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Prudential Financial, Inc. (PRU)

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CORPORATE PARTICIPANTS

Darin Arita

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

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Kenneth Yutaka Tanji

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

Scott Garrett Sleyster

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

Stephen P. Pelletier

Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

Andrew Sullivan

Senior VP & Head-Workplace Solutions, Prudential Financial, Inc.

OTHER PARTICIPANTS

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Erik Bass

Analyst, Autonomous Research US LP

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Thomas Gallagher

Analyst, Evercore ISI

John Nadel

Analyst, UBS Securities LLC

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

MANAGEMENT DISCUSSION SECTION

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

I would now like to turn the conference over to Mr. Darin Arita. Please go ahead.

Darin Arita

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

Thank you, Cynthia. 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 U.S. Businesses; along with Andy Sullivan, our next Head of U.S. Businesses; Scott Sleyster, Head of International Businesses; Ken Tanji, Chief Financial Officer; and Rob Axel, Controller and Principle 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 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 slides 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.

I'll hand it over to Charlie.

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you, Darin. Good morning, everyone, and thank you for joining us today on this call.

Yesterday, we reported third quarter earnings per share of \$3.22. We also reported a year-to-date ROE of 13%. I'll begin by discussing our progress in executing our Financial Wellness strategy.

We are committed to delivering a broader set of Financial Wellness solutions to more people in new ways, leveraging our scale across multiple distribution channels and drawing on our expertise, including product development and asset management.

During the quarter, we took steps to expand our digital distribution capabilities through the announced acquisition of Assurance IQ, a fee-based and capital-light growth engine. Assurance is a leading direct-to-consumer platform for Financial Wellness solutions that enables us to serve a different demographic segment, including the mass and middle markets.

Over time, we believe we can expand these capabilities internationally. The Assurance acquisition, which closed in October, also provides attractive financial benefits and significant upside potential. Assurance shares our purpose of solving the financial challenges of a changing world, which is at the core of who we are.

In that vein, I'm pleased to note that Fortune has named Prudential to its prestigious Change the World list for a second consecutive year. We also made progress in the quarter towards our margin expansion goals by evolving and transforming the way we do business across the organization. Along these lines, we launched a voluntary separation program in October for segments of our US workforce. These efforts are intended to better position us to meet the needs of our customers while driving greater speed and efficiency.

Finally, we continue to advance our efforts to reduce the impact of market fluctuations and add transparency to our quarterly financial performance. As a result, beginning in the fourth quarter, our Corporate & Other results will be less affected by changes in the equity market and our own stock price.

Looking ahead, we're taking a very disciplined approach to pricing to help offset the impact of rates on new business profitability, which will have an obvious effect on some of our sales. We are encouraged by our progress and are moving quickly and with conviction to implement the plans we have set forward to deliver meaningful solutions and long-term value to our customers and shareholders.

With that, I'll turn it over to Rob for a closer look at our business performance for the quarter. Rob?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Thank you, Charlie. I'll provide an update on how we're executing on our strategy to leverage our multichannel distribution, product, and asset management expertise and scale to deliver financial opportunity to a wider demographic within our U.S. Financial Wellness, PGIM and international businesses.

As shown on slide 4, U.S. Financial Wellness currently represents our Workplace and Individual Solutions divisions that produce a diversified source of earnings from fees, investment spread and underwriting income. Beginning in the fourth quarter, it will also include fee-based earnings from the Assurance business, earnings which are not correlated to equity markets, interest rates or credit.

We continue to execute our strategy to expand our addressable market. Our Financial Wellness proposition is resonating with our Workplace customers and with the employees of those customers, driving higher participation rates in the employer benefit programs and increased engagement with our advice platform.

The number of people who have activated our digital Financial Wellness platform has increased to 9 million as of September 30. This platform provides a digital venue to address a variety of needs, including education on Financial Wellness topics and assessment of financial health.

We're also growing individual relationships and expect to provide additional solutions to the employees of our Workplace customers as well as other retail customers. One way we deliver these solutions is through LINK by Prudential, which is our highly interactive personalized online resource that enables people to create a path toward achieving their financial goals.

Earlier this year, we began to deploy LINK on our Workplace platform, and we have already made it available to roughly 2.3 million people. We're on track to meet our goal of 2.5 million people by the end of the year.

And notably, with the October closing of our acquisition of Assurance, we have significantly expanded our addressable market with approximately 19 million individuals who are actively seeking insurance solutions. Assurance's direct-to-consumer platform and end-to-end engagement model, which includes over 3,000 agents,

enables us to serve more people along the socioeconomic spectrum. In addition, this platform will enable us to expand our range of available solutions to our Workplace customers by adding third-party provided health and property and casualty insurance as well as Medicare coverage.

We're also making progress streamlining our operations to increase agility while driving efficiencies and enhancing the customer experience. We're on track to achieve \$50 million in run rate margin expansion by the end of 2019 and expect this to increase to \$500 million by the end of 2022. This is being accomplished through a number of programs that we have underway. In the current quarter, we incurred about \$20 million of implementation costs to support these programs.

Shifting to a discussion of third quarter trends and the underlying fundamentals of our businesses, I'll start with flows in the U.S. Financial Wellness this quarter, focusing on our Retirement and Annuities businesses.

Our Retirement business had net outflows of \$2.7 billion, driven by a single large client lapse in our Full Service business. This was partially offset by strong sales in the quarter as the market continues to be active, including episodic large client activity.

The Institutional Investments business had net inflows of \$600 million, including \$3.6 billion of longevity risk transfer transactions. Year-to-date, we have closed \$17 billion of longevity reinsurance transactions, and we have a strong pipeline. This elevated deal activity is driven by our strong competitive position and innovation as well as by UK pension funds de-risking ahead of Brexit.

While we did not close any funded PRT transactions in the third quarter and recent declines in interest rates have impacted the funding levels of these plans, the fourth quarter has started well and we have a solid pipeline of pending transactions.

Our Annuities business experienced \$1.1 billion of net outflows, driven by normal account withdrawals as well as by elevated lapses as certain contracts moved out of the surrender period. We expect this elevated level of lapses to persist through 2020. This was partially offset by an increase in sales, including the impact of launching our PruSecure Fixed Indexed Annuity last year and expanding into the IMO channel this quarter. However, we expect the current low interest rate environment to continue to pressure sales.

Turning to slide 5, our strategy in PGIM, our asset management business, is to combine our multimanager model with global distribution and affiliated flows to grow in higher value-added strategies that serves investors globally. PGIM is a top 10 global asset manager with \$1.3 billion of assets under management. It ranks as the fifth largest investor in fixed income and the third largest investor in alternative investments with significant real estate and private investment platforms. As the investment engine of Prudential, it benefits from a symbiotic relationship with our U.S. Financial Wellness and International Insurance businesses.

PGIM's asset origination capabilities and investment management expertise provide a competitive advantage, helping our businesses to bring enhanced solutions and more value to our customers, both retail and institutional. And our businesses in turn provide a differentiated source of growth for PGIM through affiliated AUM flows that complements its successful third-party track record of performance and growth.

We generated \$800 million of net third-party flows during the third quarter. Our third-party net retail flows were \$3 billion. Strong investment performance in our growing ETF and UCITS platforms and record mutual fund sales delivered solid fixed income flows, partially offset by equity outflows. And our third-party institutional outflows were \$2.2 billion, mainly driven by a single institutional fixed income client withdrawal of \$2.9 billion due to manager

consolidation. We serve many of the world's largest institutional investors, and as a result, experience large idiosyncratic inflows and outflows from time to time.

Our asset management fees benefited from record assets under management due to market appreciation and continued robust fixed income flows. Strong investment performance and expertise across a broad range of asset classes has allowed us to continue to attract flows into higher return strategies. Approximately 80% or more of assets under management have outperformed their benchmarks over the last three, five and 10-year periods.

We continue to broaden and globalize our products and capabilities by developing and launching private and alternative investments and expanding in retail and international markets. Our multi-manager model, strong track record of private originations, and demonstrated investment performance, as well as the investments we are making in our distribution capabilities, will position us to generate positive flows over time and to grow our earnings even absent the Wells Fargo fee arrangement, which ends this year.

Turning to slide 6, our International business includes our world-class Japanese life insurance operation where we have a differentiated business model with unique distribution as well as other operations in high growth markets like Brazil. Our Life Planner strategy is to grow our high quality distribution with a focus on needs-based sales. In emerging markets, we look to combine Prudential's strengths with local expertise to serve customers in a non-traditional way.

Life Planner sales, which were about half of the total International sales in the current quarter, increased by 8% compared to the year-ago quarter. This was driven by record Life Planner count and higher US dollar sales in Japan as well as by continued growth in our Brazil operations.

Sales for Gibraltar, which represent the other half of International, were 11% lower than a year ago. This primarily reflects lower single pay US dollar fixed annuity sales in our Life Consultant channel as we continue to focus on recurring pay protection products.

In addition, the recent decline in US interest rates resulted in lower crediting rates, which also affected sales of US dollar denominated products. We also experienced lower production in our independent agency channel and lower bank channel sales due to continued heightened competitive conditions.

We will continue to innovate new products and consider pricing actions while focusing on maintaining our target level of profitability to improve sales over time.

In summary, we're going to generate profitable growth and attractive returns. We are expanding our distribution of product solutions, leveraging our asset management expertise, and focused on engaging more deeply with our customers.

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

Kenneth Yutaka Tanji

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

Thanks, Rob. I'll begin on slide 7, which provides additional insight into our fourth quarter earnings relative to our third quarter results. We began with our third quarter pre-tax adjusted operating income, which was \$1.7 billion and resulted in earnings per share of \$3.22 on an after-tax basis. Then, we adjust for the following items.

First, we adjust a variable investment income to a normalized level, which is worth \$65 million. Second, the fourth quarter will include seasonal expenses and implementation costs related to the acceleration of our Financial Wellness strategy. We expect this will lower results in the fourth quarter by approximately \$280 million, resulting in an expected loss in the Corporate & Other segment of \$475 million to \$500 million, inclusive of the cost of our Financial Wellness initiatives.

There will also be additional costs in the fourth quarter related to the voluntary separation program that Charlie mentioned. This is all part of the \$600 million to \$700 million of implementation costs to accelerate our Financial Wellness strategy as we discussed on Investor Day.

Third, there are other considerations that we expect will increase results by approximately \$25 million on a net basis in the fourth quarter. And fourth, we anticipate a \$10 million reduction in the quarterly net investment income from portfolio reinvestment, assuming reinvestment rates are held flat with the third quarter.

Absent a change in interest rates, the \$0.02 per share for one quarter would compound to \$0.30 per share over the five quarter period ending December 2020. This assumes a 7% annual turnover on \$370 billion fixed income portfolio with new money yields 65 basis points below disposition yields on average.

Combined, this gets us to a baseline of \$2.50 per share for the fourth quarter, before including the impact of future share repurchases, business growth and market impacts. This baseline includes a few items that puts it below our typical earnings level.

First, we have seasonal expenses in the fourth quarter. We expect those expenses to be similar to prior years at about \$125 million to \$175 million. Second, we expect about \$95 million of Financial Wellness implementation costs in the fourth quarter. And third, we expect \$55 million of higher than typical expenses in Life Planner.

These three items total about \$0.58 per share and explain the elevated level of expense expected in the fourth quarter baseline. While we have provided these items to consider, there may be other factors that affect fourth quarter earnings per share.

A few additional items to note. First, we issued 5.5 million shares in the fourth quarter for the Assurance acquisition. Second, as Charlie mentioned in his remarks, we have taken further action to reduce fluctuation of quarterly earnings by reducing the impact of movement in Prudential's stock in the equity markets on long-term and deferred compensation expenses.

Also, on slide 17, we have provided updated information regarding seasonal items by business. We hope that you continue to find our new disclosures, including our baseline earnings per share information, helpful in understanding the earnings power of our businesses.

We have indicated over the past few years, we are considering alternatives to how we approach guidance. With the new disclosures now in place and provided on a regular basis, we have decided not to provide annual EPS guidance or host an Outlook Call in December. We believe our enhanced disclosures and processes provide insightful information on a more frequent basis.

Turning to slide 8, I'll provide an update on capital deployment, liquidity and leverage. We feel very good about the overall strength of our capital position. We returned \$1.4 billion to shareholders during the current quarter through dividends and share repurchases.

Our share repurchase authorization for the remainder of the year is \$500 million as of September 30. And over the last five years, we've increased our dividend per share by 16% per year on average. Our current quarterly dividend of \$1 represents a 4% yield on our adjusted book value.

We also continue to maintain a rock solid balance sheet. Our regulatory capital ratios continue to be above our AA financial strength target levels and our financial leverage ratio remains better than our target.

Our cash and liquid assets at the parent company was \$6.2 billion at the end of the quarter, and that was above our top end of our \$3 billion to \$5 billion liquidity target range. As shown on the slide, we've provided a pro forma of the highly liquid asset balance that reflects the amount that funded the acquisition of Assurance in early October and brings the balance within our target range. We will look to continue to invest in the growth of our businesses, assess acquisition opportunities to build scale or gain capabilities and return capital to shareholders.

Turning to slide 9, and in summary, we are accelerating on our strategy and positioning our businesses to deliver long-term growth. We remain on track to achieve \$50 million in run rate margin expansion by the end of 2019 and \$500 million by the end of 2022.

We have generated a record high adjusted book value per share and continue to generate strong cash flows that support consistent growth in dividends and other distributions to shareholders, and we maintain a robust capital and liquidity position with financial flexibility.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We will go to the line of Alex Scott with Goldman Sachs. Your line is open.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Hi. Good morning. So first question I had is on variable annuities. And I guess, we're seeing the ROA really starting to come down. And I just wanted to see if you can dimension for us what's impacting that. Is it sort of the spread you're making on the riders? Is it just the fee levels coming down? And I think previously you talked about 115 or 116 bps or so. We're already below that. I mean, should we expect a significantly lower long term sort of trendable level at this point?

Kenneth Yutaka Tanji

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

A

Yeah. Hey. This is Ken. I'll take that. First, our variable annuity business continues to be very profitable. And that's – although it's a bit lower, it still has a high ROA and a strong ROE. We have mentioned in the past that we'd expect the ROA to trend over, over time as policies move into lower fee tiers and as we continue to diversify our product mix to solutions with less equity market sensitivity. So that continues to play out.

And while the ROA is generally a good benchmark for profitability, it will adjust when markets move significantly. And interest rates have declined pretty significantly in 2019, down by about over 100 basis points year-to-date. So

while the decline in rates increases the account value, it affects earnings by the combination of higher benefit ratios and higher DAC amortization.

So despite the decline in rates, the – again, the business continues to be very profitable and generating a quarterly cash flow. We still like the profitability, albeit at a lower ROA.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Got it. Okay. And then my follow-up question is, I guess, more broadly on expenses. There's some acceleration in Life Planner, a little bit more next quarter. You've got the digital expenses going on. But I guess you've also got Assurance IQ coming on, which I think there were some synergies with some of the things you're doing on digital capabilities.

So just wondering if you could provide more detailed thoughts on how much you'd be looking to spend over the next year or so and what kind of offset there is from Assurance coming online. And if we'll have any more like big accelerations like there was in Life Planner for other segments like once you get past whatever you're focusing on in Life Planner?

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Let me just – this is Charlie. Let me start in, and then others can join in. So we said with Assurance that there would be a certain amount of expense synergies. I think we said \$25 million to \$50 million next year, and then additional after that. So you can expect those to come in over time. Those are separate and distinct from some of the other expenditures that we're making or some of the other savings we're seeing in the margin improvements.

Kenneth Yutaka Tanji

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

A

And then the other area for the quarter was International where we did see a shift of some expenses and a higher level of expenses in the quarter.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

And so is that really one time or are you going through any kind of process where you might be assessing needs for other segments that are outside of the digital initiative that's in Corporate?

Scott Garrett Sleyster

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

A

Hi, Alex. This is Scott. I think Darin gave some guidance on what will be recurring and nonrecurring, but there's a couple of big things going on. First of all, to the specific quarters, as I mentioned before, we see evolving regulatory oversight. And we're trying to put the infrastructure in place to continue to be at industry best practices, and some of that is rolling out actually, not just in Japan but around the world.

As I mentioned at Investor Day, we also have been following some of the technology upgrades and the digital upgrades that occurred in the US. We kind of follow what worked well, and we're rolling some of those out across the board. And then, this quarter, we actually had some additional litigation and our other reserves, and finally, some things we're doing on process improvement and automation.

So I would say it really falls into those two big buckets. We were playing a bit of catch-up on the improving regulatory best practices. And then we had some significant initiative rollouts that we were doing in International that I would say lagged the US by about a year.

We're most of the way through that. And so I think if you look at the adjustments we have, call it, \$55 million in accelerated additional spending in the fourth quarter, that will disappear, as we hit our run rate going into 2020, I think we would say that's largely our new baseline.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Got it. That's all very helpful. Thank you.

Q

Kenneth Yutaka Tanji

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

A

And I'll just add, for the quarter, keep in mind, Corporate was lower and there was sort of a couple pieces there. We had lower long-term compensation expense related to the change in our share price. That, as we mentioned, will no longer occur going forward, as we've modified our long-term compensation program to no longer need to have that stock price flowing through our expense. And then, Corporate expenses were also a little bit lower. So if you looked at Corporate and International, they were somewhat offsetting.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Thanks.

Q

Operator: Thank you. Our next question comes from the line of Erik Bass with Autonomous Research. Your line is open.

Erik Bass

Analyst, Autonomous Research US LP

Q

Hi. Thank you. So you've talked about the outlook for EPS in the fourth quarter, but it sounds like that includes a number of one-off expenses in addition to the normal seasonal impact. So it's not, I guess, a real reflection of your earnings power. Therefore, can you help us think about a more reasonable earnings baseline for 2020? And is it really adding back the \$0.54 of items, so thinking of something in kind of the low \$3 range before buybacks and growth?

Kenneth Yutaka Tanji

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

A

Yeah. Hey, Erik. It's Ken. There's actually a number of ways that you can think about this and look at this. So first, I'll start with the baseline that we gave at the end of the second quarter going into the third quarter, which was about \$3. So that was sort of where we thought in the middle of the year our earnings power was. The third quarter results came in at \$3.22. And that was a little bit above that because we had favorable variable investment income and favorable underwriting expense across our businesses.

And as I mentioned in our last comments, the expenses kind of offset between Corporate & Other and International. So if you adjusted that, you got to a number that was a little better than \$3.

Now, in the fourth quarter baseline, you do have a number of items, like I said in my opening remarks, that make it a little bit below our typical earnings level. The first is our seasonal expenses that nothing unique going on this year. Typical to what we see in the fourth quarter. We have the Financial Wellness implementation costs, again, very consistent with what we articulated at Investor Day. And then, third, we have an expectation of little higher expenses in our International businesses.

If you put those items all together and you adjust it for that, you'd be back at an earnings level a little bit over \$3. So I think that's the way we're thinking about our earnings power over those timeframes.

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

A

Erik, it's Rob. Let me just sort of pick up on that sort of looking ahead of that baseline. Ken mentioned in his commentary that we do have interest rate sensitivity going forward, and we have given some guidance on that. So that's sort of updated and will be a headwind contrary to what we'll otherwise have, underlying business growth and then, obviously, the very significant increase we have in growth as a result of capital deployment from shares.

The other piece to think about with interest rates is that we'll have lower sales that come out of that in a lower interest rate environment as well, or at least that's what we're anticipating.

Recognizing all that, we are being very proactive. We're managing sales through product pricing, design and mix. We're managing costs, so that includes implementing the previously announced Financial Wellness initiatives that Ken covered as well. And we have been actively deploying capital for growth. That was evidenced very clearly in the Assurance IQ acquisition, which is not sensitive to rates or equity markets. But also the things that we've done in PGIM and its investment capabilities and its distribution capabilities and the other global technology and distribution initiatives that we have, all of which we think will contribute to the fundamental growth, and then obviously as I mentioned the share repurchases, so deploying capital for growth.

All that we believe gives us the ability in combination with what's happening on International in terms of our continued ability to grow the inforce. It gives us confidence that we can continue to show a differentiated level, or we can show going forward a differentiated level of growth and ROE vis-à-vis the industry in light of sort of the macro headwinds that we outlined.

Erik Bass
Analyst, Autonomous Research US LP

Q

Thank you. That's helpful detail. Maybe going on the interest rate comment. It seems like your interest rate sensitivity has increased versus the \$0.30 impact for 100 basis point move that you gave on last year's outlook call. Just hoping you can give a little bit more color on why that's the case.

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

A

Yeah. Sure. I'll cover that. Again, a year ago when we issued guidance, interest rates were in a different zone, and our guidance a year ago assumed 2019 would have interest rates above 3% if you use the 10-year US Treasury as a benchmark. We're at rate levels that are now over 100 basis points below that. And when we gave that guidance last year, we mentioned that our sensitivity to 100 basis point decline would be \$0.30 per share. And that's kind of what we've experienced as we've gone through the year, and that's what we've experienced in

our financial results as well. So the impact that we've experienced in 2019 is very consistent with what we provided as sensitivities, again, a year ago.

But from here, the rates are at a lower start point, and we also have more US dollar business in Japan. We have more business that's at crediting rate minimums. So there is – and it's not linear as well, and so we do have a greater impact. And you also have to consider, there's an impact on the present value of claims at a lower discount rate. So those are the reasons that we have more interest rate sensitivity now, and it all has to do with the lower rate environment.

Erik Bass

Analyst, Autonomous Research US LP

Got it. Thank you.

Q

Operator: Thank you. Our next question comes from the line of Suneet Kamath with Citi. Your line is open.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Thanks. Just to follow up on that, Ken, just as we think about this rate pressure potentially compounding over time, the \$0.02 eventually becoming a much bigger number. If rates don't move up, isn't this going to pretty much offset some of the margin expansion that you are targeting as associated with the Financial Wellness initiative?

Q

Kenneth Yutaka Tanji

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

Yeah. The interest rate impact, again, assuming rates don't change, does build over time. Eventually it does dissipate as the portfolio more fully turns over. And this is exactly the experience that we had if you go back a number of years as we shifted from the then rate environment to what was the more recent rate environment. Now we're going through that again. So that phenomena is not new. It's how it plays out. And so I think it will work its way through in multiple waves as you go out, but again dissipates eventually over time as the portfolio turns over.

A

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Suneet, just call out in the deck – it's Rob, in the deck that we provided, we gave you sort of the sensitivity of rates based on what's the delta between our third quarter new money rates and the yields on the portfolio that'll be turning over on a go-forward basis, that's about 65 basis points. So vis-à-vis where we are today, if rates modestly rise to something that's sort of in the mid-2s, not very different from where we were, just a little while ago, this phenomenon begins to wear off.

A

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Got it. Okay. And then just on the decision to not host an outlook call, I guess, for next year. Typically, it would be on that call that we would get a sense of how you're thinking about capital return for the upcoming year and a view or an outlook on year-end AAT reserves. So since we're not having that call, just wondering if you could provide some commentary on how you're thinking about those two things at this point.

Q

Kenneth Yutaka Tanji

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

A

Yeah. So, first, I'll start with AAT. Given lower rates, we would have a rise in Asset Adequacy Testing reserves, but we do have derivative – interest rate derivative hedges that would have gains as well to offset that. So we still feel very good about the RBC level of our Prudential Insurance Company of America.

In terms of our capital returns, that's a decision that the board will make in December, and we'll get that information out once the board makes that decision and does its authorization. Our free cash flow profile has been very consistent, and our capital management approach has also been very consistent. So, for now, you can factor that into your thinking.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks, guys.

Operator: Thank you. Our next question comes from the line of Tom Gallagher with Evercore ISI. Your line is open.

Thomas Gallagher

Analyst, Evercore ISI

Q

Good morning. Ken, just going through the slide that discusses the Corporate loss, if I take the \$475 million for the 4Q guide and then I strip out the \$150 million sort of the midpoint of higher seasonal 4Q expenses, and then \$95 million of one-time restructuring expenses, that gets me to a Corporate loss of about \$230 million. I think the guidance you guys have provided has been over \$300 million a quarter as more of a normalized Corporate loss. I just want to know, are you implying that you would expect the Corporate loss to be lower on a go-forward basis? Or is there – is a little over \$300 million still a decent quarterly loss expectation?

Kenneth Yutaka Tanji

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

A

Yeah. Tom, the one thing that I think you have a little bit off there is the \$150 million of seasonal doesn't all occur in Corporate & Other. Only about half of it does. So I think if you make that consideration, you're more in line with where our Corporate & Other run rate has been.

Thomas Gallagher

Analyst, Evercore ISI

Q

Okay. Thanks for that clarification. The other question I had is the – just a follow-up on capital return cash flow. I think based on – I understand there's been some GAAP earnings pressure here, but can you talk about how cash flow visibility is playing out as you head into 2020, would you still expect a similar, call it, 65% conversion ratio, or will that be changing based on where interest rates are in both Japan and the US?

Kenneth Yutaka Tanji

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

A

Yeah. Tom, our cash flow engines are still very much intact. So, first, for the businesses that have been providing quarterly dividends, PGIM and our Annuities business, as you can see, those have been very consistent, regular and paid quarterly. And Japan paid a dividend this quarter, in the third quarter as well, and we'll be filing for a dividend from PICA in the fourth quarter.

So, yeah, rates will decrease net investment income and have some modest impact as we talked about with our sensitivities, but in general, our cash flow picture is quite strong and quite consistent.

Thomas Gallagher

Analyst, Evercore ISI

Q

Got you. And then just one final follow-up, if I could. The market-related experience adjustment factor, which was I think around negative \$300 million to net income this quarter, was that just a one-time adjustment outside of the actuarial review to reflect macro? Or can you just provide some color on that? Thanks.

Kenneth Yutaka Tanji

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

A

Yeah. Sure. No, that wasn't a one-time adjustment. So that adjustment occurs to update our discount rates related to our best estimates of insurance liabilities and the amortization of deferred acquisition costs, and it did lead to a charge for the quarter.

Having said that, we had other gains as well. And if you looked at GAAP net income, it was actually above operating income. So, overall, our GAAP profile was pretty in line with our operating profile.

Thomas Gallagher

Analyst, Evercore ISI

Q

Okay. Thanks.

Operator: Thank you. Our next question comes from the line of John Nadel with UBS. Your line is open.

John Nadel

Analyst, UBS Securities LLC

Q

Good morning, everybody. Maybe a question for Rob or Ken. It sounds like this is more a macro-driven and maybe you can correct me if I'm wrong. But it sounds like your expectations are that sort of given, in particular, sustained low rates, some insurance products are simply less attractive to customers. And as a result, your expectation is that sale in such an environment would be somewhat pressured, maybe down.

First question is, do I have that right or is there something else to that story? And then the second or related question is, should we expect that, at least in the short-term as a result of that environment, your free cash flow could actually be better and maybe we ought to consider potentially at least some incremental capital deployments or capital return to shareholders?

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yeah. John, this is Charlie. Let me start and then some others will jump in, too. Let me just start this philosophically about sales. So the answer is, as interest rates decrease, absolutely sales will may well decrease as we change pricing, and as certain products become sort of much less profitable for us, and we have always talked about a sustained level of profitability over time. And so what we have to calibrate between is making sure that our products meet our hurdle rates, on the one hand and two, sustaining distribution on the other hand.

John Nadel
Analyst, UBS Securities LLC

Q

Yeah.

Charlie F. Lowrey
Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

And we're always calibrating between that. But we will – we have already and will continue to raise pricing, lower crediting rates, do whatever it takes in order to maintain a level of profitability that makes sense for the company and shareholders, and at the same time, look at what a minimum level of sales would be in order to maintain what is a world-class distribution system as we go forward. That's what we're toggling and that's what we're toggling on those two issues and you will see that as we go through. But we have already raised pricing and taken multiple pricing actions, both domestically and internationally.

Stephen P. Pelletier
Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

A

John, it's Steve. Maybe I'll amplify Charlie's comments and get a little bit more specific on what I think is a primary example of it, which is in the Annuities business. Recently, with the decline in interest rates, we have been active in making product changes that reduce the level of product benefits and effectively increase pricing. That relates to over the past couple of months reducing payout rates by 40 to 45 points in some of – in our products by reducing roll-up rate on HDI by 50 basis points.

This is something that we do, as Charlie mentioned, in the normal course of business in order to manage the business for sustainable profitable growth while certainly looking to maintain relevance with distribution partners and a competitive value proposition for customers. We've seen some competitors take some actions, but, frankly, we've made more changes than most. And as a result, it's possible that we could see our sales trajectory decline in the near-term, and we'd see – simply see that as an outcome of how we manage the business.

And I would mention as how we've managed that business for an extended period of time. If you look over a multiyear period in the Annuities business, we've certainly been active in the marketplace throughout, but we've been significantly more active during periods where capital market conditions were more supportive of product features and at issue returns. And we have been relatively less active in periods where capital market conditions were not so supportive. It's that over an extended period of time that has built the inforce block in that business that has the characteristics that Ken mentioned earlier of strong profitability, robust returns and solid cash flow.

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

A

Yeah. [indiscernible] (00:43:49)

John Nadel
Analyst, UBS Securities LLC

Q

Yeah. Listen. I appreciate the need to balance, right, maintenance – or maintaining distribution versus profitability of sales. I was just wondering if there was – if you would expect that sales would be down sufficiently such that maybe it has a near-term or a short-term impact on free cash flow, but we can take that offline.

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

A

No. John, I can cover that really quickly.

John Nadel
Analyst, UBS Securities LLC

Yeah.

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

When sales come down, yes, naturally, you would expect that cash flow would improve because we're not – we don't need to hold capital associated with new business. So that – the direction is as you described.

John Nadel
Analyst, UBS Securities LLC

Thank you. And Ken, I've got one quick housekeeping one and this is in light of really no outlook for 2020 call. But any reason why your tax rate, given the business mix, et cetera, should be any – should be meaningfully different next year than it is this year?

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

No. I think our tax rate has been very consistent.

John Nadel
Analyst, UBS Securities LLC

Thank you.

Operator: Thank you. Our next question comes from the line of Humphrey Lee with Dowling & Partners. Your line is open.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Good morning and thank you for taking my questions. Looking at PGIM, the fee rate seems to be a little bit more pressured this quarter, especially in retail and general account assets. I was just wondering if you can talk about just kind of your overall fee rate expectation in the near-term and especially the fees of the assets that have [ph] lapsed (00:45:21) and versus those that came in.

Stephen P. Pelletier
Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

Humphrey, it's Steve. I'll take your question. Well, Rob called out a specific fixed income institutional outflow this quarter, the general story throughout 2019 has been pretty strong inflows into fixed income and some other asset classes and a pressure on equity flows, negative flows in the equity space, really experienced across the industry as, I would say, the active to passive headwinds picked up again this year. Given the relative fee rates across asset classes, that migration of assets from – of asset mix from equities to fixed income has that impact that you noted on our average fee levels.

Now, I should emphasize we've been able to significantly mitigate that by drawing a lot of our flows, and including our fixed income flows, into specific strategies that have solid fee levels. But nonetheless, the cumulative impact is as you pointed out.

I would say, though, that this gradual migration of assets from equity to fixed income – of asset mix from equity to fixed income, especially fuelled by fixed income appreciation in recent quarters due to the declining interest rate environment, while that might be a source of pressure on fees, it's also highly supportive of margin in the business. Fixed income – we have scale economies throughout our asset management complex, but the fixed income business is where those scale economies are most attractive, and flows – increasing contribution of fixed income to our asset mix will be supportive of margin expansion in the business.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Got it. Appreciate the color. Just for clarification on the expenses in International, I think in response to the Alex question earlier, you talked about the \$55 million in the fourth quarter in terms of the elevated expenses is kind of where you think would drop off. But I think from last quarter's call, you talked about in Gibraltar, you expect some high expenses to continue throughout 2020. And then, especially given it seems like Gibraltar was a little bit lighter expenses in the third quarter, like, should we still expect kind of elevated expenses in International throughout 2020 and then kind of coming off after that? Or how should we think about that in general?

Scott Garrett Sleyster

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

A

Hi, Humphrey. This is Scott. I'll take that. The \$55 million really related to the Life Planner business, and as you pointed out, we had a – we actually had a kind of overshoot on what we thought our expenses might be in Gibraltar this quarter. We do still expect in Gibraltar a modest level of elevated expenses. I think where we guided you last quarter that that would continue to about midyear. But the really sizable amounts of that were picked up in 2019.

So I'd say those are relatively de minimis. And I think in the guidance on expenses that we're giving on the overnight, we have captured that bleed-in. And I would say it's not really very significant in Gibraltar.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Got it. Thank you.

Operator: Thank you. Our next question will come from the line of Jimmy Bhullar with JPMorgan. Your line is open.

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

Hi. So first a question for Ken on the interest rate impact. I'm assuming that if you don't – if rates do not change, then that at least for the next one or two or three years compounds at a much faster rate than your normal earnings growth, so it becomes a bigger and bigger headwind in 2021 versus what you've outlined for potentially the next 12 months, right?

Kenneth Yutaka Tanji

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

A

Yeah. I think you should think of it as we said \$0.30 for five quarters, call it, \$0.28 for four. And that's sort of the annual drag.

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

But then beyond that, it should be considerably higher than the \$0.28 in the next four quarters, just at the base that it's building up, correct?

Kenneth Yutaka Tanji

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

A

Yeah. That's the way the math works. Again, over time, it dissipates, but...

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

Yeah. But that's a few years out as you roll the portfolio over, assuming no change in rates again, right?

Kenneth Yutaka Tanji

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

A

That's right. That's right.

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

Yeah. And then on your Japan sales at Prudential of Japan, you – there was a tax law change. You withdrew a term product. Should we assume that at least in the near-term that sales will remain muted? Or – and if you could just give us color on what drove the weakness, if there's something besides that that drove the weak sales this quarter, and just some idea on sort of trends in that market and what your expectations are for sales?

Scott Garrett Sleyster

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

A

Hi, Jimmy, this is Scott. Let me take that a couple of ways. One, the corporate tax law change did, in fact, impact everybody in the industry, but it touched us in both POJ and in the Life Planner business. So there was the national tax authority was reviewing the rules, and there was a four, five-month period where you didn't know what they were going to look like and then an implementation period after that.

In the case of POJ, I would say the effect was more modest because of the clientele being business owners and high net worth and some of the products that are coming back there. We'll continue to sell some of the new Corporate products. But more importantly, the Life Planner growth across our channel has been strong really across the board. So that's favorable.

I would say in the case of in Gibraltar, it's really a more significant challenge. We've been seeing more – we had the corporate product. We've also continued to see pretty intense competition in the bank channel market. And we've also imposed some pricing discipline where we've favored kind of recurring premium mortality-based products versus some of the more income-oriented products as rates came down.

So when you combine those three effects, I would say, in the case of Gibraltar, the issues are more challenging. In the case of POJ and Life Planner, generally, they're more transitory in nature.

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay. And then just lastly, any comments on what's going on in the Chilean market just with all the political instability and the potential for pension reform at some point?

Scott Garrett Sleyster

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

A

Yeah, a couple of comments. Our business there with Habitat actually has performed very well year-to-date. And we actually had very favorable [indiscernible] (00:52:44) performance based on the underlying markets this quarter. That being said, I would say we've been in touch fairly frequently with what's going on there and I wouldn't really downplay what's going on there. It's relatively serious. I think the people there are concerned about the unrest.

That being said, one of the responses and one of the requests, if you will, the demands that are out there and the factors impacting insecurity relates to people being nervous about old age retirement. And so there's actually proposals to materially increase the deposits and call it, the generosity of some of the systems. We may or may not benefit that much from that because sometimes when they increase the deposits, they don't allow fees on them and what have you.

But in general, I would say I think it's a serious situation down there. That being said, we're actually quite well positioned, and we're in a space in the market where the demands of those that are feeling disadvantaged are looking for government actions that would be supportive of our sector.

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

And also, don't forget, we have the lowest fees and some of the best investment performance in the business. And therefore, within the pension sector, we're very well positioned as well.

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

Operator: Thank you. Our next question will come from the line of John Barnidge with Sandler O'Neill. Your line is open.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Thanks. Another life insurer had a large write-down in the quarter on private equity position. Can you walk us through how many different private equity or venture capital positions you have, average investment size, and largest on carrying value, please?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

John, it's Rob. In our – if you look at our alternatives portfolio, a couple things to note. One is it's extraordinarily well diversified. They're in excess of 2,000 underlying companies invested through somewhere around 300 funds in that portfolio. So we do not have any particular concentration. To the extent that we have direct investments in

companies in that portfolio, which come about as they do in these kind of strategies by co-investment rights, they are primarily, if not exclusively, in private equity, not in venture capital, and therefore, tend to have significantly less volatility. And any of those underlying investments are relatively small.

So, obviously, in the context of our alternatives portfolio, we have out and underperformance, that's a reflection of markets and overall segment performance. We tend to have a little less of the idiosyncratic performance as a result of single investments. We're not entirely immune from it, but nothing to particularly call out there. Well diversified and relatively conservatively positioned.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Great, and my follow-up, most of them have been answered. But are you seeing any signs of early activity in flu season? It seems like everyone here is sick earlier.

Stephen P. Pelletier

Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

A

John, this is Steve. I'll answer your question. I think – I don't know about the immediately present state of the flu season, but I think that we did see in this quarter our life mortality in the Individual Life business have some experience that was counter to what we normally see as the seasonal trends.

Normally, the third quarter is a – tends to be a positive experience in life mortality. It didn't play out that way this quarter. We saw the unfavorable experience in this quarter in blocks that have really generally trended quite favorably over time. And as a result, we believe that this quarter's result is more of a random fluctuation rather than indicative of any underlying issues or trends.

I would say also in relation to the third quarter mortality experience being different from normal seasonal patterns in Life, we saw exact – the similar phenomenon play out in the Retirement business, a business that normally has in the third quarter less favorable reserve experience. And in this quarter because of a similar mortality trends, the business was able to realize outsized reserve gains, again, kind of pushing away from the normal seasonal patterns. And I think this speaks to our complementary business mix working out as we've – as we intended to and as we've designed it to.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Great. Thank you very much.

Operator: Thank you. Our next question will come from the line of Elyse Greenspan with Wells Fargo. Your line is open.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Q

Hi. Thanks. Good morning. My first question. So I recognize you guys aren't hosting an Outlook Call anymore, but I guess is there a way that you can give us some kind of baseline EPS growth or maybe where you come in within your ROE band in 2020? Just so we get a sense of kind of the forward base beyond just, I guess, thinking about some of the items you called out in the slides as well as, right, the higher corporate expenses that do recur every fourth quarter.

Kenneth Yutaka Tanji

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

A

Yeah. Sure. I'll just sort of echo some of the things that Rob mentioned earlier. And I sort of described how you can think about whether the baseline that we described coming out of the second quarter or our results for the third quarter adjusted for the things that were a bit favorable or the fourth quarter baseline we've provided adjusted for the elevated level of expenses, all kind of gets you to an EPS number that's a little bit better than \$3.

And then, our businesses are growing. We articulated some of our growth thoughts at Investor Day. And now, we do have a lower interest rate environment. So that eats into that a little bit as we described and given sensitivities to. But then on top of that, we have the margin improvement that we have underway, which, again, we've articulated and given measures for, as well as the impact of Assurance IQ acquisition, which we expect to be accretive in 2020.

So I think those are all the components that we think about as we look to 2020 and would encourage you to think about for yourself.

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

Elyse, it's Rob. Let me just sort of jump in on the ROE portion of your question. First, I'd note that in the third quarter we had an ROE of – in excess of 13%. So while we had headwinds associated with equity markets, we did have positive impacts associated – headwinds associated with interest rates, we had positive impacts with the movement in equity markets.

And if you think about the little better than \$3 quarterly baseline number that Ken triangulated around, that would still represent an ROE that would be about 13%. And so when we provided our outlook of 12% to 14% ROE, it was obviously in an environment where interest rates were much higher. But the expectation was that, absent those interest rates, we would be in the midpoint of that, the 13% as the midpoint between 12% and 14% was more sort of a baseline expectation as opposed to the high end of our range. With the headwind in interest rates, it could put a little bit of pressure on that, but I think the statements we made with regard to that range of 12% to 14% have not changed materially by virtue of anything that's occurred since the point in time where we've gave out that guidance, absent the recalibration for interest rates.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Q

Okay. Thanks. And then, in terms of Assurance, that deal is now closed. Is there anything in terms of modeling that you want to point out in terms of the seasonality as we put that into our models? I believe you guys have previously said it was more weighted towards the fourth quarter. Just anything that stands out as we think about getting that into 2020 on a quarterly basis?

Andrew Sullivan

Senior VP & Head-Workplace Solutions, Prudential Financial, Inc.

A

Yeah. Sure, Elyse. This is Andy. I'll take your question and thank you for the question. There will be seasonal variability quarter-to-quarter. And right now, a good portion of the revenue is driven by the Medicare Advantage product and the individual under age 65 product that are really driven by the open enrollment periods in the fourth quarter. So when you think about earnings pattern, with the current mix of business that we have with Assurance and prior to us executing on adding additional products to the platform, the fourth quarter will likely be our heaviest from both the revenue and earnings perspective.

Kenneth Yutaka Tanji

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

A

Yeah. But keep in mind, again, this is a young company and a growing company, and we didn't expect it to be material to the fourth quarter, but we feel good about the progress we're making and the outlook for 2020 and 2021.

Andrew Sullivan

Senior VP & Head-Workplace Solutions, Prudential Financial, Inc.

A

Yeah, maybe just two add-ons. Obviously, in this fourth quarter, we'll experience transaction and financing costs. Also, the core results are going to be net of the amortization of the intangible assets that are – that went on the books. So...

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you very much.

Operator: Thank you. And with that, I'd like to turn it back over to Charlie Lowrey for any closing comments.

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you. So, as you heard, we're committed to delivering on our purpose of providing financial opportunity to more people. And we look forward to keeping you updated on our progress in the months ahead.

But before wrapping up, I'd like to take a moment to recognize Steve Pelletier, who is retiring next month following an extraordinary 27-year career at the company. Thank you, Steve, for your many contributions to Prudential throughout your career. And for those of you who are not in the room here, but on the telephone, I wish you could see his grin, which is from ear-to-ear as he participates in his last earnings call.

And with that, I'd like to thank you again for joining us today, and we look forward to more conversations in the future. Thank you.

Operator: Thank you. And ladies and gentlemen, this does conclude today's conference call. Thank you for attending. You may now disconnect.

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