

02-May-2019

# Prudential Financial, Inc. (PRU)

Q1 2019 Earnings Call

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## OTHER PARTICIPANTS

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**Thomas Gallagher**

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**Suneet Kamath**

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Ladies and gentlemen, thank you for standing by. Welcome to the Prudential Financial Quarterly Earnings Conference Call. At this time, all participants are in listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time. [Operator Instructions] As a reminder, today's conference is being recorded.

And, I would now like to turn the conference over to the Head of Investor Relations, Darin Arita. Please go ahead sir.

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### Darin Arita

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

Thank you, Brad. Good morning and thank you for joining our call. Representing Prudential on today's call are Charlie Lowrey, Chairman and CEO; Rob Falzon, Vice Chairman; Steve Pelletier, Head of Domestic Businesses; Scott Sleyster, Head of International Businesses; Ken Tanji, Chief Financial Officer; and Rob Axel, Controller and Principal Accounting Officer. We will start with prepared remarks by Charlie, Rob and Ken 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 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 slide titled Forward-Looking Statements and Non-GAAP Measures in the appendix to today's presentation, which can be found on our website at [investor.prudential.com](http://investor.prudential.com).

Also as a reminder, we will be hosting an Investor Day here in Newark, New Jersey starting at mid-day on June 5. The focus will be on our business strategy with plenty of time to interact with our executives. We will also feature a financial wellness experience exhibit at the start of the event. We hope that you will be able to join us.

With that, I will hand it over to Charlie.

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### Charlie F. Lowrey

*Chairman & Chief Executive Officer, Prudential Financial, Inc.*

Thank you, Darin. Good morning and thank you for joining us today. The first quarter of 2019 marked a solid start to the year for Prudential. We accelerated our strategy to bring greater financial opportunity to more customers. We produced a 12.6% adjusted operating return on equity increased our book value per share and generated good business fundamentals. With a foundation of a rock solid balance sheet we continue to return capital to shareholders, totaling \$915 million this quarter via share repurchases and dividends.

Our three interconnected businesses are the drivers of our financial results. They are the U.S. Financial Wellness business; PGIM our global asset manager; and International which has our life insurance business in Japan and smaller businesses in growth markets around the world.

In our U.S. Financial Wellness businesses we continue to grow our suite of solutions to help the employees of our workforce – of our workplace clients, learn, adopt and practice positive financial behaviors. Rob will provide more color on these solutions in a moment.

Our workplace clients employ millions of people giving us a distinct advantage in our ability to connect with a large population via a trusted environment. These workers can engage with us how, when and where they prefer in an in-person, phone or digital way. We see a significant opportunity to expand our total addressable market and to grow as we holistically serve people's needs including investment, retirement income, protection as well as savings and debt management.

PGIM is a top 10 global asset manager, with leading positions in alternatives including real estate and private credit. The business continues to generate consistently strong investment performance, third-party flows and core earnings growth. PGIM provides a competitive advantage for our other businesses by helping to innovate new solutions and by generating differentiated investment returns. PGIM in turn benefits from Prudential's significant pool of assets and large balance sheet.

Finally, our international operations further distinguish our business model from that of our peers, as they provide sustained growth, strong returns and steady capital generation. We continue to grow our Japan business, maintaining a leadership position in the Japan life insurance market and also have businesses in highly populated growth markets, including Brazil, Chile, Indonesia, India, China and Africa.

Turning to slide 3. I'll provide four additional financial highlights on the first quarter. First, first quarter adjusted operating earnings declined from the year ago period, primarily due to two factors: one, higher cost per compensation plans tied to Prudential's stock and overall equity market returns; and two, lower fee income reflecting lower average variable annuity assets under management. These two items were partially offset by continued underlying growth across a number of our businesses. Second, our adjusted book value per share grew to more than \$96. Third, we deployed our capital into growing the business, repurchasing shares and paying dividends. And fourth, we achieved all of this while maintaining a robust capital position consistent with our AA standard.

We also saw solid drivers across many of the businesses. Our Retirement business account values increased to a record level, Individual Annuity sales continue to increase and the business maintained its regular quarterly capital generation with \$285 million paid to the holding company, and our Life Planner business also delivered a strong sales quarter, driven by a record quarter of Life Planners.

While we are encouraged by the momentum of our businesses, it is important to highlight that we remain disciplined on pricing to ensure that we continue to generate returns at or above our target levels, given the recent decline in long-term interest rates, which has had an effect on the level of sales in some of our businesses. Before I turn it over to Rob for more on how our businesses are executing on our strategic priorities, I'd like to say a few words about our commitment to solving the financial challenges of our changing world.

So let's turn to slide 4. Underlying our purpose is a commitment to fostering sustainable business that produces attractive returns for our long-term shareholders, along with an integrated environmental, social and governance framework. We've been recognized by a number of third parties specializing in ESG with high marks from Sustainalytics, Institutional Shareholder Services, MSCI and CDP.

As an example of our actions, just last month, we announced a \$180 million investment in opportunity youth. This funds partnerships, grants, corporate contributions and impact investments through 2025 to improve the financial

security of young people around the world. We care about ensuring that future generations are prepared for a successful professional and financial life and we are proud of our commitment to their success. This is a great example of who we are as a company and the purpose for which we exist.

Thank you all for your time this morning and with that, I'll turn it over to Rob.

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## Robert Michael Falzon

*Vice Chairman, Prudential Financial, Inc.*

Thanks Charlie. I'll provide more color on how we are growing our three businesses; U.S. Financial Wellness, PGIM, and International. As shown on slide 5, U.S. Financial Wellness represents our workplace and individual solutions businesses that produce a diversified source of earnings from fees, investment spread, and underwriting income. Our broad capabilities including advice, investment, retirement income, and protection solutions, continue to help clients with their Financial Wellness needs.

We have three key growth priorities for Financial Wellness. First, we are continuing to help employers understand our differentiated value proposition. Since the launch of our Financial Wellness capabilities in 2015, we have generated about \$11 billion of full service retirement plan sales and over \$130 million in Group Insurance case wins that we can attribute to the competitiveness of our platform. In addition to helping us win new clients, we expect to retain more of our existing clients that are aligned with our value proposition.

Second, we are engaging and educating workers to better understand and utilize their existing Workplace Solutions. We activate these relationships through our Prudential Pathways program and our digital Financial Wellness platform. Our Prudential Pathways program has been adopted by nearly 600 of our Workplace clients. In this program, employees of our Workplace clients participate in worksite financial seminars delivered by Prudential's financial advisers.

Our digital Financial Wellness platform has been adopted by nearly 3,100 clients reaching nearly 8 million employees. This platform provides a digital venue to address a variety of individuals' needs including education on financial wellness topics, assessment of financial needs, and tools that allow individuals to take action.

And third, we are addressing the holistic financial needs of individuals. One way we deliver that is via LINK by Prudential which we launched in the second half of 2018. This is a highly personalized online experience that helps employees customize financial goals, connect with advisers digitally or via phone, and obtain investment, income, and protection solutions. We recently released LINK to our Workplace clients and are already beginning to experience good traction on engagement at the individual level.

What we do is making a tangible difference. Based on case studies we have conducted, employers are experiencing a significant increase in the productivity and satisfaction of their employees. This includes substantial increases in retirement plan participation, employees increasing their retirement plan contributions to their company's match level or above, and more appropriate asset allocation by utilizing tools that help participants decide on a mix of investment options that meet their particular needs.

Ultimately, we believe our solutions can change the behaviors for workers, produce better results for employers, and significantly expand our addressable market, thereby enhancing our long-term growth potential.

Turning to slide 6. We recently rolled out additional solutions for our Workplace clients. As I previously mentioned, we extended the reach of LINK by Prudential to our Workplace clients. In addition, we are piloting a financial coaching service available via phone and one-way screen share designed to help individuals learn about and

adopt healthier financial behaviors. And we've deployed student loan assistance capabilities, including helping individuals evaluate student loan consolidation and repayment options, to more than 350 employers during the first quarter of this year. Also, employers can activate a feature that allows them to pay down the student loan debt of their employees.

For individuals going through a job transition, we introduced PruPassages, which helps people maintain financial wellness and make more informed decisions to navigate changes during this time. And for those who have just lost a loved one, we're providing new beneficiary services, an easier claims process and resources to help guide their decisions during an emotionally challenging period.

All of these enhancements are aimed at meeting individuals' needs at critical moments in their lives while improving productivity for employers and generating positive financial outcomes for our business.

Turning to slide 7. PGIM, our global asset management business has over \$1.2 trillion of assets under management. In the current quarter, we generated \$1.4 billion of positive net third-party flows, including \$1 billion of institutional and about \$400 million of retail net flows. These positive net flows include solid fixed income flows and are driven by our strong long-term investment performance.

I would specifically highlight our five-year performance and note that 92% of the assets under management have outperformed their benchmarks over that period. Our strong investment performance and diversified product offering has allowed us to attract flows into higher return strategies such as emerging markets and alternatives.

By way of example, we are the third largest global investor in alternative investments with our significant real estate and private credit platforms. This has contributed to keeping our overall asset management fee yield stable at 22 basis points. We are encouraged by our pipeline and our ability to continue to grow.

Our distinctive multi-manager model with broad asset class capabilities helps us to expand including globally with roughly 30% of assets under management currently sourced from outside the U.S.

Now turning to slide 8. Our International business includes our world-class Japanese Life Insurance operation as well as other businesses including those in high growth markets with attractive demographics. Our differentiated business models and proven ability to execute our strategy combined with seasonally higher earnings from annual premiums led to a record level of earnings in the quarter.

Life Planner sales, which were about half of the total International sales in the current quarter increased by 19% compared to the year ago quarter. This was driven by higher U.S. dollar sales and the number of Life Planners in Japan increasing by 6% to a record level of more than 4,300. Sales for Gibraltar, which represents the other half of International, were lower than a year ago. This primarily reflects continued competitive combinations in the bank channel.

In summary, our momentum remains positive across our businesses U.S. Financial Wellness, PGIM and International. We have thoughtful strategies and quality execution that continue to build strong fundamentals as we serve our customers well and we are monetizing those fundamentals to generate profitable growth at attractive returns.

With that, I'll hand it over to Ken.

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## Kenneth Yutaka Tanji

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

Thanks, Rob. Slide 9 includes the notable items which had an impact on adjusted operating results in the current quarter. We highlight these items because they may not be indicative of future performance.

In total these three items reduced pre-tax earnings by \$10 million or \$0.02 per share. Excluding the notable items, earnings per share would be \$3.02, relatively consistent with the year ago quarter.

First, variable investment income, which includes non-coupon and prepayment income was about \$100 million below long-term expectations. This reflects the one quarter lag effect of private equity returns and lower than expected prepayment fee income, partially offset by higher than expected hedge fund returns.

Second, equity market appreciation in the current quarter resulted in a \$70 million favorable adjustment to certain – in recognition of certain benefits and costs primarily associated with variable annuities and variable life policies. And third, underwriting experience was in line with our seasonal expectations and reflects the benefit of our complementary, mortality and longevity profile as highlighted on page 22 in the appendix.

Regarding our quarterly earnings pattern, I would also like to highlight a couple of additional items also included in the appendix that impacted current quarter results. Long-term compensation expense for retiree eligible employees is recognized when awards are granted which is primarily in the first quarter of each year. This resulted in about \$30 million of expense in corporate and other and \$30 million, \$35 million of expense in PGIM.

In addition certain deferred compensation and long-term employee compensation plans are based on Prudential's stock and equity market performance. Market appreciation in the current quarter exceeded our expectations and resulted in an incremental expense of \$50 million, primarily in corporate and other.

In total these two items reduced pre-tax earnings by \$120 million or \$0.22 per share. I would also like to highlight a concentration of annual premiums in our International Insurance operation results in an earnings pattern that favors the first quarter. We estimate that this benefited the current quarter results by about \$55 million.

Turning to slide 10. I'll provide an update on capital deployment, liquidity, and leverage. We returned \$915 million to shareholders during the current quarter through dividends and share repurchases. We repurchased \$500 million of shares through our \$2 billion share repurchase authorization for 2019.

In addition, we increased our quarterly common stock dividend per share by 11%. Our cash and liquid assets at the parent company amounted to \$5.5 billion at the end of the quarter consistent with year-end 2018 and higher than our \$3 billion to \$5 billion liquidity target range. We also maintained a strong balance sheet. Our regulatory capital ratios continue to be above our AA financial strength targeted levels and our financial leverage ratio remains better than our target.

Turning to slide 11 and in summary, our market-leading global businesses, complementary capabilities are providing integrated financial wellness solutions to more customers. We generated a strong adjusted operating return on equity along with our record adjusted book value per share and continued underlying growth across a number of our businesses and we distributed \$915 million to shareholders and maintained a robust capital and liquidity position with financial flexibility.

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

## QUESTION AND ANSWER SECTION

**Operator:** [Operator Instructions] Our first question today comes from the line of Erik Bass from Autonomous Research. Please go ahead.

Erik Bass

*Analyst, Autonomous Research*

Q

Thank you. I was hoping you could comment on the pension risk transfer pipeline given the strong momentum you've seen to start the year. And, is this pulling forward activity? Or do you expect it to remain a very active year?

Stephen P. Pelletier

*Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.*

A

Erik, it's Steve. I'll address your question. We look at the pension risk transfer pipeline for the – for this year as still quite solid. The decline in interest rates has impacted funding levels in plans on an aggregate basis. However, we still see the need for the solution as being quite strong and we still see a very solid opportunity set before us in regard to companies that have already taken steps to hedge or mitigate their exposure to capital markets movements. So, we still see a pretty solid pipeline. This is on the U. S. funded side that I'm speaking about and we feel very good about our opportunities to compete with the net opportunity set.

On the unfunded side, the longevity reinsurance side, the U.K. business, we actually see a very strong pipeline. We reported in the aggregate \$1.1 billion in PRT flows this quarter. That was \$400 million in funded business and \$700 million in longevity reinsurance.

Also, since the beginning of the second quarter, we publicly announced another couple of billion dollars in longevity reinsurance and we expect the demand to stay pretty strong on that front for the balance of the year as companies look to manage their risk in this area ahead of Brexit considerations.

Erik Bass

*Analyst, Autonomous Research*

Q

Thank you. And then can you talk about the returns you're able to generate on new PRT business? I think historically you'd talked about it being in line or higher than the corporate objective of 12% to 13%. Is that still the case?

Stephen P. Pelletier

*Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.*

A

Yes. That would still be the case, Erik. For quite some time we've been able to write this business at a return level that is consistent with our corporate objectives actually in the low double-digits on an unlevered basis, so quite consistent with our corporate objectives.

There are certain instances in which we might choose due to the risk characteristics of a certain pieces of business to make that into the very high single-digits. But by and large, we do this business at our target levels that are quite consistent with our corporate return objectives.

Erik Bass

*Analyst, Autonomous Research*

Great. Thank you.

Q

**Operator:** And we do have a question from the line of Jimmy Bhullar with JPMorgan. Please go ahead.

Jaminder Singh Bhullar

*Analyst, JPMorgan Securities LLC*

Hi, I had a couple of questions. First, can you just give us some color on what's going on in the Japanese business in terms of competitive conditions and just your expectations for sales? Obviously, you had a pretty good quarter on the Life Planner side, but a very weak result at Gibraltar.

Q

Scott Garrett Sleyster

*COO & Executive VP-International Business, Prudential Financial, Inc.*

Thanks Jimmy. This is Scott. I'll think I'll answer that in two ways. For the traditional Life Planner business, we feel like our model is fairly differentiated. Its well-trained Life Planners, it's a needs-based selling model and the benefit you're seeing now is that our Life Planner count in Japan is continuing to increase. I think we were up over 250 Life Planners in Japan or 6% this year. So, I think that's fairly straightforward if you will.

A

If you look over at the Gibraltar businesses, you do end up with a different set of activity there and that we are in the bank market there and that market is a little more, it's a little more opportunistic. First of all, the competitors there have different drivers than we do, in some cases, and we also compete against the mutual fund market and other things that customers might be looking to do on the margin.

For the most part, our business there we're very focused on recurring premium. You may recall from our Japan Investor Day that what we like to do is take former Life Planners that are well-schooled in needs-based planning and move them into the bank channel. And therefore their focus I think is substantially different than the average player in the market.

Market's been pretty competitive. You've seen a decline year-over-year, although not so much quarter-to-quarter and that will just vary. And if we're going to maintain our pricing discipline, it's really a little bit hard to forecast from that perspective. But I would say there's a stable core of what we do that customers need in the banks and we're going to stick to our knitting there.

Jaminder Singh Bhullar

*Analyst, JPMorgan Securities LLC*

And for Ken, how much insight do you have on just the book value impact or earnings, increase in earnings volatility you might experience from just changes in accounting for long duration products?

Q

Kenneth Yutaka Tanji

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

Yeah. So, Jimmy, this is Ken. We're in our early days of adopting those new accounting methods, and it's too early to provide any guidance. Overall, we're working our way through it and our objective is to, in the end, be able to provide clear measures of our fundamental business performance that's in line with the economics that are appropriate for our business mix. So, it's still very early days, too early for us to comment on directional impact.

A

Jaminder Singh Bhullar

*Analyst, JPMorgan Securities LLC*

Q

Okay. And then just lastly, on the \$55 million tailwind to 1Q earnings that you don't expect to repeat in 2Q, that's an after-tax number?

Kenneth Yutaka Tanji

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

A

No. It's a pre-tax.

Jaminder Singh Bhullar

*Analyst, JPMorgan Securities LLC*

Q

Pre-tax number, so it's going to be like \$0.08, \$0.09 to EPS, right?

Kenneth Yutaka Tanji

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

A

I think that's about right, yeah.

Jaminder Singh Bhullar

*Analyst, JPMorgan Securities LLC*

Q

Okay. Thank you.

**Operator:** And we do have a question from the line of Tom Gallagher with Evercore. Please go ahead.

Thomas Gallagher

*Analyst, Evercore ISI*

Q

Hi. So, it looks like your Holdco debt went up by about \$1 billion versus 4Q, but Holdco cash stayed flat. Can you comment on what's happening there? Was that just timing of dividends out of the subs? Or are you planning on using leverage to fund part of your buybacks and dividends this year? That's my first question.

Kenneth Yutaka Tanji

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

A

Yeah. So overall, we feel very good about our position in terms of capital and highly liquid assets at the holding company. The liquid assets were flat from year-end. We did issue \$1 billion of debt and that is really to position us well for a pre-funding of debt that matures in the second quarter.

We did have cash flow come into the holding company from our businesses that pay dividends quarterly and regularly, and that was from annuities and PGIM, which are nice stable fee businesses that we have on a – providing dividends on a quarterly and regular basis. And then we tend to have the dividends from our insurance operations in the second half of the year. So, our businesses are generating solid cash flow and support – will support our plans for shareholder distributions as we go through the year.

Thomas Gallagher

*Analyst, Evercore ISI*

Q

So, Ken, I guess, yes. So, bottom line there, you expect to fund your dividends and buybacks with all dividends from subs throughout the course of the year, not through leverage? Is that a fair conclusion?

Kenneth Yutaka Tanji

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

A

That's right. And over time, actually you've seen our leverage trending down, and that's reflective of the strong cash flow nature of our business.

Thomas Gallagher

*Analyst, Evercore ISI*

Q

Got you. And then just my follow-up is just on PGIM. Now I know you don't disclose it this way on asset flows, but from the ending balances between equity and fixed income, it looks like you're seeing pretty big inflows into fixed income and outflows in equities. Just want to know is that what's happening underneath? And also would that, are there implications for revenue yields that you see there because PGIM revenue yields have held up quite well, so just curious if you would expect that to remain the case?

Stephen P. Pelletier

*Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.*

A

Tom, it's Steve. I'll address your question. Thanks for it. You're right in making the observation that by and large we've seen flows into fixed income and outflows on the equity side. That's been the case for the past several quarters, largely in the face of the active to passive trend, especially in equities. Although generally speaking we've seen that, we've seen the pressure on our equity flows moderate in the course of 2018, say.

Our equity performance as well as our fixed income performance remains very strong. We see a good pipeline of mandates. So, based on the observation that at the end of the day investment performance really is the beginning of the virtuous cycle in the asset management business, we remain very confident in our ability to continue to generate flows in certainly fixed income and equities as well.

In regard to revenue yield, I would say that our flows into fixed income have been into relatively speaking higher fee-yielding strategies. That's been especially true over the past say, 1.5 to 2 years. And so we have been able, even in the face of some equity outflows and strong fixed income inflows, we've been able to maintain that 22 basis point fee level for some period now. That remains quite stable and we expect it to be so. I'd also just make the final observation that while all of our businesses are at scale with PGIM, the scale characteristics of our fixed income business are especially strong. So when we attract flows into that business it bodes well for our operating margin in the business.

Thomas Gallagher

*Analyst, Evercore ISI*

Q

Okay. Thanks. That's helpful.

**Operator:** And we now have a question from the line of Suneet Kamath with Citi. Please go ahead.

Suneet Kamath

*Analyst, Citigroup Global Markets, Inc.*

Q

Thanks. I just wanted to start with the Wellness initiative. Can you give us a sense of how much you're spending on that on an annual basis and what kind of the spend has been maybe over the past couple years and where it's showing up?

Stephen P. Pelletier

*Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.*

A

Suneet, I would address it. We've spoken before about our initiative spendings overall as a company. The Financial Wellness spend is a meaningful portion of that, but we have not broken that out as a separate matter. I would say that a fair amount of the spend is visible in our Retirement and Group businesses kind of concentrating on the top of the client engagement funnel if you will. That's where people come into the Financial Wellness experience through Group and Retirement. So when you see some pick-up in expenses in G&A expenses in those businesses, a significant portion of that is due to the Financial Wellness effort.

In regard to the returns, we're realizing on it we're actually very pleased in the areas that Rob outlined in his opening comments. We definitely see that momentum on the top, at the top of the funnel, the very strong momentum in our full-service sales and in our group sales over the past couple of years is directly attributable to the Financial Wellness effort. And Rob highlighted those numbers in his comments. And we see very strong beginnings of engagement of individuals with the Financial Wellness experience. Lots of different numbers, I could cite from Rob's presentation, but in particular, I'd speak to the 8 million people who are now accessible, who can now access the digital Financial Wellness portal through the 3,100 employers that have activated that portal.

And we see the beginnings of very solid engagement, engagement with the digital properties that are in the portal with the digital properties that are being introduced across the Financial Wellness platform in particular LINK, and some of the other capabilities that Rob mentioned.

We see very solid engagement with those capabilities. We see people completing the kind of learning experiences and needs-based analysis that is embedded in that experience. And over time, we like the prospects for this resulting in individuals who come to us via the Financial Wellness portal engagement with our solutions, with our individual solutions as well, investment solutions, retirement solutions, and insurance solutions.

I will emphasize that those individual-based revenues will emerge over an extended period of time, but all of the metrics that we're tracking, and we'll talk more about this on Investor Day in June, all of the metrics we're tracking lead us to feel that this initiative is well on track in terms of achieving those outcomes for individuals and their employers.

Kenneth Yutaka Tanji

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

A

And I'll just add, this is Ken, overall, we've been very disciplined and consistent in our approach to managing our operating expense resources. And that reflects a combination of taking actions to gain significant efficiencies across the company by creating centers of excellence, pulling together functions to gain efficiency, and improving quality and improving systems and implementing automation.

And those savings and efficiencies allowed us to, at the same time, increase resources to the initiatives that Steve just described to you in building data, digital customer service and customer engagement capabilities and expanding our PGIM business globally. So if you looked across the surface at our operating expense you'd see a pretty stable outlook modestly growing and growing at a rate below our earnings growth and expanding margins, but at the same time being able to invest into the capabilities that Steve described.

Suneet Kamath

*Analyst, Citigroup Global Markets, Inc.*

Q

Okay. Thank you. And then, on the compensation plan, I guess that hit in the first quarter for the retirement eligible employees, can you give us any kind of sensitivity around, either sensitivity to the markets or your stock price just to help us model this? It seems like that was a decent portion of the shortfall relative to consensus.

Kenneth Yutaka Tanji

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

A

Yeah. There was really kind of two pieces to that, and I think it's important to distinguish between them. The retiree-eligible piece means that if you're retiree-eligible, the accounting requires that we expense that when it's granted even though it is paid out over typically over a three-year period. And that was \$70 million, \$35 million in PGIM, \$35 million in Corporate, but that's not market-sensitive. That's going to occur in the first quarter when their grants are typically made and that occurred this quarter, and it occurred in prior quarters as well. So it's more of a seasonal timing of expense than market-related.

On the market-related piece, which was \$50 million, and primarily in Corporate, you can think of that as having our compensation plans tied to the performance either of our stock and aligned, aligning management's interest in that, or to the extent people defer compensation and linking it to market indexes it would experience fluctuations with those markets.

In the first quarter that was \$50 million and our stock price improved by 13% and the S&P improved by 13%. So, you can sort of calibrate \$50 million to a 13% change in both of those components.

Suneet Kamath

*Analyst, Citigroup Global Markets, Inc.*

Q

And will that happen every quarter? Meaning that second one the \$50 million is that adjusted on a quarterly basis?

Kenneth Yutaka Tanji

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

A

Yes. It will as market moves. And if you look to the fourth quarter you saw it in the opposite direction actually to a more sizable degree.

Suneet Kamath

*Analyst, Citigroup Global Markets, Inc.*

Q

Got it. Okay. Thanks.

Robert Michael Falzon

*Vice Chairman, Prudential Financial, Inc.*

A

Suneet, it's Rob. The only thing I'd add is that that is factored into the sensitivities that we've given you for full year earnings for the, plus or minus 10% in equities. We talk about that being \$0.30. That \$0.30 is net of this. It's just the timing of it is such that we give you a full year number on sensitivity, but the compensation piece hits in the current quarter whereas the benefit is sort of spread throughout.

Suneet Kamath

*Analyst, Citigroup Global Markets, Inc.*

Q

Okay. Thanks, Rob.

Robert Michael Falzon  
*Vice Chairman, Prudential Financial, Inc.*

A

Okay.

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**Operator:** And, we do have a question from the line of John Nadel with UBS. Please go ahead.

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John Nadel  
*Analyst, UBS Securities LLC*

Q

Thanks. Good morning. So, Rob I appreciate your comment there at the end in response to Suneet's question. It's a good segue to where I wanted to go. It seems to me at a high level that the strong market performance in the first quarter actually on an aggregate basis for your company's earnings had a negative impact given we get the point-to-point impact through these compensation arrangements. But the average market performance impact was not that significant and we ought to be getting that on more of a lagged basis as we work through the rest of the year.

So, I guess just to confirm your comment, 10% or 10% -plus, I mean the market's up almost 17% at this point year-to-date performance. We ought to be seeing the first quarter pressures more than overcome by business segment earnings results right?

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Kenneth Yutaka Tanji  
*Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.*

A

Yes, this is Ken. That's exactly the way to think about it, it's a timing. So, the \$0.30 that we provided for a increase of 10% in the markets, that was over a year and you saw the first component of that being the impact on costs of \$50 million of the deferred and long-term comp expense hitting this quarter and then in subsequent quarters, you would see the benefit which would be more than the \$0.30 over a year's period. Does that make sense?

---

John Nadel  
*Analyst, UBS Securities LLC*

Q

It does make sense to me. I guess when I think about the, one of the slides in your deck shows seasonal pattern, and I know this isn't necessarily seasonal, but you highlight that, and this has been the case forever, that your International operations benefit seasonally in the first quarter and to some degree relative to the rest of the year. But you're not really highlighting for us the negative impact of this particular comp item relative to the positive impact that you ought to see in the rest of the businesses on a, for the remainder of the year.

And I guess I'd advise you guys, if I could be so bold, as to try to lay that out for us, even if it's not on this call, at your Investor Day coming up, because you've missed earnings now, right, for four straight quarters, despite what's been a pretty good, other than 4Q, a very good market backdrop. And I think there's some significant disconnect. I hear some really good commentary about growth around Financial Wellness et cetera, et cetera. It seems to me there's more upfront cost and more lag to revenue effect. Maybe you could help flesh that out as well. I just see you guys as performing so well from a strategic perspective and there's some miss between the connection of earnings to consensus expectations. That's all.

---

Kenneth Yutaka Tanji  
*Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.*

A

Yes. It is a timing consideration. We do think it's important to align management's interest with the performance of the stock and that, the accounting for that is appropriate recognized immediately and then the fees will occur over

time. So over time, we think obviously the equity markets are a very positive thing for our underlying earnings power and you should expect to see that in the subsequent quarters.

Charlie F. Lowrey

*Chairman & Chief Executive Officer, Prudential Financial, Inc.*

A

Hey, John, it's Charlie. First of all, let me say thank you for your comment. No, we really appreciate it. And to be candid, it's a source of frustration for us as well. We think our businesses are performing well. We are very pleased with the businesses we're in. We think they're high quality, they're at scale. The Financial Wellness initiative is bringing them all together in an integrated way. And this is – we've been on a long journey and we're proud of where we've come from in terms of divesting of non-strategic businesses, acquiring businesses that we want to be in.

And so, we are also, quite frankly, frustrated by the noise that's out there, that is created by some of the accounting regulation and other things. And so, we will work on that and we'll try and see as we have, and Rob and his crew over the years have tried to simplify our earnings. And you've seen us be able to simplify them and bring net income more in line with AOI over time, but we have more work to do and we will commit to working on that. To try and clarify and simplify our results to reflect what we think is a really good business system that we have and a good strategy.

John Nadel

*Analyst, UBS Securities LLC*

Q

I appreciate that Charlie. Thanks very much.

**Operator:** And we do have a question from the line of Ryan Krueger with KBW. Please go ahead.

Ryan Krueger

*Analyst, Keefe, Bruyette & Woods, Inc.*

Q

Thanks. Good morning. I had a question on the holding company liquidity above your targets. Your buyback and dividends are relatively equal to your free cash flow generation. Just curious how you're thinking about utilizing excess capital that's above your targets over time and if it's more dependent on opportunistic situations or if you'd look to manage that down?

Kenneth Yutaka Tanji

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

A

Well again, we feel really good about our capital position and our cash flow. It's been a pretty consistent picture of us generating good cash flow from our businesses, using that in a combination of ways. One, first is to grow our businesses in attractive opportunities such as pension risk transfer. We have also had the opportunity to reduce leverage and that is – sort of also provides a source of financial flexibility for us. So overall, we feel real good about our capital position. It's been very consistent. We've been increasing our shareholder distributions in line with our earnings and as we generate cash flow. And we – I think you should expect that to continue.

Ryan Krueger

*Analyst, Keefe, Bruyette & Woods, Inc.*

Q

Okay. And can you give any perspective on how you're feeling about interest rate assumptions and policyholder behavior trends in variable annuity – in the variable annuity business heading into the actuarial assumption review?

Kenneth Yutaka Tanji

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

A

Yeah. We're still going through that. As you know, we do that in the second quarter. We're still doing our work and we don't – we would prefer not to preview that on this call.

Ryan Krueger

*Analyst, Keefe, Bruyette & Woods, Inc.*

Q

Okay. Understood. Thank you.

**Operator:** And we do have a question from the line of Humphrey Lee with Dowling & Partners. Please go ahead.

Humphrey Hung Fai Lee

*Analyst, Dowling & Partners Securities LLC*

Q

Hi. Thank you for taking my questions. My first question is related to prepayment income. Obviously, it's lower in the quarter and I think some of your peers talked about having lower prepayment income as well, which is kind of surprising given yield came down in the quarter and spread tightened. I was just wondering, do you see that as a timing issue or is there any structural changes to the debt issuance market as refinancing activities slow down?

Kenneth Yutaka Tanji

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

A

No. I think it's just – the way to think about it is typical volatility – less tied to rate environments and more tied around the financing needs of the borrowers. And that's typically tied to some transactions or strategies that are underlying their businesses. So, the change has been very typical and if you looked at that – as we look at that over time – it tends to be above and below our expectations on a fairly consistent basis, and so we see what happened this quarter as just kind of typical.

Humphrey Hung Fai Lee

*Analyst, Dowling & Partners Securities LLC*

Q

Got it. And then shifting gear to PGIM, just looking at the gross sales, especially on the institutional side, came down by a fair amount. I was just wondering if you can talk a little bit about what you've seen recently and then also in terms of your pipeline in terms of – on the gross sales perspective?

Stephen P. Pelletier

*Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.*

A

Humphrey, it's Steve. I'll address your question. And in doing so, I'll echo some of the comments I made earlier. We do see some solid pipeline in front of us across multiple asset classes, in particular in fixed income, but also in equities as well. And with the performance – investment performance that we're generating – with the build-out that we've made in our global distribution platforms, and with some of the mandates that we've, that we're already seeing, some of which have yet to fund but they've already been awarded, we do continue to feel very confident that our long, long string of positive net flows from the institutional market has every prospect for continuing.

Humphrey Hung Fai Lee

*Analyst, Dowling & Partners Securities LLC*

Q

So the low gross sales is just more of a timing issue as opposed to a change in client demand?

Kenneth Yutaka Tanji

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

Correct.

A

Humphrey Hung Fai Lee

*Analyst, Dowling & Partners Securities LLC*

Okay. Thank you.

Q

**Operator:** And we do have a question from the line of John Barnidge with Sandler O'Neill. Please go ahead.

John Bakewell Barnidge

*Analyst, Sandler O'Neill & Partners LP*

Thanks. Both VA and FA sales did well. How much of this momentum have you seen carry over into 2Q? And then, how much of this growth do you think is coming from just the industry being hot versus Financial Wellness program-driven demand?

Q

Stephen P. Pelletier

*Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.*

John, it's Steve. I'll address your question. We think that the sales that we saw in the first quarter really reflect the strong momentum that we have in the business. It's across multiple products and we see very strong diversification and growing diversification of our business, with our Prudential-defined income product having a major contribution, and building momentum in our fixed indexed annuity. And that in particular was a product which basically got off the ground a year ago when we saw \$200 million in sales in it this quarter.

A

We see this strength across multiple distribution channels within the industry and we think we have every prospect of continuing the momentum. In saying that, we always run all of our businesses for sustainable profitable growth and we will continue to manage them accordingly and to take a look at our pricing dynamics in relation to the market environment in which we're operating.

But I think what we're really seeing is growing demand among financial advisers for their clients to be able to access this type of solution. There has been a pickup in industry sales, but I will say, we're pleased to see that both in 2018 and in the first quarter of 2019 our growth has been above industry levels. So we've been gaining share in this market.

John Bakewell Barnidge

*Analyst, Sandler O'Neill & Partners LP*

Okay. And my follow-up, with this being the first tax season since reform was finalized have you noticed any changes in behavior on the part of the consumer business owners and this may also be more relevant for 2Q than 1Q? Thanks for the answers.

Q

Stephen P. Pelletier

*Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.*

I've not seen any particular dynamics from the, any behaviors in regard to tax season that would be unusual compared to previous years.

A

**Operator:** And we do have a question from the line of Alex Scott with Goldman Sachs. Please go ahead.

Alex Scott

*Analyst, Goldman Sachs & Co. LLC*

Q

Hi, good morning. First question I had was just on dividend capacity. I think you commented some on it already, but I guess just in light of sort of the mix of dividends this last year and it kind of being, I think a bit more weighted towards International versus your biggest U.S. OpCo, could you talk about how dividend capacity looks this year? Where you expect to have access to dividends?

Kenneth Yutaka Tanji

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

A

Yes. This is Ken. Last year, I'll remind you that we did have the impact of tax reform and that led to a strengthening of our capital position in Prudential Insurance Company of America, our flagship U.S. insurance company, and so we didn't take a dividend from that business last year, but we would expect to this year in ordinary course, as well as, having the diversity of our cash flows from our other businesses with PGIM generating cash flow quarterly, annuities generating cash flow quarterly and our international businesses particularly in Japan also with a source of cash flow at the typical levels which will vary over time and certainly quarter-to-quarter, but is about 65% of after-tax earnings.

Alex Scott

*Analyst, Goldman Sachs & Co. LLC*

Q

Got it. Okay. And my follow-up question was just on PGIM. When I look at earnings and maybe a margin sort of adjusted for the other related revenues and earnings that you receive there, I mean the core margins, and I appreciate that there was sort of these first quarter seasonal deferred comp expense, but even just looking relative to other 1Qs, I mean the margin, I think was down around four or five points from where it's been.

So, I'd just be interested if there was anything else that's sort of going on there. I mean, should we expect margins to sort of remain at this lower level? Or do we – or should we expect them to go back up to a higher level? And if you could remind us – I think you guys have talked about a core margin target there before, that maybe it was closer to 30%?

Stephen P. Pelletier

*Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.*

A

Alex, it's Steve. I'll address your question. We do not – the numbers that we look at, we're not seeing the same type of margin erosion to which you refer. Maybe we can follow up in due course. But we do see that – as we attract flows into businesses at scale and maintain our average fee rate, which we've been quite successful in doing, we see the ability to continue to gradually and, all other things being equal, expand our margins in the business. The, in the range of the 30% plus is how we see our margin objectives in the business. We can talk more about this, again, at Investor Day, but we do see the opportunity and the reality of continued margin expansion in the business.

Alex Scott

*Analyst, Goldman Sachs & Co. LLC*

Q

Thank you.

**Operator:** And at this time for closing remarks, I'll turn the conference back over to Charlie Lowrey. Please go ahead, sir.

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**Charlie F. Lowrey**

*Chairman & Chief Executive Officer, Prudential Financial, Inc.*

Sure. Thank you. Let me close with a few final thoughts. We feel confident about our strategy, the scale of our businesses and the strength of our balance sheet. As we continue to focus on our businesses and deploy new technology to grow and expand our markets, we will make an even greater impact on the financial lives of our customers and in the global community. This should lead to growth in our businesses and greater value for our shareholders. We look forward to providing you with more details at our Investor Day here in Newark on June 5. Thank you for joining the call and have a nice day.

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**Operator:** And ladies and gentlemen, that does conclude your conference for today. Thank you for your participation and for using the AT&T Executive TeleConference Service. You may now disconnect.

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