

05-Feb-2021

Prudential Financial, Inc. (PRU)

Q4 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

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

Darin Arita

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

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; Andy Sullivan, Head of US 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 comments 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 their 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 and the quarterly financial supplement, both of which can be found on our website at investor.prudential.com.

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

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you, Darin. Good morning, everyone, and thank you for joining us today. As we approach the one-year mark of the global pandemic; I hope that you, your families and colleagues remain safe and healthy in this continuing difficult environment.

As before, we remain deeply focused on the well-being of our employees, customers, communities, and other stakeholders and on addressing their evolving needs and challenges. Amid the extraordinary events of 2020, we continue to take steps to evolve our business for the future while living up to our purpose.

Turning to slide 2. We successfully executed on a number of our strategic initiatives in 2020 to reduce our market sensitivity and increase our growth potential, including the expansion of our cost savings program, while further solidifying our already robust financial position. We're now focused on building upon our achievements over the past year to further accelerate our strategy. I'll speak to this next phase of our transformation in more detail momentarily. But we'll start by recapping our accomplishments in 2020.

Turning to slide 3. We realized \$215 million in cost savings during the year, exceeding our \$140 million target. Recall that last quarter we increased our cost savings targets to \$750 million to be realized by the end of 2023.

We also began to rotate our international earnings mix towards higher growth markets. During the year, we completed the sale of our Korea business and announced the sale of our Taiwan business.

We also took significant steps to address the low interest rate environment with de-risking actions such as repricing products and pivoting to less interest rate sensitive solutions. This pivot included discontinuing sales of variable annuities with guaranteed living benefits and launching a buffered annuity product, FlexGuard, which is less sensitive to market fluctuations while continuing to serve our customer needs.

Turning to slide 4. As we look ahead, we're building upon the actions we've already taken as well as our competitive strengths to significantly transform the company over the medium term. To achieve this transformation, we expect to deliver on our cost savings program and to reallocate \$5 billion to \$10 billion in capital over the next three years as we pivot towards higher growth and less market sensitive businesses.

In parallel to this capital reallocation, we anticipate returning \$10 billion of capital to shareholders over the next three years. This includes dividends as well as share repurchases that are resuming in the first quarter under our new \$1.5 billion authorization. As a result of these efforts, Prudential should emerge as a higher growth, less market sensitive and more nimble business that is positioned not only to deliver growth for shareholders but also to make a more meaningful difference in the financial lives of more people around the world.

Turning to slide 5. As we transform to become a higher growth, less market sensitive business; we expect to double our growth businesses to more than 30% of earnings and halve our Individual Annuities business to 10% or less of earnings. We will change our business mix primarily through organic growth and programmatic acquisitions for both our global asset manager, PGIM, and in emerging markets within our International Businesses. PGIM manages \$1.5 trillion of assets, which we have grown both organically and through acquisitions of talent and capabilities.

In emerging markets, we have expanded with joint ventures and acquisitions in regions with large markets and favorable demographic tailwinds such as Asia, Latin America and Africa. We benefit from strong relationships with companies that have a large footprint and a significant local market expertise.

In addition, we will remain focused on investing in our other businesses to expand our addressable market as well as continue to improve expense and capital efficiency. Additional actions to change our business mix include de-risking and other transactions in conjunction with running off certain blocks of business.

The \$1.6 billion of capital generated from the sale of Korea business is included in the \$5 billion to \$10 billion we plan to reallocate into our growth businesses. Our change in business mix will obviously not be a straight line. But as we reallocate capital, we'll provide you with information to help you both understand and measure our progress.

Turning to slide 6. We are well positioned to execute this strategic plan with a rock-solid balance sheet. At the end of the fourth quarter, we had \$5.6 billion in highly liquid assets. And our operating subsidiaries continue to hold capital to support AA financial strength ratings.

Finally, let's turn to slide 7. During this time of change and transformations, our commitment to our company purpose and to supporting all our stakeholders remains as fundamental as ever. The importance of this work is reflected in the multiple environmental, social and governance initiatives that we advanced over the course of this quarter and throughout 2020.

Here are some of the noteworthy accomplishments. We became the first US insurer to insure a green bond aligned with the United Nations Sustainable Development Goals. We furthered our commitment to environmental transparency and accountability by disclosing our environmental impact through CDP, the world's leading environmental disclosure platform. Prudential scored an A minus on CDP's 2020 Climate Change Survey.

We introduced nine commitments to advance further the work we've been doing on racial equity spanning our talent practices, our design and delivery of products, our investments and public policy work and our support of community institutions working to remove persistent obstacles to black economic empowerment.

I'm also pleased that we'll continue to tie inclusion and diversity with executive compensation. Three years ago, we added an inclusion and diversity performance modifier that factored into our 2020 compensation plan. Over this period, diverse representation amongst senior management has increased. We're including this type of modifier again to drive us to improve further our inclusion and diversity over the next three years.

Before closing, I'd like to say thank you to all our employees around the world. It's through your hard work and dedication that we've been able to successfully help our customers and advance our transformation.

With that, I'll turn it over to Rob for more specific details on our business performance. Thank you all for your time this morning.

Robert M. Falzon

Vice Chair & Director, Prudential Financial, Inc.

Thank you, Charlie. I'll provide an overview of our financial results, an update on our strategic progress and highlights of our outlook for our US, PGIM and International Businesses.

Turning to slide 8, I'll begin with our financial results for the year. On a pre-tax adjusted operating income for 2020 was \$5.1 billion or \$10.21 per share on an after-tax basis. In the fourth quarter, our pre-tax adjusted operating income was \$1.5 billion or \$2.93 a share.

Earnings exceeded the year ago quarter as increases in our PGIM and International Businesses as well as our Corporate & Other operations offset a decline in our US Businesses. Results of our US Businesses reflected heightened COVID-19 related mortality experience as well as lower fee income in our Individual Annuities business primarily due to outflows.

This was partially offset by higher net investment spread results driven by higher variable investment income and lower expenses. In addition, we made a change in our Individual Life procedures that provides policyholders information to better manage their policies and premiums for certain flexible premium policies.

Due to this change, we have revised the estimated premiums to be paid for these policies resulting in an adjustment to reserves. We also established an incurred but not reported or IBNR reserve in our Group Insurance business for the expected increase in disability claims as a result of the lag effect from higher unemployment.

PGIM, our global asset manager, reported record assets under management of \$1.5 trillion, up 13% from a year ago as well as higher net asset management fees and record high other related revenues. And earnings in our International Businesses increased 6% reflecting business growth, lower expenses and more favorable underwriting results, partially offset by lower net investment spread.

Turning to slide 9. Our US Businesses produce a diversified source of earnings from fees, net investment spread and underwriting income, which includes the benefits from netting longevity and mortality experience. We continued to make progress this quarter executing on our priorities, including implementing pricing and product actions to de-risk our business mix while protecting profitability and expanding our addressable market.

Our product pivot has worked well with sales of our buffered annuity, FlexGuard, doubling to \$1.2 billion in the fourth quarter from \$600 million in the third quarter. And the pandemic has increased awareness of the value of our broad set of life insurance and financial solutions as we continue to enhance our capabilities to reach people when, where and how they want. These capabilities include traditional agents and financial advisors, the workplace where over 20 million people have access to our financial wellness [indiscernible] (00:12:28).

With respect to Assurance, we launched our Medicare business a little more than a year ago. As a result of investments in our distribution capacity, marketing capabilities and development of new technology; we nearly tripled our fourth quarter Medicare revenues versus the year ago quarter.

We expect to continue to grow these revenues as we further expand distribution, utilize newly developed tools for data-driven consumer product recommendations and broaden our marketing. In addition, this gives us further confidence as we develop and launch additional product lines.

Customer interest for our SimplyTerm life insurance product through Assurance has been strong, although sales have been lower than expected. We continue to modify our underwriting processes to allow for more instant decisions. As we streamline this process and improve the customer experience, we expect our life revenues to grow.

Total revenues, our primary financial metric for Assurance as we concentrate on scaling the business, doubled versus the year ago quarter. We're adding more carriers in all of our existing markets and expanding into new product lines. To execute this expansion, we have increased our investments in marketing, distribution and infrastructure. We expect operating losses in the near term and earnings to emerge as we reach scale.

Now turning to slide 10. PGIM continues to demonstrate the strength and resilience of its diversified platform as a top 10 active global investment manager. PGIM's strong investment performance and diversified global investment capabilities in both public and private asset classes across fixed income, alternatives, real estate and equities position us favorably to capture flows.

PGIM's investment performance demonstrate resiliency with more than 90% of assets under management outperforming their benchmarks over the last 3-, 5- and 10-year periods. This investment performance contributed \$6.3 billion of third party net flows during the fourth quarter, including \$3.8 billion of retail and \$2.5 billion of institutional flows, resulting in \$20 billion of net flows for the year.

Of note, PGIM investments achieved the highest US mutual fund franchise ranking based on net flows in 2020. PGIM's strong overall flows were driven by continued investor appetite for fixed income strategies, particularly higher-yielding strategies, and for real estate.

PGIM's asset management fees increased [ph] to (00:14:58) 12% compared to the year ago quarter, reflecting growth in average assets under management. In addition, record high agency loan production and the effect of strong investment performance on incentive fees as well as co-investment and seed investment earnings drove significant growth in other related revenues.

These results contributed to an increase in PGIM's operating margin, which was in excess of 36% for the quarter. While PGIM's operating margin will vary with market conditions, we expect to sustain a margin of approximately 30% across the cycle.

Turning to slide 11. Our International Businesses include our Japanese life insurance operation, where we have a differentiated multichannel distribution model, as well as other operations focused on high-growth markets. As anticipated, Life Planner sales in the quarter were reduced by the accelerated sales in Japan last quarter following the US dollar-denominated product repricing in August. For the year, we were pleased that sales were about flat as our high-quality distribution overcame the effect of the pandemic-related shutdown.

Similar to Life Planner, Gibraltar sales were reduced in the current quarter and sales for the full year were about even with the prior year. While we do not report separately on our emerging markets businesses, we would note that Brazil's life insurance in force grew by 10% from a year ago. And our Chilean pension business held its number one ranking for market share, benefiting from continued favorable investment performance. On slide 17 in the appendix, we listed some of the emerging markets that we're in and our local relationships that have significant market leadership positions.

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 12 which provides insight into earnings for the first quarter of 2021 relative to our fourth quarter results. Pre-tax adjusted operating income in the fourth quarter was \$1.5 billion and resulted in earnings per share of \$2.93 on an after-tax basis. Then we adjust for the following items.

First, variable investment income outperformed expectations in the fourth quarter, which is worth \$360 million. Second, we adjust underwriting experience by a net \$65 million. This includes a placeholder for COVID-19 claims experienced across our businesses of \$170 million based on 250,000 COVID-19 related fatalities in the US during the first quarter.

Third, we expect expenses to be \$165 million lower in the first quarter primarily due to seasonal items in the fourth quarter. Fourth, there are other items that may be \$40 million more favorable in the first quarter. As Rob discussed, in the fourth quarter, we recorded a charge for the change in our Individual Life business practice, which was partially offset by strong other related revenues in PGIM.

Fifth, we anticipate net investment income will be reduced by \$15 million, reflecting the difference between new money rates and disposition yields of our investment portfolio. And last, we expect the first quarter effective tax rate to normalize. These items combined gets us to a baseline of \$2.54 per share for the first quarter.

I'll note that if you exclude items specific to the first quarter, earnings per share would be \$2.90 per share. The key takeaway is that this is roughly in line with the prior quarter. While we have provided these items to consider, please note that there may be other factors that affect earnings per share in the first quarter.

As we look forward, I'd like to bring your attention to a few other items in the appendix. In addition to the seasonal considerations on slide 25, we have included other considerations for 2021 on slide 26. Notably, we expect to realize an increase in cost savings from \$250 million in 2020 to \$400 million in 2021. We also provided the expected net cost for Corporate & Other, the yen foreign exchange rate and the effective tax rate for 2021.

On slide 13, we provided an update on the potential impact of the pandemic. The estimated sensitivity of operating income for 100,000 incremental US deaths due to the pandemic is \$85 million based on our updated outlook. This is up slightly from our prior sensitivity as the virus more broadly spreads across demographics and geographies, including the insured population.

As I noted earlier, our first quarter baseline includes a net mortality impact of \$170 million due to COVID-19. The actual impact will depend on a variety of factors such as infection and fatality rates, geographic considerations and the speed and effectiveness of the vaccine rollout.

Turning to the slide 14. We maintain a robust capital position and adequate sources of funding. Our capital position continues to support a AA financial strength rating and we have substantial sources of funding. Our cash and liquid assets at the parent company were \$5.6 billion at the end of the quarter, which is greater than three times annual fixed charges. And other sources of funds include free cash flow from our businesses and other contingent capital facilities.

Turning to slide 15. And in summary, we successfully executed our 2020 initiatives. And we are building on those initiatives to transform Prudential into a higher growth, less market sensitive and more nimble business. And we continue to benefit from the strength of our rock-solid balance sheet.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from the line of Suneet Kamath with Citi. Please go ahead.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Thanks. I wanted to start high level if I could. Charlie, at the 2019 Investor Day, I think you guys laid out a strategy around financial wellness. And that initiative was supposed to get you to double-digit EPS growth and a 12% to 14% ROE kind of over the long term. Based on what you're talking about today, do you need to take these additional capital reallocation steps to get there or should we think about these initiatives as potentially pushing you above what you guided to?

Robert M. Falzon

Vice Chair & Director, Prudential Financial, Inc.

A

Suneet, it's Rob. I'll jump in on that if you don't mind. So a couple of thoughts. One, since our Investor Day, obviously rates have declined quite materially. And given our current business mix, a low interest rate environment with the 10-year hovering around 1.1%, 1.15% present headwinds to an improving ROE. I would note, nonetheless, that in a challenging year for the industry, 2020; we achieved an ROE of just under 11%. And I think that speaks to the strength and earnings potential of the mix of businesses that we have.

I'd also add that our focus, Suneet, is on not just ROE but also on cost of equity and importantly the spread between the two. And the strategies and initiatives that Charlie outlined; I think around de-risking, simplifying and reducing market sensitivity and changing the business mix; I would look at as very much geared toward expanding that spread between our return on equity and our cost of equity.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Okay. And then as we think about that \$5 billion to \$10 billion of capital that you're going to reallocate, is it fair to think about most of that coming from life and annuities? And can you give us the amount of capital that's currently being consumed by those two businesses?

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yeah. Let me jump in on that, Suneet. As we've said in the past, I think everything is on the table. But what we've also said in this call is that we're really focused on annuities. And one of our priorities is annuities and shrinking annuities to 10% or less of earnings. But in addition to that, what we're doing is that we're looking at all market-sensitive, low-growth businesses or blocks of businesses in terms of runoff, reinsurance or sales. So we're going to continue to look at those. Life will be one of the businesses we look at in addition to annuities but not necessarily the only one.

Kenneth Yutaka Tanji

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

A

Hey, Suneet, it's...

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Thanks. Yeah, go ahead.

Kenneth Yutaka Tanji

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

A

Yeah, it's Ken. You asked about the amount of capital. Our annuities business is predominantly within one company, in a statutory company called Prudential Life Assurance Company and its statutory capital is a little bit more than \$6 billion. Our life business is well capitalized, but it's across a number of companies. And I don't have that aggregate number handy here.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks, Ken.

Operator: Thank you. Our next question comes from the line of Yaron Kinar with Goldman Sachs. Please go ahead.

Yaron Kinar

Analyst, Goldman Sachs & Co. LLC

Q

Thank you. Good morning, everybody. I guess my first question is around the reduction of earnings coming from individual annuities. Can you achieve that without a block transfer or reinsurance deal? And the reason I ask that is I would think that there may be a bit more of a challenge to dispose of that given that it is more of a GLWB variable annuity block. And we haven't seen a lot of appetite for that in the market to date. So maybe you could address those questions.

Robert M. Falzon

Vice Chair & Director, Prudential Financial, Inc.

A

Yeah. Yaron, it's Rob. I'll jump in first and then maybe Ken or Andy might want to jump in after me. But just with respect to the first part of your question, as we think about our objective of getting our annuities business to represent 10% or less of our overall earnings is – I think as we indicate in our slides, a not inconsequential component of that comes from the runoff of the existing legacy block to the tune of about – that legacy block runs off at about \$3 billion a quarter. And so that gets us to a range of 40% to 45% of our objective just with respect to runoff. Why don't I defer to Ken and Andy to talk a little bit about the multiples and deployment of capital in the market?

Kenneth Yutaka Tanji

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

A

Yeah, sure. Yaron, our variable annuity business is, as we've said in the past, very well capitalized. It has a good profitability, cash flow and risk profile. And we don't see the fact that it's a GMWB book to present any unique or difficult challenges.

Yaron Kinar

Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's helpful. And then I guess on the flip side of that and in terms of growth into the double growth markets. I'm assuming there's this large inorganic component there, just considering the \$5 billion to \$10 billion that you're looking to deploy. In those markets, I would think the valuations there may be a little bit higher. So how do you go about determining the use of – prioritization of capital between buybacks, inorganic growth and organic growth in those emerging markets, asset management and the like?

Robert M. Falzon

Vice Chair & Director, Prudential Financial, Inc.

A

Yaron, it's Rob. I'll start out with that and then I'll turn it over to others to answer the second part of your question. Just in terms of the amount of inorganic versus organic, as you think about the businesses that are grouped together in that sort of area that we're trying to grow to in excess of 30% or more of our earnings, those are higher growth businesses.

They're dominated by PGIM. And PGIM, as we've said before, is a business that is growing in the mid to high single digits on an organic basis. And so as we think about that combined with the emerging markets and Assurance which we think have the potential for quite high growth rates, we think that in excess of a third of our objective can be accomplished simply by organic growth. So let me stop there and turn it over to others to answer the second part of your question.

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

So Yaron, it's Andy. Maybe I'll jump in. This is a good spot to talk about PGIM and our plans around PGIM and how to accelerate into programmatic M&A. But first, I'd reemphasize what Rob said. We've had great growth in that business and we expect that great growth to continue.

When we look at our M&A opportunities in PGIM, we're looking to do as we've termed programmatic, which we would frame as methodical and planful specifically leaning into new product and investment strategy capabilities. We feel very confident that when we do that, we can gain leverage from our distribution might and strength. Obviously, anything we do has to fit with our multi-manager model because we don't want to be disruptive to that

multi-manager model. And particular areas of interest are areas that are higher growth as parts of the asset management business. So I would name alternatives as a key area as well as International.

Yaron Kinar

Analyst, Goldman Sachs & Co. LLC

Got it. Thank you and good luck with the execution.

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

Erik Bass

Analyst, Autonomous Research LLP

Hi. Thank you. And how are you evaluating potential acquisitions in the growth markets that you've highlighted? And are you focused on near-term earnings accretion? Or is the bigger priority finding scalable properties with large addressable markets that you can grow over time?

Scott Garrett Sleyster

Executive Vice President and Head of International Businesses, Prudential Financial, Inc.

This is Scott. Why don't I start with that on the emerging markets front. First of all, we expect to remain focused on Latin America, emerging Asia and Africa. And primarily on those markets where we already have established operations and partners and in some cases I think that would include expansion into adjacent markets.

For the most part, we've been looking at, if you will, expanding into the markets that we're already in. And so we might be adding a capability or a little bit of scale. I think in those situations, the valuations have been relatively attractive. But going back to Charlie's opening remarks, we're going to be a disciplined buyer and make sure that we're earning an attractive return over our cost of capital before we deploy any funds over a reasonable amount of time. Thanks.

Erik Bass

Analyst, Autonomous Research LLP

Thanks. And then maybe another one on a similar topic. But as you consider annuity reinsurance transactions, how do you think about the challenge of replacing the lost earnings and potential for EPS dilution if you're selling what's a relatively low multiple business to potentially buy higher multiple businesses?

Kenneth Yutaka Tanji

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

Hey, Erik. It's Ken. We are reallocating capital, as you suggest, to achieve better growth, to lower our market sensitivity and improve our quality of earnings. And the combination again will deliver higher growth and less market sensitivity. And that we believe will get recognized in terms of a lower cost of capital and expanded valuation that would offset the dilution.

Erik Bass

Analyst, Autonomous Research LLP

Got it. Thank you. That's helpful.

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

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. First, I just had a question on the Assurance IQ results. It was a good quarter on revenues, but you generated loss. And it seems like at least from the outside, the business has done significantly worse than would have been expected when you announced the deal. So what are your impressions of how that transaction has gone now that you've had it for about a year – a little bit over a year?

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

Yeah, Jimmy. It's Andy. So I'll handle your question. And you're correct, we now have four full quarters of operating the business under our belt. And we are very encouraged and glad that we have Assurance as part of our business mix and see it as an expansion extension of our business model.

Pretty early on in 2020, we made an explicit decision because we saw market opportunity to both expand and broaden the Assurance platform. And we did that from both a product and a distribution perspective. So if you think from a product perspective, we began to add on additional product lines, product categories like Medicare and like property and casualty.

On the distribution side, we determined that we would be more successful over the long term if we added onto the on-demand agent model. So we now have an external BPO agent component and we're building out a Prudential W2 agent component. That leaning in to organically growing the business and expanding the business has led to a pretty significant increase in OpEx as you would expect. And that's why we're so focused on revenues because now it's about scaling up the platform.

And we're very confident over the long term about the growth potential both from a revenue perspective but also expanding margins over time. As we said in previous quarters, we don't intend to provide or update any Assurance-specific guidance other than what Rob sort of said at the top of the section about – in the near term, given our organic investment that I spoke to, we expect operating losses.

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay. And then just on your annuity business; sequentially, you saw an improvement in variable annuity sales. And I wanted to get an idea – and a lot of that I think is being driven by the FlexGuard product. But just wanted to get an idea on – is that fully rolled out to your distribution? Or is there sort of still ramp-up potential for sales in that product? And relatedly, should we assume that sales in 1Q and through the first half of this year would be weak because you're withdrawing the traditional living benefit products?

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

So Jimmy, it's Andy. I'll take the question. And let me start with FlexGuard. Yeah, we've been very, very pleased with the success that we've had of the FlexGuard buffered annuity product. In essence, we rolled it out in May and May through December, we almost crossed \$2 billion in sales. We think it's one of the most successful launches probably in the industry. And the strength there is really coming from the strength of our business; the fact that our brand is so strong, our distribution and our relationships are so strong and we came out with a very good product.

To your question around momentum. We still are rolling it out to additional third-party intermediaries. So we have some additional work to go there. And we also have a couple of states left that haven't rolled out. So we're seeing

great momentum and expect that momentum to continue. To the second part of your question. Given the pivot that we're doing in that business, it was a pretty assertive and material change to cease selling of our highest daily income and Prudential-defined income products. They were a big part of our sales in the past. So that will have an impact on our overall sales and flows. And I think you could expect that we will see outflows from the business due to that change.

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Thank you.

Operator: Thank you. Our next question comes from the line of Elyse Greenspan with Wells Fargo. Please go ahead.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Hi, thanks. My first question I guess is going back to some of the transactions you've been talking about on the annuity side. So depending upon how this is structured, you could potentially – and how the sales or transaction takes place, there could potentially be some hits that I imagine you could potentially take to equity. So how do you think about the leverage within your capital plan? Can you just update us on where you would see leverage going? And I'm assuming as you think through kind of freeing up capital, that you've taken this into account and that you could probably absorb some hits and still keep your leverage within target. So the capital freed up could, like you said, be used for some of this M&A within the growth market.

Kenneth Yutaka Tanji

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

Yeah, Elyse. It's Ken. As we look at these transactions, we'll be looking at a number of key metrics and making sure we keep them all in balance. That's whether it's potential charges or gains to our equity depending upon the transaction terms, what it would do to our cash flow going forward, our earnings and our risk profile. And very importantly, we'll be focused and disciplined on looking at fair value as we conduct these things. So we've managed our leverage ratio over time within our objectives to maintain our AA credit rating and we'll continue to keep that a priority.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

So how high could it go? How high could the debt-to-cap go?

Kenneth Yutaka Tanji

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

We have some room and some flexibility. I don't want to pinpoint a number. But we managed to make sure we keep our objectives with our credit rating.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Okay. And then my second question. On your slide deck when you guys talk about the growth market, doubling that to the greater than 30%; that does include – you do mention that your growth markets do include Assurance IQ. So I guess following up on one of the earlier questions. So they're obviously embedded within the three-year

outlook. There is some assumption for the Assurance contribution to earnings because it sounds like your margins improve as the business scales. So could you give us a sense, as you put this plan together over this three-year time period, what you're kind of assuming Assurance does ultimately add to earnings over time?

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

A

Yeah, Elyse. It's Ken. As Andy mentioned, we are very focused on growing this business. And that includes expanding distribution and expanding product lines. And that's requiring that we make some investments to realize the growth potential that's in the business. That will lead to a modest loss in the near term. But as that business scales and gains efficiency, we would see that gaining profitability. That's what I'd add.

Elyse Greenspan*Analyst, Wells Fargo Securities LLC*

Q

Okay. Thank you.

Operator: Thank you. Our next question comes from the line of Ryan Krueger. Please go ahead. With KBW.

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

Q

Hi. Good morning. In terms of the \$5 billion to \$10 billion of capital reallocation, given that the higher growth businesses are generally not – wouldn't be very capital-consumptive; is it fair to assume that \$5 billion to \$10 billion would also equate to the rough amount of programmatic M&A that you're anticipating to do?

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

A

Yeah, Ryan. It's Charlie. I think that's a fair assumption. In other words, as we think about reallocating capital; we're reallocating capital from the lower growth, less market-sensitive businesses into the opposite, higher growth, higher market-sensitive businesses. So it really is – it's a reallocation of that capital, if you will, between the businesses.

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

Q

Got it. And then on the Individual Annuity business, can you give us a rough sense of what percentage of those earnings are generated from the blocks that you've now discontinued that have living benefit guarantees?

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

A

Right now our current earnings are driven largely by our legacy business. We're new in the FlexGuard space. We're gaining great traction and it's going well. But the majority of our current earnings are from our legacy business.

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

Q

Got it. Thank you.

Operator: Thank you. Our next question comes from the line of Andrew Kligerman with Credit Suisse. Please go ahead.

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you very much. So another question on your M&A approach. You've mentioned asset management, emerging markets. Haven't heard anything about Retirement and Group. And I'm wondering if there's – I think these are growth businesses. And I'm wondering whether full service and recordkeeping and various group and voluntary businesses might be attractive M&As as well.

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Hey, Andrew. It's Charlie. Let me start and then I'll turn it over to Andy and Scott to elaborate some. But I think it's important to start with what we're not interested in. So we're not interested in doing a mega transaction that expands over multiple businesses.

What we've said and what we're going to stick to is really looking at our less market sensitive, higher growth businesses, in this case, emphasizing asset management and emerging markets. And so that's what we're going to do. And we're going to do it in terms of programmatic M&A that really emphasizes the multi-manager model in PGIM and certain specific markets in emerging markets. But I'll turn it over to Andy and to Scott to elaborate on that.

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

Yeah, Andrew. It's Andy. I would just add – you specifically mentioned our institutional businesses – I'll frame it that way – in Full Service and in Group Insurance. We've seen very good success in particular with our financial wellness strategy at strengthening our institutional value prop in general. And that has led to good growth in both of those businesses. So I would say our focus in those businesses is to lean into that organic growth and to continue to see net revenue growth that flows from the investment in financial wellness.

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. Very helpful. And then in the Individual Life segment; I saw a line item, \$130 million from reserve refinement. And I think as I kind of very generally understand it, it was providing customers with information around options that they could have maybe in their UL policies. I'm wondering, what are those options? What exactly was offered to the customers and just how did that \$130 million reserves impact evolve?

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

So Andrew, it's Andy again. I'll take your question. So this was a business practice change where, in essence, we're giving more detailed communications to certain of our flexible premium product holders. The intention of that information is to help them proactively manage their policies and premiums. And we believe that it will lead to less premiums coming in over time; thus, the financial charge. It does not have a material impact from a go-forward perspective on earnings.

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

I'm just trying to understand what would it mean that they don't have to pay premiums, they could use their cash value and that might prompt them to think, well, I shouldn't have been putting cash into the product. I just would like to understand what behaviors will change as a function of that because \$130 million is a significant charge.

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

Yeah. So Andrew, it's Andy again. So in essence, on their annual statements and their payment notices, we're giving them more details around their premium flexibility, their requested premium amounts and their guarantees against lapsation. And we think that the customers working with their advisors, that'll lead to less premiums coming in over time.

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Thanks, Andy.

Operator: Thank you. Next, we go to the line of Tracy Benguigui with Barclays. Please go ahead.

Tracy Benguigui

Analyst, Barclays Capital

Q

Good morning. As you're in the market speaking with potential buyers of closed block sales; I'm wondering if PGIM third-party investors, maybe consortium, has expressed any interest or appetite. That does not preclude other buyers. Just want to get a sense of PGIM's familiarity with [indiscernible] (00:45:38) can reduce the bid-ask spread at all.

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

So Tracy, it's Andy. Thank you very much for your question. We absolutely think PGIM clearly is a net positive to this overall process. We see more and more capital that sees value in the types of things that we do. And we think that does enhance our opportunity in many different ways.

We feel advantaged in that we own world-class origination capabilities, very strong asset-liability matching capabilities and PGIM as a world-class investment manager, in particular, being very strong in alternatives. And as I said earlier, that being one of the areas that we look to strengthen even further. So I do think that that is a positive for us and we're excited for the possibilities that could create over time.

Tracy Benguigui

Analyst, Barclays Capital

Q

Okay, great. And then besides your motivation of reducing market sensitivity, is part of the motivation to complete a block sale from the upcoming accounting changes from LDTI? Another insurer is divesting their own life and annuity business and said that the reduction to equity under LDTI would have been worse than the book value lost from the sale. Now I'm not asking you to comment on that specific transaction. But just to get a sense of your willingness to sell at a loss and how LDTI may be a motivating factor.

Kenneth Yutaka Tanji

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

A

Hey, Tracy. It's Ken. First, TI is a few years away. And I don't want to comment on someone else's deal nor do I have a specific transaction for us to comment on. But with respect to deals, like I said, we're going to evaluate things through a number of metrics. One will be its impact on book value, earnings, cash flow, capital, risk. We'll take that all into consideration. And so I can't comment beyond there because it would be being too general.

Robert M. Falzon

Vice Chair & Director, Prudential Financial, Inc.

A

Well, maybe I'll just add, Tracy. Recall, our accounting that we use for our annuities is different than most others that are in the industry are using for their accounting. And under TI, there actually is not a significant change to the accounting of the living benefit in our book vis-à-vis the way in which we currently account for it. So that may be part of the explanation to your question as well.

Tracy Benguigui

Analyst, Barclays Capital

Q

Okay. Thank you for the color.

Operator: Thank you. Our next question comes from the line of Humphrey Lee with Dowling & Partners. Please go ahead.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Good morning and thank you for taking my questions. Just to follow up back on Assurance IQ. I understand that you don't want to provide any kind of updated guidance in terms of revenue or margin since the original announcement. But basically, you're suggesting you'll be in operating losses in the near term. Given I guess where it's been trending, do you feel like it could turn to be profitable by 2022? And then also, how should we think about the impact on the additional earn-out? Looking at it right now, it doesn't look like that may be achievable. So could there be any impact to the key person retention issues given the challenges on the earn-out?

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

So Humphrey, it's Andy. As we talked about, we are seeing progress. As we launch product lines, the process we basically go through is we need to become more efficient at marketing those products. And then, obviously, as we build out the distribution end of things, we need to get to a place where we're getting better and better at conversion.

We have seen quarter-over-quarter throughout 2020 our conversion rates get better. We have seen and we won't get into specifics but product lines that we've started to see start to get towards the levels of profitability that we would expect. We're still not going to comment on specific timing. But we do like the trajectory that we're on and we intend to continue investing. The operating losses near term have everything to do with the decision we made to really accelerate our investment. And now we have the job in front of us that we're confident in of scaling up the revenue.

Kenneth Yutaka Tanji

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

A

And Humphrey, it's Ken. On the earn-out, it's based upon variable profits and it's over a three-year period. So it's still in place till the end of 2022. And it was designed to incent them to outperform our expectations. And right now, it still has two years to go and it's still in place.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Okay. Shifting gear. As you shrink the annuity business, how should we think about the overhead or kind of potential stranded costs related to shrinking that book of business; especially given two years ago, when you talked about the financial wellness, part of the cost synergy was having all of the different businesses sharing the call center and the back office support. And now you have a major part of that potentially shrinking and reducing your overall earnings contribution. So how should we think about the potential kind of overheads related to that side of the business? And how are you going to address that?

Kenneth Yutaka Tanji

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

A

Yeah. First, as we indicated with our progress in 2020, we're making really good progress. We accelerated our progress and increased our objectives with our transformation program. And it's also given us capabilities that we'll be able to apply should, as we reallocate capital, we need to deal with stranded costs. Also keep in mind we're reallocating that capital. So as we may shift it from annuities, we'll be redeploying it into new earnings opportunities as well.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Got it. Thank you.

Operator: Thank you. Our next question comes from the line of John Barnidge with Piper Sandler. Please go ahead.

John Barnidge

Analyst, Piper Sandler & Co.

Q

Thank you very much. Does it seem reasonable to think that there will be elevated administrative expenses in group disability to process COVID claims as long as the pandemic remains? I ask that in light of the 2-point increase through the year.

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

Yeah. John, it's Andy. I'll take your question. Yes, your assumption is absolutely reasonable. One of the most important things during a period of time like this as a disability carrier is properly investing in the disability claim staff.

So some of what you saw in our admin ratio in the fourth quarter was us adding to staff. That's claims managers, that's nurses, that's [indiscernible] (00:52:48) specialists to make sure that our claims personnel have the adequate time and space to properly help our customers and help them return to work. So it is reasonable to assume as incidence goes up, which typically happens during a recession – we have not yet seen that on the

LTD side, but we are expecting to see it – that we would continue to invest and maintain the right level of claims teams. And that would be a higher level of investment.

John Barnidge*Analyst, Piper Sandler & Co.*

Q

Great. And then unrelated to that. Israel has been the country that has enacted the most aggressive vaccination program globally. Are there any markers that you've seen out of the country in the weeks since they began this that provides maybe some insight around timing of maybe COVID tapering off a little bit?

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

A

So John, this is Charlie. I think we're encouraged by what we see in terms of both the introduction of the Pfizer and Moderna vaccines but also the potential of Johnson & Johnson coming with a completely different kind of vaccine. It's a one-shot vaccine. It doesn't need cold chain storage. And we think that could have a large effect on the ability of this country to get vaccinations, if you will. So over the course of the next three to six months – we're not going to say it's going to happen overnight. But we think there's going to be a material change in the ability to vaccinate people as we go forward. And that can only enure to the country's benefit and to the reduction in the transmission of the virus.

John Barnidge*Analyst, Piper Sandler & Co.*

Q

Thank you for your answers.

Operator: Thank you. Next, we go to the line of Tom Gallagher with Evercore. Please go ahead.

Thomas Gallagher*Analyst, Evercore ISI*

Q

Hi. So first question is – Rob, you mentioned that one-third of the \$5 billion to \$10 billion of capital deployment will come through organic growth. I guess that seems like a high number considering PGIM and Assurance IQ shouldn't have much capital intensity. So is that largely coming from the EM side?

Robert M. Falzon*Vice Chair & Director, Prudential Financial, Inc.*

A

Yeah. Let me clarify what I said, Tom. Apologies if I wasn't clear. What I was saying is that in excess of a third of the earnings growth that gets us from 18% of our total earnings to 30% of our total earnings comes from organic growth, not that in excess of a third of the capital is organic. So I hope that clarifies that point.

Thomas Gallagher*Analyst, Evercore ISI*

Q

That does. The other question I had is just a follow-up on the broader M&A strategy. I get why group benefits and Retirement aren't high-growth businesses, but they're capital-efficient. And so just curious why these wouldn't be M&A areas.

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

A

So let me start with that and, Andy, you may want to join in afterwards. But the way we look at those businesses and I think consistent with what Andy said before is it is not that we are not investing in those businesses. We will continue to invest in them for purposes of organic growth. But when you think about the areas in which we want to reallocate capital, if you will, to higher growth businesses with less market sensitivity; those are our priorities are certainly PGIM and emerging markets. And, Andy, I don't know if you want to expand on that. But...

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

No, nothing to add, Charlie.

A

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Okay.

A

Thomas Gallagher

Analyst, Evercore ISI

Okay, thanks.

Q

Operator: Thank you. And our next question comes from Josh Shanker with Bank of America Securities. Please go ahead.

Joshua Shanker

Analyst, Bank of America Securities-Merrill Lynch

Yes. Thank you for taking my question late in the call. If we go back to the Investor Day that we keep bringing up, I guess the big difference is the parting ways of the annuities or at least certainly the high capital-consumptive annuities. If I want to like – are there other strategic changes that really come out? Have you just put numbers to things that were already in motion? Or are there other strategic changes embedded in those numbers that we really should focus on?

Q

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

So I'll take a first stab at that. And then, Rob, maybe you want to join in. But I think when you look at our strategy, we still have the wellness strategy. That still exists. It's still a very much part of what was our Investor Day presentation back then and continues to be there. What we've done with a much lower interest rate environment and with a strategic review is again say where we want to reallocate capital. And that's new and that's what we've come out with this quarter in terms of thinking where we want to be in three years with the higher growth businesses. So if I were to articulate a difference, it would be there. And, Rob, I don't know if you have other things you can elaborate on.

A

Robert M. Falzon

Vice Chair & Director, Prudential Financial, Inc.

Yeah, Josh. So thank you for the question. Just to elaborate a little bit on what Charlie's saying. I think, Josh, if you think about what we said in Investor Day; all of that is largely intact as we described it around our organic growth opportunities. We had said that our near-term aspirations around some of that are – we're facing headwinds with regard to a much lower interest rate environment than we were in at the point in time in which we articulated that.

A

But I think it's not just the pivot away from annuities. But as Charlie said; it's also, as contrasted to what we described in Investor Day, the active reallocation of capital more broadly and into those growth businesses. So I would call out not just the de-emphasis of annuities because of its – not because we don't think incidentally it's a very good business. We think it produces tremendous cash flows. It's well-capitalized. It's well-hedged. We just happen to believe that it's a business that we'll get better value in private markets than how we're getting rewarded in the public market for that today. And that gives us an opportunity to arbitrage capital and to reinvest it into areas in which we can be rewarded in the public market. And those would be the growth areas that we've articulated.

Joshua Shanker

Analyst, Bank of America Securities-Merrill Lynch

Q

So in presenting the plan to the board, where it's going to be probably earnings dilutive but we're going to get higher multiple earnings out of it and less market sensitivity; is there any frame for the magnitude of the dilution that was presented in order to make this change?

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

So let me take a stab at that. And what we present to the board and what we present externally, it's really a balance. It's a balance between the reallocation of capital into these higher growth businesses, but also a redeployment of capital. And in this case, we've articulated \$10 billion to shareholders in terms of share repurchases and dividends.

And so what we've attempted to do is balance the two. Say we're going into higher growth markets. And so therefore, hopefully, we will have a higher multiple as we go forward and yet return a significant amount of capital to shareholders as we have done in the past and will continue to do in the future.

Joshua Shanker

Analyst, Bank of America Securities-Merrill Lynch

Q

Okay. Well, I'm trying to do some math and maybe Darin will help me out down the line. Appreciate it. Thank you.

Operator: Thank you. Now we will send it back to Charlie Lowrey for closing comments.

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Okay. Thank you very much.

In closing today, I'd just like to reinforce our commitment to creating a new and more nimble Prudential; one that remains deeply focused on its customers, that will have a higher growth potential and will be less market sensitive in the future. We're excited and we're optimistic about this next phase of our transformation. And we look forward to keeping you updated on our progress. So thanks again for joining us today.

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

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