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Prudential Financial, Inc. (PRU)

Keefe, Bruyette, & Woods Insurance Conference

CORPORATE PARTICIPANTS

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

MANAGEMENT DISCUSSION SECTION

Unverified Participant

All right. We are going to get started. Pleased to have Prudential with us again this year. Thanks for the continued support. Up here with me is Mark Grier, Vice Chairman. I also want to recognize Darin Arita and Bob McLaughlin from Investor Relations sitting in the front row.

QUESTION AND ANSWER SECTION

Q

So, to kick it off, I guess, a couple of years ago, Prudential had established an intermediate-term ROE target of 12% to 13%. If we look back over the last couple of years, you've really still been kind of doing 13% to 14%. Can you talk about what factors have led you to outperform the 12% to 13% expectation that you had provided, as well as what your expectations are now going forward?

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

A

Yeah. The 12% to 13% actually was the result of ratcheting down our previous 13% to 14% target. And the discussion at that time centered around the structural impact of chronically lower interest rates, the idea being that although there aren't a lot of concentrated risk, there's sort of a macro spread on the company that over time when rates are low, compresses. And so, we ratcheted the target down from the 13% to 14% range to the 12% to 13% range.

And our view is that that's kind of an over time structural earnings power concept that we think about in the context of through a cycle. And we think about fluctuations around that either through the cycle or because of things that are happening in the short run. And the outperformance has reflected a number of variable items, different things at different times.

We've had some benefits from positive mortality occasionally, we've had some benefits from better longevity experience occasionally, we've had better investment experience particularly in alternatives occasionally, and more recently, we've had better expense experience in Corporate and Other. So, there's not one item that has resulted in that outperformance, it's several different things coming together sometimes, or at different times individually. And until we have a bigger discussion and change it publicly, that's the range that we're still focused on, as the center of gravity for our structural earnings power.

Q

Got it. Similar to my question on growth, you had guided to 6% to 11% EPS growth for 2018 before tax reform. Certainly, it seems like you're travelling more towards the high end of that at this point. So, I was hoping you could talk a little bit about how you view the growth potential of the company at this point at an overall level, if we think about kind of both the growth as well as the incremental impact of the capital management?

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

A

Well, let me separate the first part of your observation, which is sort of a tactical arithmetic of where we are now. And I would attribute those variances to some of the same kinds of things that I just talked about, mortality, longevity experience, investment experience, and expenses particularly in Corporate and Other, where in the short-term we have done a little bit better on those things and so the same things about ROE would translate into the impact on earnings.

I think the question about growth in general is a more robust business question, not just related to the things that fluctuate in the short-term. And I would say that we're pretty optimistic about growth opportunities. And particularly in the U.S., we're growing very handsomely in asset management. We've had great flow results which ultimately are monetized into earnings results.

And you heard us start to talk about our wellness initiative in the U.S. We launched this for investors in the summer of 2016 when we had Investor Day. We had a panel of business leaders from our U.S. businesses, talking about the financial wellness initiative and here's the gist of that. For a long time, people in our industry have looked out the window and said, we have X million customers underneath our group clients, or underneath our retirement clients, and we're going to cross-sell to them, and we're going to harvest this huge retail opportunity through the people that we touch in the institutional and commercial businesses.

And it's never worked, that they mail out stuff, or they try to cross-sell products from other parts of the company. And no one's ever really gotten traction around that. The closest anyone has come is selling voluntary benefits, which has been successful in some cases, but that really extends the core group of retirement business, not – it doesn't really access the retail opportunity in that client base.

And our approach then is not based on the notion of cross-selling, I used the term financial wellness, it's anchored in the idea that at the employer level, we tell them you will be better off if your employees are financially secure. They'll be more productive, they'll be more retirement ready, they'll be less likely to go out on disability, and you can quantify the benefits to an employer.

And from that employer entrée, with that substantive value proposition, we follow with a complete business system that delivers to the retail opportunity in the [ph] employers' universe (05:47). And by complete business system, I mean channels and products, face-to-face channels, digital channel, website channels with the employer, and products that are designed for the wellness environment in the employee base, including planning and budgeting, including protection products, investment products and retirement products.

And so, we view this as an extremely attractive growth opportunity and one for which we have cracked the code in a way that the industry has been looking for, for a long time. This magic of the employer value proposition and the entrée and then the way that goes into, again, a dedicated business system instead of a cross-selling exercise is turning this into something that we find very attractive and appealing and that is resonating in the market. The early proof points for growth here are winning institutional business, and we are. We're being told, in fact, by clients that you weren't the cheapest, but we're giving you the business because of the wellness package.

And then, the second early proof point is enrollment of employers in the process, and we're seeing that. We have more than 350 employers enrolled in what we call Pathways, which is our initial wellness package, more than 350 employers with 4 million clients. And so, all of a sudden, this is right in front of us as a U.S. retail growth opportunity that's got substantial scale behind it.

So, our view on this one to come back to the specific growth question is that while we're not quite ready to put a lot of guidance-type metrics out there. We do expect that this will move the needle in terms of domestic growth and move the needle doesn't mean tenths of a percent, it means more than that. So, just to stylize it, if you were thinking we might grow at 4%, you might think this could add 2 percentage points and we grow at 6%, or if you were thinking 8%, maybe we grow 10%. So, this is an opportunity that's substantial scale and very real for us.

We've got a lot in it. We've got real capital, we've got emotional equity and we've got a big execution process pushing this. But this would be the foundation of a domestic growth strategy that is different for us, and I think different for the industry and can change things in terms of how investors can look at the growth opportunities for a company like Prudential.

On top of that, we have our international pieces. We're growing consistently and profitably in Japan. We have other initiatives in Brazil, China, India, Indonesia, a small business in Chile. And all of those are contributing as well to the potential over the next few years to produce more attractive growth.

We certainly understand the growth challenge. I think we're realistic about the opportunities to keep doing what we've been doing. And so, thinking about something different like the wellness initiative, as I said, can both move the needle and change the game for us.

Q

How far along would you say you are in developing and rolling out the wellness initiatives to the extent now? Are you pretty far into it at this point, or you think in the next few years this can produce tangible benefits to your growth rate, or is this something that's more a long-term?

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

A

I think the real retail results are in the three- to five-year timeframe. But in terms of execution process, we're getting there. We launched recently our LINK platform, which is a digital information, advice and execution tool that supports the wellness initiative, as well as direct-to-consumer initiatives in other parts of what we do. As I said, we're seeing proof points now in terms of winning business in Group Life and winning business in Retirement. So, that's revenue today. And the intermediate step of having employers enroll in this is also showing very positive return. So, the revenue impact today is really institutional side. The retail piece is coming, let's say, three to five years. But in terms of the maturity of the initiative, the platform is in place.

Q

Any idea on the retail side would be to sell Annuities, Individual Life, other supplemental products...

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

Yeah. Mutual funds.

[indiscernible] (10:16)

Q

Okay.

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

Yeah. Investment products, protection products, retirement products. We have an income product, for example, that's not quite the traditional variable annuity, it's called GIFT, which stands for Guaranteed Income For Tomorrow. This is one of the clever things that we work on, naming stuff. And that product allows individuals to essentially have their own defined benefit plan and the product is outcome driven meaning, you buy today retirement income.

So, what the customer sees is, if I put $100 a month into this, I'm buying X dollars a month when I retire. So, it's a very easy linear connection between the need, retirement income and the solution GIFT without all the noise in between about product complexity and the challenges of the traditional variable annuity products. So, it won't just be cross-selling existing products. There are products designed for the channel.

Q

Got it. Then shifting to free cash flow, in December, you raised the free cash flow conversion to 65%. I think it was previously 60%. What drove that increase and do you view that as a sustainable level at this point going forward?

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

So, when we raised it to 65% of sort of center of gravity target over time for the generation of cash flow relative to earnings, we talked about it in the context of sustainability. This was something that, as we raised it from 60% to 65%, reflected the real structural considerations in the company around where and how we generate cash. We have the envious position of very well diversified profitable businesses. And so, when we look at the aggregate, we get a pretty high comfort level with the stability of the way it can all come together, even though from time to time one thing or another might fluctuate.

Increasing that partially reflected the successful results of restructuring our variable annuity business, where we have now a very investor-friendly variable annuity business generating cash, generating attractive returns with transparent economics and less volatility. That was a big contributor, and we talk now about the VA business generating cash at roughly that same corporate rate. But we have a lot of cash-generative businesses that are strong and profitable.

Q

And then if we I guess shift to capital deployment, if I take your dividends and your repurchase authorization and compare to the earnings you're generating, it looks like it's more like 55% to 60% of capital deployment and below your free cash flow. You certainly talked a lot about having very strong capital levels. I guess when you take those two things combined, it feels like there could be an opportunity to deploy more capital. Is that – how do you feel about that?

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

A

Yeah. I think it's fair to conclude that we have some flexibility with respect to capital. We've been going through the impact of tax law changes and the perverse consequence for an insurance company's balance sheet of capital strain from lower tax rate. Some changes happening in the NAIC, RBC calculations that impact capital. We're less subject to where the VA thing comes out, because we kind of been ahead of the game on variable annuities with respect to everything, reserves and capital and hedging processes. But we have given ourselves some room to make sure that as these changes occur, we're flexible and strong and manage through it, and we have been. So, I would say, it's fair to think that we've got some flexibility and capital.

Q

And then, I just wanted to touch on the various changes. We have tax reform that's going to lower industry RBC ratios, C1 changes, year two that will also probably lower industry ratios. Do you see that as actually having any real impact on how you think about your capital position or do you think it's really more optic?

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

A

Well, I think it's an open issue. The dust has to settle around all of this, and we've got to understand what the economics of the balance sheet look like. The rating agencies have to sort through some things about what tax law changes mean, particularly for things like margins and reserves and some of the conservative elements of statutory reserves.

So, there are open issues out there. And I guess, the question that's in front of us is what will be the new normal, how will we focus on the right sort of 40,000-foot targets for things like RBC. And I think it's an open issue. I'm not quite sure where that goes. I think in general, lower tax rates make us stronger, although as I said, there is a perverse impact up-front, but we've got to see where it settles out.

Q

Got it. So, in the second quarter, you took the GAAP long-term care charge of $1.5 billion. The main driver was removing the assumption of morbidity improvement in your reserves. Can you talk more about what drove your decision to do that and what your comfort level is in LCC reserves, now that you've taken that charge?

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

A

Yeah. With respect to the driver – the decision, we update our actuarial assumptions in the second quarter every year for the last couple of years, that used to be third quarter. And so, everything is looked at on an annual basis and in some cases, even more often than that.

So, we've stayed on top of this, well, for a long time, but in 2012, we put it in loss recognition which puts it in a different category around reserve testing. So, that's been part of our process. And basically the morbidity experience side of it accumulated to the point where it was signaling the need to make a change in that assumption. We can't react to one single data point, but over time, we were seeing that the morbidity assumption that was in there for improvement in morbidity was not coming true. And so, we passed the thresholds on the actuarial side that would lead us to recalibrate that decision. And as a result of that, took the morbidity improvement assumption out of reserves and that resulted in $1.5 billion increase in reserves.

I would say that our comfort level is very high. Rob Falzon, our CFO, has used the phrase, put it behind us, when he's talked about long-term care. And we feel like there's conservative assumptions reflecting sound analysis and a thoughtful approach to reserves has put us in a position where we're very comfortable with our reserves at this point.

Q

I guess, without – do you see this this year and last year, you had an Individual Life charge when you did your assumption review. So, there's been some volatility in the last couple of years. You've done a lot of other things to try to reduce volatility. I guess do you feel like, given some of these impacts you've had, they're behind you now and you can kind of achieve what you're trying to accomplish with the reduced volatility going forward?

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

A

Yeah. Let me start with the second half of what you said, which is, we have done a lot of things. We've done some structural things that have had a huge impact on things like the FX remeasurement challenge that we had where we had some asymmetry in economics going through income statement and balance sheet differently that created huge volatility with no economic consequence, and we've been working on a variety of other aspects of the way in which we either true-up our reserve and manage some things like derivatives and mark-to-market exposures that create some of those disconnects between AOI and net income.

So, we've been working on managing both absolute volatility as well as the difference between AOI and net income and that sort of volatility and aggravation. And as we approached the reserving challenges where we can use corridors, or different approaches that help us mitigate the volatility, we're trying to do that.

So, the general answer is, we have done a lot, we've taken a lot of that below-the-line volatility out of the company, but there will be intrinsic volatility in insurance. Some of these things just look like that and can't be avoided, but staying on top of it, making sure that we're in the right place on our assumptions, we're asking the right questions. And again, where we have structural issues about how we do things, or the use of corridors, for example, those things can all help mitigate that volatility.

So, we feel like we've made a lot of progress, but we're not crazy about having to go through what we went through second quarter last year on Life and second quarter this year on Long-Term Care, but we have done a good job of staying on top of it. The other thing is, we've tried to enhance transparency. And so, this Long-Term Care entry reflects not just the $1.5 billion that we link to the morbidity assumption, but along with that, more disclosures of sensitivities and the risk profile of our book. So, things that improve transparency there also add to the comfort around where we are and what we're doing and why that volatility might be out there.

Q

Got it. More on the business side. So, your pension risk transfer activity has been fairly modest for the overall industry except for the one big transaction this year. Seems like all the variables point to a lot more activity, so can you talk about how your pipeline looks? And do you expect activity to really – to meaningfully pick up kind of from where it's been in the last half year or so?

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

A

Yeah. I'll just repeat what Steve Pelletier, who runs our U.S. businesses, has said about this. He has added an extra very to the sentence about the pipeline being very, very strong, that there's a lot of activity out there and a lot of interest in doing these deals and that he expects to see good results. Takes a long time. They're lumpy. We do a lot of work to make them happen, but Steve is very optimistic about the opportunities in pension risk transfer.

Q

Got it. I guess related to that, it seems that you've had kind of a rip – multiyear string of kind of saying, you're having favorable longevity experience in that business. What are you seeing there? Do you attribute that to pricing, or are you seeing something fundamentally kind of different emerge that's better in the results?

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

A

I think there are two parts to it. One is that in the deals we do in the jumbo market, we do custom underwriting of the blocks. So, we are conservative in underwriting. So, you might expect if we're genuinely as conservative as we think we are, maybe we ought to do a little better than we anticipated when we set up the reserves. So, there is a conservative bias in underwriting, but there's also the overlay which you read about in the newspapers now of generally a slowing in mortality improvement and so, we're probably seeing a little bit of that too in terms of the flip side with respect to longevity. So, some of it is, I would say, real experience related to that aspect of what's going on and some of it's our own conservative approach.

Q

In PGIM, your results have continued to be very strong. Can you talk about some of the key drivers that are driving both flows and margin improvement in that business and your expectations for PGIM going forward?

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

A

Yeah. Thanks for that good question. PGIM is a great story for us. We're doing extremely well. And I would describe a lot of what Prudential is all about in the sequence that goes from good strategies, to effective execution, to building business fundamentals and then monetizing fundamentals, and then ultimately, validating that monetization by paying dividends or buying back stock.

And you can look at PGIM exactly in that model. That's kind of what's been happening there, strategy, execution, business fundamentals, and monetization. But then to be a little more specific around PGIM, there are probably three macro drivers that are noteworthy.

One is, investment performance has been extraordinary. One-year, three-year, five-year performance record for nearly 90% of our assets in round numbers are exceeding benchmarks. So, when you look at the grid that shows green, yellow and red for beating benchmarks, our grids are big in green.

So, we've had sustained very good investment performance. And the leading indicators of future performance are also good where we see a one-year record that will be a three-year record, or a three-year record that will be a five-year record. That all looks good. And you're all in the investment management business, you know that success starts with that performance picture and beating benchmarks and having that green grid is the starting point for being successful.

The second thing would be targeted investments and the payoffs that we're getting from investing in distribution, particularly internationally, investing in some product capabilities including things like multi-asset class advisory capabilities, some of the collective investment trust products that we're launching in Europe, some variations on active management, particularly in actively managed ETF. So, there are new product initiatives as well that are working for us.

And then, I'd say the third thing is, in that bucket of execution, not just the way we execute our initiatives, but we're very consistent. We have very low turnover in portfolio managers, we have very low turnover in client-facing personnel. We're not a flavor-of-the-month shop that's chasing the latest ideas. We're very consistent around the products that we offer and the discipline reflected in the way those products are managed. So, I think we pull together a consistent execution picture with taking advantage of some opportunities the right way, but again, underpinned by good investment performance. And it's turned into a story that's a very strong part of what we do.

Q

Moving to variable annuities, the industry and Prudential has seen a pickup in sales in the last couple of quarters, finally. How are you thinking about the variable annuity business now, as it sits within PRU and then balancing both kind of new business growth versus the cash flow generation that you talked about earlier?

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

A

Well, I mentioned before that we have an investor-friendly variable annuity business. And so, I think the starting point is that one. We're not – a lot of companies are solving problems that we don't have. And so, we sit with a high return, generating good cash and with an economic and volatility picture that's pretty attractive. So, the attributes of VAs as part of Prudential overall fit in well and are attractive. The umbrella over this is a secure retirement income strategy, not a VA product strategy.

We fulfill our mission in secure retirement income using VA products, but we do it in other ways, too. PRT is a secure retirement income product, the GIFT products I mentioned earlier is a secure retirement income product, but we think the strategic fit is in the arena of secure retirement income. Sales have picked up, the products have been repriced, higher rates that have allowed us to put a little more value into the guarantees. And so, that gets people's attention.

We also see better results in guaranteed products like VAs, when the market gets a little choppy, or when there's a little more uncertainty around where things are going. Then there's a higher perceived value to the guarantees and in fact more attention. And we see sales go up. So, I think that the comfort people get from guaranteed products probably also has been helped a little bit by some of the macro uncertainty, and some of the headline risks that are out there on the economic side.

So overall, it's a pretty good picture. Profitable products performing well, a compelling strategic opportunity in secure retirement income and then the product opportunities that we have now with product design, pricing and the way we can fit all these things into that secure retirement income strategy. So, the answer is, we like it. We would like to do more. It's intrinsically very profitable for us. And we continue to say that we're going to have a lot of money left over at the end of the day out of the VA business.

Q

And you also started selling index annuities to some extent right more recently...

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

A

Yeah.

Q

...is that something you view as a meaningful opportunity? And then, I guess, what led you to start selling that product after you hadn't for quite a number of years?

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

A

We started selling that as part of our sense that we should flesh out the portfolio. I don't think I'd say we're all that excited about it as a big opportunity. But as part of being complete in our offerings, it makes sense.

Q

Okay. Internationally, I guess, in the past few – or at least a couple of years ago, you had talked about a 50 basis point annual drag on ROE from low interest rates. Interest rates at least in the U.S. are up, and part of your portfolio is U.S. based in Japan. So, has that drag less than that all at this point?

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

A

In a very broad sense the answer is, no. In Japan, since we said that, rates went down even more and have come back up a bit. But we, still as a result of just purely sort of reinvestment of enforce, are subject to the impact of lower rates versus the rate on what's rolling off. And so, maybe there's a nuance, but not a big thing.

Q

Okay. And then just some – maybe can you help us think about kind of the overall growth picture internationally? I think earnings generally have been growing in the low-to-mid single digits, is that still the right way to think about that business and its growth potential?

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

A

In the short-term, yes, the dominant influence on our international results and a big influence on overall Prudential is Japan, and that's become big. It's harder and harder to grow very much at the margin. But the intrinsic growth in the business is in that low- to mid-single-digit range. And so, that does dominate what happens to us on the international side.

However, things are coming online. In Brazil, we're executing extremely well. It's like Japan in the sense that it's very much bottoms-up driven, and so I think we'll see that and start to talk about it more and more. I mentioned other places where we are like China and India and some of those initiatives for growth, which will come online over the coming years. In the short-term, heavily dominated by Japan and what that growth rate looks like. But again, things coming online that will start to kick in and I think make that growth rate look better.

Q

And this is a bit more of an industry question, but FASB finally has approved the new framework for [indiscernible] (30:08) concerns accounting that will go into effect into 2021. I guess, how do you think about this new framework and how it might impact the industry?

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

A

Well, we sat among the leaders on the resistance front and have nothing crazy about some of the provisions. I guess, I'd make three comments. One is that it's going to play out over time. So, this is down the road. It's not something that's going to be in front of us tomorrow.

However, having said that, the second point is that there are some issues around the volatility that some of these approaches create. And in fairness, there's a mixed bag. Some things are simpler and better. Other things are not. But as it plays out, it may become more volatile and create a need for more explanations and maybe what would it have looked like if it hadn't changed.

But then the third thing is, we're still working on it. It's work in process for the industry and so, we're going to continue to work with our industry colleagues on exactly how this gets interpreted and what it means and how it's used. It would be safe to say, we're not crazy about it, but we're going to work on it as it plays out over time and see.

Q

Got it. Are there any questions in the audience? All right. I had one last one which was just, how do you think about the M&A environment at this point? You've typically done deals in the opposite of this environment, I guess more in depressed environments. So, how are you thinking about things right now?

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

A

Well, we think about it the way you just described. We're better opportunistically. We're not very good if an investment bank is running an auction for an insurance company in Vietnam. There are going to be a lot of buyers, it's going to be very well priced. And sometimes, we even tried to talk ourselves into bidding more, and we can't bring ourselves to do it. So, we tend to gravitate towards being a value buyer.

And we're a good buyer in a distressed situation. When there's a motivated seller, when the deal is complicated and hard, when certainty of close matters, then we're a good buyer. We pay a fair price, but we pay a price that reflects the value we bring as a result of dealing with challenges, complexity and certainty of execution. So, this is not a great environment for us to be looking for deals. Your take on that is exactly right.

Unverified Participant

All right. We're going to wrap it up there. Thanks a lot, Mark, for participating. Appreciate it.

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

Thank you. Thank you, all.