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Prudential Financial, Inc. (PRU)

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CORPORATE PARTICIPANTS

Mark B. Grier
Vice Chairman, Prudential Financial, Inc.

MANAGEMENT DISCUSSION SECTION

[Abrupt Start]

Unverified Participant

...joined by Mark Grier today. So he's Vice Chairman of Prudential Financial. Mark's been with Pru since 1995, first serving as CFO, and now is Vice Chairman. In his current role, Mark is responsible for, colon, and it's a very long list.

I should probably have a list of what he is not responsible for. That would be a little bit quicker. But I'm not even going to go through the list. Look at his bio. But through his oversight, Mark and his team have taken several steps over the last couple of years to manage Prudential through a difficult macroenvironment. And I'm sure we'll get into some of those actions over the course of the presentation.

Mark, it is my pleasure to bring you up to the podium.

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

Thank you. Mostly, by the way, I've been successful at promoting myself by hiring other people to do jobs that then report to me. So I keep moving up as a result of piling them in underneath. So that's why that list is as long as it is.

So I hope it's good news for you that I'm not going to recite a bunch of things that are otherwise out there in disclosures or conversations about earnings and more tactical stuff. I want to talk more about what Prudential's all about, how we think about things, and how we got where we are and what's important to us. And I'm going to talk about business aspects of those kind of themes. But again, I'm not going to go through earnings disclosures and some of the business metrics that typically are part of an earnings presentation. It'll be more of a business type presentation.

So let me start with the forward-looking statement disclosure. And then into one of the major themes, and I guess, if there's a headline over us, it's that we're a pretty good story around thoughtful strategies and quality execution, and ultimately, monetization and realization of the result of building good business fundamentals. And we play the long game and I'm going to make some specific references in a few minutes to some aspects of playing a long game and things that are coming through for us that have reflected work over a number of years, and in some cases, even, by the way, decades.

But we play the long game in an environment that is sort of defined by what this arrow looks like. We have a clear purpose. Our mission is to provide financial security and so we have commercial objectives, ROE, earnings growth, balance sheet metrics, credit ratings, statutory financials, and the business metrics are all part of fulfilling that mission. And by the way, if we don't achieve our commercial targets, we don't get a chance to fulfill the rest of our mission and do what we're doing around providing financial security. So this starts with a strong sense of what we're all about, that filters into commercial objectives, but the commercial objectives don't define us. It's that theme of financial security that defines Prudential.

Financial strength as a cornerstone. We ask our clients to accept promises from us that may extend 70 years. We're writing life insurance on babies today, who may live 100 years. So financial strength is a given for us, validated by transparent effective regulation, credit ratings, disclosures, the realization of cash in our businesses to help convince U.S. investors and clients that all this really works the right way. So financial strength is a given in delivering that mission around financial security.

Strong core businesses, I mentioned the theme of strategy, execution, and business fundamentals that are monetized. We pay a lot of attention to the real drivers of business success, sales and flows and margins and expenses and the matching of channels and products. So there's a whole overlay on business fundamentals that gets us to connect strategy and execution with monetization. And so when we talk about strong core businesses, that's something that we pay a lot of attention to. And we don't just define strong core businesses around an earnings metric or a capital metric, we define it around the real guts of the things that make us successful in our markets.

And finally, at the end of the arrow, we produce differentiated results. We have, since we went public, focused primarily on return on equity as sort of the key differentiating metric for us and we do today produce an ROE that is distinctive, relative to most of the companies that you would consider to be our peers. And it's at the end of the arrow because it's the result of all the things that happen in that chain that I talked about. It's not the cause, it's the effect.

I want to move on to elaborate a little bit on some of the drivers of success and some of the things behind the way I just talked about linking strategy and execution and results. And going down the left side, you've got a portrayal of some of the drivers that we're most heavily focused on. And maybe to word it a little bit differently, we pay a lot of attention, as executives in the company, to talent, culture, and execution, and the key theme there is that we pay attention to the way those things flow together, to get things done and produce results and advance the cause. Talent in a silo, culture in a silo, and execution in a silo are not nearly as compelling a story as an integrated picture of talent, culture and execution, driving business results and ultimately monetization.

This hasn't always been true. I would say there were a lot of years when we viewed talent as a talent exercise and we viewed culture as sort of what you write on the side of the coffee cups about how you want people to behave. And then we viewed execution [audio gap] (00:06:43) focused on that ROE target. But we [ph] find (00:06:47) ourselves now in a much richer environment around the way those things connect. And there's a powerful story about the talent side and the culture side and the execution side. And again, feeding results that are more robust than just the ROE achievements, but the real substance of the business, actually fulfilling the mission of providing financial security and earning attractive commercial results.

So that left-hand side, fleshed out the way I just fleshed it out, is probably for us as a management team the center point. That's how we think about what we need to be doing, connecting those dots across those different dimensions in the context of the strategies that we've established. And then in the middle, you see the key elements of what I would define based on the way I've been talking about it as the key commercial objectives. I'd highlight the bottom two. One is our sustainable earnings power ROE which we're defining as 12% to 13%, down a bit from 13% to 14% a few years ago. And the 13% to 14% target was set right after the financial crisis, when we thought it was important to put a stake in the ground around our earnings power in the environment that, at that time, was being called the new normal. That range was lowered as a result of the chronic erosion of yields with low interest rates. But still at 12% to 13%, we are distinctive among our peers.

So we still focus on ROE as a very important commercial objective for us and we do deliver in terms of a differentiated ROE. The bottom point refers to the generation of cash. We have been talking about cash flow generation since we went public. I remember back in 2001 in the early days of Prudential after we de-mutualized, which isn't a word by the way, after we went public, we were targeting at that time 50% cash flow generation from operating earnings and that cash flow generation target has moved up until we recently increased it from 60% to 65%.

And this is an over time concept, quarter-to-quarter, sometimes year-to-year, things bounce around a bit. There's some statutory complexity to the realization of cash and the distribution of cash, so there's some moving parts in this. But the gist of our objective is 65% over time, and again, that's been increasing through our life as a public company. And so that's an important part of a commercial objective, but I also mentioned a few minutes ago, it's an important part of validation. If cash really is coming out of this thing, then something's probably working right. So we view the visibility of cash as an important indication of how things are going in terms of what's happening in the core businesses that maybe complicated and not necessarily, particularly transparent.

So key elements on this slide, commercial objectives on the right, some of the essential things about how we get there portrayed on the left. And I mentioned that we're delivering. These are three financial performance metrics showing five-year time period from 2012 to 2017 in terms of earnings growth, 11% growth in EPS over that time; in terms of return on equity, a 200-basis point increase from 11.8% to 13.9%; and growth in adjusted book value per share of 9%. So this kind of summarizes the monetization of the business fundamentals that have resulted from what we've done in strategy and execution. And it's a pretty good story. When the inflation rate is 1% or 2%, 11% growth in earnings is a pretty good piece of it.

By the way, if you're thinking in the back of your mind, what's going on in this company that makes this kind of thing happen, we've got a particularly strong lift from pension risk transfer deals that we did in the early part of that five-year timeframe. There was a discrete move from 2012 to 2013 in earnings and ROE as a result of a couple of the big pension risk transfer deals that we did. So there's one particularly big piece, and I'll come back to that, one particularly big piece that moved the needle. But otherwise, we generally grow in our businesses and so that's reflected in these high level metrics about how we're doing.

If you've been following us even casually for very long, you'll hear us comment often on our mix of businesses and we talk about business mix from a number of different directions. We talk about the risk profile and how risks complement one another. We talk about business models. We talk about geography. We talk about which side of the business proposition we're on, protection, retirement or investments, and we cut it geographically. So we come at this business mix thing a lot of different ways.

This slide shows you our business mix in two different dimensions. On the left, you see the businesses and the way they're represented here is characterized by a risk summary on the outside on the top right part of the circle.

We start with insurance risk and the things we do in international insurance are almost entirely insurance risk related, very heavy mortality risk in those businesses.

And then as you move around the circle, going from 1 o'clock up to 11 o'clock, we migrate from more insurance risk to more market risk. And so you go through asset management, where the level of fees depends on assets under management, which fluctuate with markets as well as depending on some independent investing activities, and then ultimately, the variable annuities, which have a lot of market risk content. So we like the story. We like the mix of risks across insurance risks. And by the way, that includes mortality at 1 o'clock, and then down at 6 and 7 o'clock, longevity risk in the retirement business. And then market risk, which includes equity market risk, interest rate risk, credit risk and the various other FX risks, for example, that would be in there. So it's a good story in terms of diversification, in terms of the way risk connects to business strategy and business results and the risk dimensions that drive the things we do in our business. Taking mortality risk for example is, in Japan, a very high value risk that drives attractive commercial results. So we have a business system that's really good at originating that high value risk. And so there's a direct connection between the attraction of the risk and the business system that's out there, either originating the risk in the case of mortality risk in Japan or mitigating the risk in the case of market risk in variable annuities.

So, again, we talk about this business mix story from a lot of different directions, important ones especially when things get interesting like they have over the past few weeks, relates to this portrayal of risk. And then on the right, you see where our book value is deployed. This is the size of the businesses according to book value capital, and so you see international insurance is the largest slice of the pie. U.S. individual solutions includes variable annuities, well, variable annuities, annuity business and individual life and then U.S. workplace solutions includes group life and retirements, and then the final slice up there is our asset management business, now known as PGIM. So that's a portrayal of where the capital sits on a book value basis. And on the left, you see a portrayal based on sort of a qualitative directional view of the kind of risk that's most important in executing within the business, but then also influencing financial results.

I want to move down to some comments on things that have been going on in the individual businesses, and I'm not going to hit a highlight on every single bar graph that's on this page, but let me start with workplace solutions, and what I want to highlight there is pension risk transfer. I mentioned earlier that we play the long game. We gave the first presentation to our board of directors about pension risk transfer in 2006 and we didn't do our first deal until seven years later. And now it's 2018 and this business is contributing meaningfully, strategically important, and important to the mission, but it took us a long time to build the capability, which we built as a dedicated capability, and ultimately, to penetrate the market and do the first really big deal, which we did with General Motors.

So there is an important element of the overlay of how we think about things and how we execute, how patient we've been in this case waiting for those deals to come true, and the result of that is as you see in retirement a very substantial growth in asset values, 8% annually, up to about $430 billion. I would just comment briefly on group insurance. There's been a bit of a cycle there. We have some challenges around profitability in underwriting and client mix. And so we worked hard on re-underwriting, re-pricing, changing the mix of clients. And so what actually happened in between those lines that look sort of flat was we went down and back up. So now we're in a more stable spot and beginning to move forward, but it hasn't been flat like this over five years. It's been moving around, again now to the point where it's starting to grow and we're seeing results that we're pretty pleased with.

Moving to the top right, U.S. individual solutions. What I want to highlight there is variable annuity and the headline is that we have a very investor friendly variable annuity business. Now if you fall out of your chair and wonder what in the world I'm talking about, I'm not surprised, because these things are all over the place out there. But the fact is that our VA business generates a high return and generates a substantial cash flow, roughly over time on par with our 65% of operating earnings target for the total company. But again, to the point about the long game, decisions that we made in 2004 and 2005 have had an impact on where we are today in the VA business. Part of that by the way is that when we set up captive insurance agents, I mean, captive insurance companies, to manage some of this risk, we never arbitraged or compromised reserve levels, capital levels or quality of assets.

So, as we have reconfigured and recaptured our living benefit captive, we were never in a hole around some of the big issues that others have had to deal with as they recaptured living benefit subsidiaries. But again, this is a decision that was made in 2004. Now, since then, by the way, we've been in a process of continuous improvement around modeling and understanding the liability, around hedging technology, doing some things on the accounting side to dampen volatility, and also increase transparency. So there's been a constant process since 2004, 2005, 2006 in the variable annuity business. But again, when we're talking about our outcome, this wasn't something we woke up last July and did. This is the result of taking that long view and making this work over time and getting to the point where today we can say, we have an investor friendly variable annuity business that we like quite a lot. So good outcome there.

Moving to the bottom left, let me make a couple of comments on investment management. First of all, in terms of unaffiliated third party assets under management, we went above $600 billion at the end of last year. We are among the 10 largest asset managers in the world and we're executing extraordinarily well. We are realizing the benefits now of investments that have been made over the past 4 or 5 years in distribution and capability. But more importantly, I think we're realizing the benefits of the quality and consistency of execution in that business.

Right now, in our PGIM business, 93% of the assets under management are exceeding benchmark performance levels over 5 years. It's around 90% if you look at over three years. Now you're mostly in the asset management business. If you could have one thing in your pocket, when you go to call on a client, you'd like to be able to say that most of our assets outperform their benchmark. So it comes down to that, but there's a lot of execution behind it. And as I said, there also are impacts from new initiatives in both distribution and product, so very good story there.

International is one of our real genuine flagship success stories. Again, to make the point about the long game, it goes back about 30 years and the things that we have been building for 30 years, our fundamental strengths that are helping us continue to perform in a very challenging market in Japan. I mentioned earlier that we're good at originating mortality risk, we are. We're also good at selling U.S. dollar denominated products. And so in this environment, the combination of those two things gives us the competitive advantage in the market. But it's not because we woke up last July and said, let's do some of this stuff. It's because for 30 years, we've been building that differentiated distribution capability. And now in a tough market, we can continue to perform because of our ability to sell high margin protection products and because of our ability to sell U.S. dollar denominated products.

So extending these stories, these points about PRT, about variable annuities, about investment management, and about Japan, to a longer context is I think an important part of embellishing those themes of strategy, execution and results. Because we see this unfolding for us purposefully over time in a number of areas that we've chosen to pay a lot of attention to, been thoughtful about developing strategies, and are now realizing the benefits of what happened to us as we develop those strategies.

I want to take a minute to talk about U.S. business strategic focus and I want to give you a couple of headlines over this. We have like a lot of companies, a lot of individual clients underneath institutional businesses. And by that, I mean, in group insurance, we insure a whole lot of individuals, but we do it through the employer. And in retirement, we touch a lot of individual plan participants, but we do it through the employer. The cliché view of this opportunity, meaning the vague connection that we have to those underlying individuals is to think about "cross-selling". And so people will launch initiatives then say, okay, they already do business with Prudential because they're in our group life program, let's mail some stuff to them. Well, people have tried that forever. And if you come to conferences like this, you've heard for years, people stand up like I'm standing up and say, we've got 20 million people out there and we're going to take advantage of that.

Well, for the most part, those efforts have gone nowhere. And so what this slide highlights is a different approach to that underlying retail opportunity that's embedded in our institutional businesses. And the key point is that we have a value proposition to employers around the benefit to them of financial wellness on the part of their workforce. Employees who are more financially secure are more productive, less likely to go out on disability, more likely to be retirement ready, so they're not clogging up the talent chain, and so there are tangible benefits to employers of pursuing a financial wellness initiative with their employees. And so that's where it starts, and then we go from there to access employees. We access them in two ways. One is highlighted here, a program we call Pathways. Pathways puts an agent in front of or an advisor, in front of employees, but not in selling mode, in educational mode around protection, savings, retirement income and investments. And then it goes from there.

We also have a digital platform that provides access. And you see a node in that Pathways box that the early returns on this program are very positive, although we've just started. We've already got more than 300 employers participating in this. And underneath that base, there are about 3 million employees. So this is a way to build the opportunity in what has so far not been an addressable market for us. This is mostly middle-market, mass-market, that has not been an addressable market for us. And to do it in a way that we're very optimistic about in terms of realizing the results.

I would add that another payoff is coming to us as we're winning business at the employer level because of our wellness package. We've recently won a couple of big group life contracts. Names of companies that I'm not going to disclose, but that you would readily recognize, who have told us you weren't the lowest price, but we're giving you the business because of the wellness program, because they want to do that for their employees. It doesn't cost them by the way.

So this initiative as the centerpiece of recent reorganizations, investments in product design and systems and the marketing initiative is a pretty big deal for us. I'm excited about it. I like the opportunity, I like the prospects. The qualitative goal is that this will move the needle in terms of domestic growth over the next five years and I don't think there's any reason not to believe that. So there's a lot of good stuff going on here and it's hanging on that quality value proposition to the employer. It's not hanging on the thin premise of we can cross-sell because they know who we are, and so a lot more substance and a lot of good stuff. We like this one. We talked about it on Investor Day in some detail, including a panel made up of the business leaders, who are actually out there implementing.

I mentioned financial strength. You hear this from us all the time, but just directionally two things. We're getting stronger. Leverage is coming down that's the left-hand side of this graph and we're distributing a lot of cash to shareholders. You see on the right-hand side, dividends. We recently raised our dividend by 20% more and share buybacks, which we also recently increased by 20%. We're distributing to shareholders almost all of that, roughly 65% of free cash that comes out of our businesses. So good story here and this is where our priorities are evident. It's really important for us to have visibility around cash, and it's really important for us to be consistent in distribution. And so that's what's going on. And again, another part of the message is we're also getting stronger, leverage is coming down.

The next slide is designed to get at the completeness of what we're all about. I highlighted earlier that commercial metrics are part of the story. [ph] It's table stakes (00:28:12), if you want to stay in business, it's also important to exceed your commercial objectives and create more rather than less shareholder value. But this slide gives that other dimension of us, our diversity, our emphasis on sustainability. We're one of the largest impact investors in the world with a portfolio of almost $600 million in impact investments.

So this is more of the intangibles, but also tangibles that reflect the more complete view of what Prudential's all about, coming back to that starting point in the arrow, the propose and the mission, and how that's fulfilled across other dimensions beside just the tangible sale of products that provides financial security.

And so this is the summary. If it's a [ph] true (00:29:02) summary, and I go through, it will be completely repetitive, so I won't. I've got about six-and-a-half minutes or so left for questions. So I will stop here. Before I move to questions, let me restate again the basic points around thoughtful strategies, quality execution and monetizing results. And some of the elements of consistency and staying power over time.

So I'll stop there and I'll take questions about anything that's on your mind.

QUESTION AND ANSWER SECTION

Mark B. Grier
Vice Chairman, Prudential Financial, Inc.

A

Yeah?

Q

You touched obviously on the pension risk transfer market. Do you think the opportunity is better for you in the next sort of 12 to 18 months, given what's going on with one of your competitors in the space or equal?

Mark B. Grier
Vice Chairman, Prudential Financial, Inc.

A

Well, market conditions are attractive. Generally, when we're asked on our earnings call about the outlook for pension risk transfer, Steve Pelletier, who's Head of the U.S., says that the pipeline is strong. On the last call, he said the pipeline is very, very strong. He used two verys and you couldn't see it on the phone, but he was also smiling. So the increase in rates, which reduces the value of the liability that's being bought out, the increasing rates and the fact that asset values have generally performed well has overall positively impacted funding status.

So I think generically that's likely to be a more important driver than competitive circumstances. I would emphasize though that decisions to derisk pension plans are totally idiosyncratic. Every company has its own issues around funding status, volatility, the mix of business they're in versus the size of the plan, and also maybe the CFO or CEO outlook for interest rates. Rates go up a little and everybody thinks they're going to keep going up, they may not want to do deals. If they think they're hitting the peak and making a good call on rates, then maybe they will. But I would say generically, the environment is conducive.

Q

Just a follow-up on that.

Mark B. Grier
Vice Chairman, Prudential Financial, Inc.

A

Are you actually allowed to ask questions, I thought you were the host?

Q

I can ask.

Mark B. Grier
Vice Chairman, Prudential Financial, Inc.

A

All right.

Q

[ph] Generic set of questions (00:31:15). You obviously have been a big player here, what are the factors other than price that come into winning new business here? It's not just price, so what else are you guys doing to potentially gain share?

Mark B. Grier
Vice Chairman, Prudential Financial, Inc.

A

I take back the fact that I implied criticism to the fact that you're asking a question. That's perfect. I like it. Thanks. Let me start off with a headline. Our sales force would tell you anecdotally that we're not the lowest price on about half the business we win in PRT. There are other things in the mix and let me hit a couple of high spots here. There is tremendous operational complexity to the execution of the deal. Just think for example when we did the General Motors deal for $25 billion, we had the value $25 billion in assets and we had to move them into our systems and we had to book them on our books. Then beyond that, you've got all the underwriting dimensions of what goes on, on the liability side.

Beyond the execution event, there is ongoing operational complexity in administering the payment of the pension obligations. The day we did the General Motors transaction, we were responsible for sending payments to 115,000 individuals every month. And so the operating platform that gets it right that has a call center that actually answers the phone and answers questions, that makes the pension payment on time in the right amount, is an enormously important and sensitive issue to plan sponsors. They really don't want the ball dropped between the glitz and glam of the financial headline and what's on the ground in terms of making payments.

The only halfway joke that I make about this is that these are retirees who have a lot of spare time. And if you make a mistake in making payments, somebody is going to hear about it and it might be the CEO of General Motors or it might be the CEO of Prudential, but this is something that is going to be noticed. And so the ability to deliver on the execution event and then the ability to deliver with respect to ongoing service and distribution of pension payments are both extremely important elements in this. We did a deal with one very large client and there was skepticism in the ranks, not everybody was happy with Prudential assuming this pension obligation.

One of the plan participants called our call center and he couldn't have been happier with the service he got. His question was answered. Well, first of all, the phone was answered on time, and his question was answered and he was well treated. Turned out that he was the father of the CFO of the company and so think about how that could have gone differently, but it didn't. So he said to his son, I get it. I didn't like this when you did it, but now it's fine. So that kind of says it all. There is a lot in this that goes beyond the headlines that look so interesting. It's actually in the guts of it even more interesting, but they're hard and complicated.

And again thanks for that question. I appreciate it.

Q

We've got time for one more question, about a minute left, [ph] to fit in for a (00:34:33) short one. Yeah?

Q

You talked about operationally what can go wrong in pension risk transfer. What about from the financial standpoint, will you target certain type of employers, how do you price the product on the pension risk transfer business side?

Mark B. Grier
Vice Chairman, Prudential Financial, Inc.

A

All right. The basic pricing platform is pure corporate finance. If you look at what you're learning in corporate finance 101, it's a projection of cash flows. It's got two sides. There's a liability projection and an asset projection. And then we model how those cash flows might vary. By the way, the biggest sensitivity is asset mix. It's how much is in there and things like hedge funds or real estate or private equity. And so we construct essentially an efficient frontier that shows the right return given the asset mix and given the liability risk. And by the way, we can shock liabilities, these are pension payments, so we're shocking for longer lives. We can introduce into this model something like a cure for cancer or we can introduce into the model something like a cure for Alzheimer's. We know how things are going to move with those kinds of events. So we shock it and we look at the required return on capital, given risk and it's literally a pure risk return trade off. We price it with some daylight above it, real economic cost of capital, and we back it with real cash economic capital. In our case, it doesn't end there. We have to put it through a statutory screen and we have to put it through a GAAP accounting screen, but the foundation, the real platform is hard economics, and literally as I said, pure corporate finance. It's a risk return picture.

And I think that's it. Thank you all very much. I appreciate your interest.