process of completing and so they will sunset or go away in the course of sort of 12 months to 18 months; and then the remaining third probably represent ongoing costs of group supervision that we expect to incur both in response to the group supervision in New Jersey as well as the engagement that we have on an international basis as well.

Stephen P. Pelletier

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

A

Nigel, this is Steve. I'd like to jump back in and just expand a bit on the question you asked about Annuities ROA; because in my response to that I mentioned the variable selling costs. And I think I'd like to put overall expense profile of the U.S. businesses year-over-year into context. In the overnight calls a few different people inquired about the increases in expenses in the U.S. businesses and I think the numbers that you were looking at very much included those variable selling costs. We look at our operating expenses exclusive of those costs, because those costs naturally go up and down with our sales levels and in a robust sales quarter, which we hope to continue, they were elevated this quarter.

Year-over-year, the operating expenses in the U.S. businesses exclusive of variable selling costs were up 3%. That 3% includes normal inflationary adjustments. It also includes substantial investments that we are making in the current and future growth of our businesses and growth of their earnings.

You're going to hear more about these investments in our guidance call next month, but suffice it to say for right now, we already see these investments paying off. I just call out a couple of examples. In PGIM, the investments we made in our distribution capabilities and in our product range have continued to drive flows and profitability in the business; and in Group Insurance the investments we made for example in disability claims management has been a big part of the earnings progress of that business.

We also are making significant investments in our financial wellness value proposition and advancing that into the marketplace. And we're continuing to see a favorable impact, especially at the employer level. Since we embarked on this, call it a year-and-a-half plus ago, the financial wellness initiative has accounted for about \$100 million in group premiums, which we consider to be an early indication of the success of this. But, like I say, these investments are already included in that 3% growth. The reason we're able to make these types of investments and still show very – a moderate and well-controlled expense growth is that we continue to – as Mark mentioned in his comments, we continue to find opportunities to create cost effectiveness and cost savings in the kind of call it, business as usual platforms for our businesses. It's not been our usual practice to make big announcements about finding these cost savings and to call them out with major cost – with major charges taken in association. This is part of our DNA; this is what we do year in, year out; quarter in, quarter out. And so again, we're able to make significant investments while showing well-controlled expense growth.

Nigel P. Dally

Analyst, Morgan Stanley & Co. LLC

That's very helpful. Thank you.

Q

Operator: Thank you. Our next question comes from the line of John Nadel with UBS. Please go ahead.

John Nadel

Analyst, UBS Securities LLC

Hi, good morning everybody. I have two questions on PGIM. The first is, if we think about the base asset management fees, it looks like that's trending very nicely and sort of in line with your expectations. Other revenues are maybe – what we used to think of as the incentive and transaction sort of revenues, were pretty low this quarter, frankly lowest we have seen in several years. I'm just curious whether that's more of a function of a mix shift where we ought to expect that that contribution is going to be lower on a go forward basis or is there just timing issue here?

Q

Stephen P. Pelletier

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

John, it's Steve. I'll address that question. We don't really think in terms of the run rate on the other related revenue because of the inherent variability of it. We have observed – just to be helpful, we have observed in the recent past that the mathematical average of that over the past few years has been right around the \$50 million range, but I think we've also been careful to caution against looking at that as a run rate. What drove the lower number this quarter was a couple of things. Lower agency production, which is again going to be inherently variable quarter-to-quarter, but where we continue to see solid growth year in year out in our agency production. And the second is strategic investing. Strategic investing for us is very much associated with the extension of our product design and the launch of new product and the investment of seed money in those products. This quarter

A

we put some seed money and did some strategic investing in some global and emerging market strategies, and emerging markets had a tough quarter. So that is just kind of associated with the extension of the product design.

John Nadel

Analyst, UBS Securities LLC

Q

Understood, that's helpful. And then just a bit broader question but – obviously PGIM runs a general account. I'm just wondering what the investment side of the house is thinking in terms of where we are in the credit cycle, how close to a turn and what if anything you're doing with the general account, maybe reposition to get a bit more defensive as we get later and later in the cycle.

Robert Michael Falzon

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

A

So John, it's Rob. Let me take a whack at that. So first, we look at credit management investing as one of our core strengths. We have a very strong investment portfolio. We carefully manage that to concentration limits and we're really disciplined about ALM; it is one of the core strengths of the organization and I think as – you've seen the manifestation of that in how we perform cycle in and cycle out.

Our standard portfolio frankly is more defensive than you will find if you look at the industry benchmarks. We hold a larger-than-typical portfolio of government bonds, driven in part by our business in Japan, but it's in excess of a third of the portfolio in the general account and in excess of 40%, 45% of the – of our fixed maturities are actually in U.S. or JGBs or other government bonds. The below investment grade portion of our portfolio is only around 4%; and within that some 60% to two-thirds of that is actually in private placements which is of a significantly higher caliber than what you're going to find if you look at below investment grade publicly traded securities. We are underweight energy, finance and telecom; and by contrast we overweight things like consumer noncyclical utilities and transportation. And then when you look at the mortgages that we hold, the real estate portfolio, we are overweight in multifamily and industrial and we are underweight in office and retail; and so that would play itself well to, if you sort of think about how cycles play out.

So we don't really manage the portfolio up and down in anticipation of the cycle. We do, do things on the margin obviously and – but if you look at how the portfolio was managed sort of throughout the cycle, what you would find is, it is conservative vis-à-vis our peers. Two other things I'd probably want to throw on to that to think about, John. We leverage PGIM. So, PGIM is one of the ten largest global investment managers with a real franchise in fixed income and our general account benefits by that both in terms of their overall expertise and then very specifically with regard to their ability to generate private placements and privately originated commercial mortgages for the portfolio.

These are much higher quality than we find, again in the public marketplaces or that might be agented and underwritten by brokers. And those securities have a really attractive risk return profile that's associated with them. And all of that produces – if you look at our Kenya loss experience, what you're going to find is, it's below our benchmarks, it's below what we embedded in our pricing and all of that includes having gone through the financial crisis when you sort of look at those statistics.

The second thing I want to mention – since you brought the topic up, if you don't mind is that I've seen a number of research reports that try to look at credit exposure for us and others in the industry by looking at kind of a leverage ratio, looking at the assets on the balance sheet as contrasted or measured against the equity on the balance sheet.

And I think that's an interesting and potentially helpful way to look at exposure to credit, but ought to be sort of more nuanced ones than what I've seen to-date. And particularly, when I look at our ratio on that, on a superficial basis we would look to be on the higher end of our peers, but when you look at it on sort of the actual underlying credit leverage that we have, we're actually at the very low end of the peer group. And there is a couple things that are particularly noteworthy there that drive that. The first is, we have \$80 billion of general account assets where we actually don't bear the credit exposure; it's passed through to the participating policies, like for instance our closed block which is some \$60 billion of that in assets. And incidentally, when you look at the leverage ratio on a GAAP basis that actually has negative GAAP equity to the tune of about \$1.7 billion.

So, it throws those ratios off when you include something like that. As I mentioned before, we hold a significantly larger than typical portfolio of government bonds in around a third or so of the general account. So, our credit leverage, when you pull out both the – when you adjust for the government holdings and you adjust for the participating assets, the participating liabilities that we have is significantly lower. And then, there are some other adjustments that sort of feed into that, that are worth thinking about as well, like our foreign exchange re-measurement adjustment that we make when we calculate our return on equity. That's about \$2.5 billion of incremental equity that is temporarily hung up in AOCI and really belongs in retained earnings. And we have very little goodwill; so when we look at those measures, our goodwill is like \$850 million on the balance sheet.

So probably adjusted, when you think about our credit leverage ratio using the construct that I've seeing in a number of reports. what you would see is that we are very, very low on that ratio, reflecting all the conservative management of the portfolio that I was articulating in the first part to your question.

John Nadel

Analyst, UBS Securities LLC

Q

Point very well taken, thank you. If I can sneak one last in; I'm sorry. Just – Steve, you had mentioned that expenses were a bit higher maybe to the tune of something like two basis points to four basis points on the ROA and annuity. Charlie, I know you don't necessarily want to talk about the ones and twos in International overall, but is it fair for us to think about the lower level of expense in International being largely offset by the higher in Annuities?

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

I'm looking at Steve with that one because I'd...

Stephen P. Pelletier

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

A

I guess that's how it works out kind of mathematically, John, but I don't see – we don't see any particular correlation between the two.

John Nadel

Analyst, UBS Securities LLC

Q

No, no, no, I'm not looking for – I'm not saying there is a correlation.

Stephen P. Pelletier

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

A

Okay.

John Nadel

Analyst, UBS Securities LLC

I'm just wondering if they're roughly similar, that's all.

Q

John Robert Strangfeld

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Yeah, well, that's another way of getting at the question that was asked before, which is, how big is the number in International? So we're not really giving out a number. We're just saying that there were some expenses that were probably deferred to the fourth quarter. And then there were some good guys that fell our way. And those were in the \$1 million here, \$2 million there, \$3 million there, but they added up to a material number.

A

Robert Michael Falzon

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

So, John, it's Rob. Let me just add one last comment onto that is – and I think it perhaps is what you are getting at. As we look at the quarter holistically, there were puts and takes. And so – and that's what you're articulating.

And so when we look that result on an overall basis, what you're seeing is the benefit of having a diversified portfolio of businesses that are all high quality in and of themselves. But at any given point in time may produce results that are above or below what we would normally expect or see in a given quarter.

And what you saw in this quarter is, International outperformed and some of our domestic businesses underperformed for the very specific reasons that we mentioned. And those things offset. So when we look at the holistic results for the quarter, we think you can look at that as representative of the totality of our businesses.

A

John Nadel

Analyst, UBS Securities LLC

Got it. That's very helpful. Thanks, Rob.

Q

Operator: Thank you. Our next question comes from the line of Suneet Kamath with Citi. Please go ahead.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Yeah, thanks. Good morning. A few questions on capital. If I look at your year-to-date capital return measured against your AOI, I think you're tracking less than the 65% sort of free cash flow guidance. So any reason why maybe you're below that? And is there the potential to maybe accelerate buybacks, drawing down some of the holding company cash, which is at the high-end of your \$3 billion to \$5 billion range?

Q

Robert Michael Falzon

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

Suneet, it's Rob. So as we've articulated, and you've floated this, we think that about 65% of our operating earnings do translate into free cash flow. We've typically thought about redeploying that. And we redeploy it in a combination of dividends, so typically without being mathematical about it, within a range. We think about half that working its way back in the form of dividends to shareholders. And the other half of it we think about as redeploying either in the form of returns to shareholders, or we have the opportunity to deploy it into investments, which can grow our businesses inorganically.

A

And so as we think about that, there is no reason to believe that our philosophy in that has changed at all. The mathematics of that can vary in any given quarter or within the year or for the year. But we have a very disciplined approach and a very thoughtful approach.

And as we look at establishing our expectations for buybacks in a given year and our dividend policy in a given year, we refer back to – just the way you articulated it. And we've got 65% and that's available to either return to shareholders or to redeploy otherwise or to grow growth on behalf of – grow earnings on behalf of shareholder returns as well.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Okay. And then I guess my follow-up question. If I think about Lincoln's earnings call from last week, they brought up this idea of kind of using some of the legacy blocks in reinsurance transactions, bring capital to – even do more on the share repurchase side.

Just given where your valuation is, and it's reasonably similar to where Lincoln's is, is that something that you guys have in the tool kit around capital. I really haven't heard you guys talk about that much.

Robert Michael Falzon

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

A

Suneet, Rob again. So, yeah, we are always reviewing opportunities to optimize capital management. And we're engaging with market participants to understand the range of opportunities that might be out there.

I would note with respect to the specific Lincoln example that we generally have very well underwritten books. And we are not a distressed seller. And so any transaction would need to be economically compelling to us in light of what we think are the highly attractive economics associated with the portfolio that we've got. But I'll end with where I started, which is we are absolutely always reviewing those opportunities and seeking to optimize our capital management.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

And then if I could just sneak one more in on a related topic. Just on Long-Term Care. I mean we've heard on different calls that private equity is kind of sniffing around Long-Term Care blocks. Are you guys hearing anything in that regard with respect to your block?

Robert Michael Falzon

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

A

I wouldn't change the answer that I gave you to the prior question, Suneet, which is Long-Term Care would be included in that evaluation that we do in the things that we evaluate.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks, Rob.

Operator: Thank you. Our next question comes from the line of Erik Bass with Autonomous Research. Please go ahead.

Erik James Bass

Analyst, Autonomous Research US LP

Q

Hi, thank you. Your group margins continue to be favorable relative to your guidance at the beginning of the year. And I think this has been a consistent trend we've seen across the industry and others have talked about expecting this to continue near-term. So I guess as you look at your experience, is there any reason to think that you couldn't continue to turn the – kind of the favorable end of your guidance range?

Stephen P. Pelletier

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

A

Erik, this is Steve. I'll address your question. I think you're quite right in observing that we've been at the positive end of the range, the low end of the range or below. And that's for certain kind of fundamental reasons that we've spoken about, including well underwritten business and effective claims management.

We do think that these trends that we've created in the business are for solid fundamental reasons and that that bodes well for their sustainability. We're not prepared right now to offer any change in the guidance we've previously given. But you're quite right in noting where we are and in the fact that favorable positioning is driven by fundamentals.

Erik James Bass

Analyst, Autonomous Research US LP

Q

Thank you. And then maybe if I could ask a bigger picture question just around your M&A interest. I'm curious if there's any change in your areas of focus, I guess particularly given the wellness initiatives and your belief in the ability to cross-sell and leverage employee relationships. Does this change your level of interest in Group or Retirement businesses or other platforms that would bring on kind of more employer-employee relationships?

Stephen P. Pelletier

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

A

Erik, this is Steve again. We are quite interested in various opportunities as they may arise. We feel very good about our ability to kind of build the customer engagement funnel that we have in our financial wellness offering. Obviously the top of that funnel starts with the employer business – businesses as you mentioned of Group and Full Service Retirement and we're very alert to opportunities as they exist in addition to the organic growth that we've been able to sustain and in fact accelerate in various of our lines of business as witnessed by our strong Group sales earlier in the year and our strong Full Service sales throughout this year, including in particular this quarter.

As we assess those opportunities, we will very much look at them in the context of the lifetime value of the customer because we feel we have built a capability to engage with customers throughout that engagement funnel in ways that will enable us to offer solutions to those customers that help them achieve their financial objectives and help us achieve that lifetime value.

Having said that we will continue our longstanding approach of being a disciplined acquirer. And as we previously noted, some of the Group transactions that have taken place in the marketplace have taken place at multiples that let's just say have been highly elevated. But that's not to say that we don't continue to look for those opportunities, even as we continue to build momentum in our organic ability to expand that top of the funnel.

Erik James Bass

Analyst, Autonomous Research US LP

Thank you.

Q

Operator: Thank you. And our last question comes from the line of Alex Scott with Goldman Sachs. Please go ahead.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Hi, first question I have is just a follow-up on the Annuities ROA. I think in the past you guys have talked about a 115 basis points sort of long-term ROA target. Could you talk about, are you seeing any of the drivers that would drive you down towards the 115 basis points from sort of the 120s plus that you have seen previously? I mean, are hedging costs ticking up and is there any offset from interest rates that might allow that long term target to be higher?

Q

Robert Michael Falzon

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

So, Alex, its Rob. Let me take part of that and then I'll turn it over to Steve to talk about sort of the longer term trends and specifically around the hedging piece of it. So, let just sort of provide a little bit of a backdrop and then talk about hedging costs specifically. But if you look at our hedge effectiveness during the course of the quarter, it was 97% effectiveness; and then if you roll that forward and look at the month of October, given there was significantly higher volatility in October, we were still in excess of 90% hedge effectiveness. So, on a year-to-date basis through the end of October we actually had 99% hedge effectiveness.

A

When we talk about hedge effectiveness, that includes the cost of hedging in that effectiveness and that cost of hedging is included in the AOI results that you're seeing in the current quarter and prior quarters. So there has been – when you look year-over-year, we called out in our release the increase in hedging costs; but that was really just – that wasn't sequential, that was year-over-year, because when you look at the third quarter of last year, that was before we put into place the refinements in the hedging strategy that we introduced in the fourth quarter which allowed us to sort of reduce the level of variability and outcomes, given the very high economic results that we are getting out of the Annuities business by adjusting the equity hedges that we had in the portfolio. So, that was in place both in last quarter and this quarter; it just wasn't in place a year ago.

So when we look at the hedging costs, there isn't a bias toward that producing pressure on our ROAs on a go forward basis. The cost we're incurring from hedging are within a range of our expectations. So with that let me turn it over to Steve to sort of talk about longer-term prospects.

Stephen P. Pelletier

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

Alex, I spoke earlier about a couple of specific costs that are affecting this quarter's ROA. In addition to that as we previously pointed out, there was one factor that will produce very, very gradually over a multi-year period some pressure on the ROA, and that is the emergence of more of our business – the maturation of more of our business and its emergence into lower fee tiers. This is a very common pricing practice in the Annuities industry that the fee tiers lower some time at or after the end of the surrender charge period.

A

And the facts are simple: we wrote a lot of highly profitable business in Annuities in the 2009, 2010, 2011 years when equity markets were suppressed and it was a good time to take on this risk. We were writing that business even as many participants in the market were pulling way back. So we do have a meaningful amount of business now emerging beyond the surrender charge period and into these lower fee tiers. But the emergence of that impact I will emphasize again is very, very gradual and occurs over a multi-year period.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Got it. Thank you. And maybe just a quick follow-up on Full Service. Can you quantify at all like how much of the positive flow experience and volume growth you've been getting is from sort of the initiatives that you've been undertaking with LINK in expanding your platform?

Stephen P. Pelletier

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

Alex, Steve again. We feel that over the past several quarters, as we've advanced the financial wellness value proposition into the marketplace that that financial wellness offering has been accountable for, let me call it some \$5 billion of our Full Service sales. So a healthy contribution to our momentum in the business.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Got it. Thanks very much.

Operator: Thank you. That concludes our question-and-answer session. I will turn the call back to John Strangfeld for 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 a few final thoughts. It's been a privilege to lead our company over the last 11 years and parenthetically 44 earnings calls during which we've significantly evolved and grown our business and delivered innovative solutions to our customers. And I'd like to personally thank all of our employees for their dedication and support as they are at the cornerstone of the company's success; success in delivering value to our customers, our community, and our stakeholders.

And I'd also like to recognize the extraordinary partnership I have had enjoyed with Mark over the last 11 years, which is highly productive, personally enriching and an incredible and unforgettable example of the power of partnership, one that's based on mutual respect, complementary skills, and trust. And I look forward to Charlie and Rob experiencing the same kind of partnership as they moved forward, working together with an outstanding management team.

With that, I'd like to thank you very much for your time and attention and wish you a good day.

Operator: Thank you. Ladies and gentlemen, that does conclude your conference for today. We thank you for your participation and for using AT&T Executive TeleConference Service. You may now disconnect.

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