06-Dec-2018

Prudential Financial, Inc. (PRU)

Q4 2019 Guidance Call

CORPORATE PARTICIPANTS

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

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

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

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

Stephen P. Pelletier
Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.

OTHER PARTICIPANTS

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

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Thomas Gallagher
Analyst, Evercore Group LLC

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

MANAGEMENT DISCUSSION SECTION

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

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

Darin Arita

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

Thank you, Cynthia. Good morning and thank you for joining our 2019 financial outlook conference call. Please find our presentation for today's call on our website at www.investor.prudential.com. Representing Prudential on today's call are Charlie Lowrey, CEO; Rob Falzon, Vice Chairman; Steve Pelletier, Head of Domestic Businesses; Scott Sleyster, Head of International Businesses; Ken Tanji, Chief Financial Officer; and Bob Axel, Principal Accounting Officer. We will start with prepared remarks by Charlie and Rob, and then we will take your questions.

Today's presentation includes forward-looking statements. It is possible that actual results may differ materially from the predictions we make today. In addition, this presentation includes references to non-GAAP measures. The slide deck includes a reconciliation of such measures to the comparable GAAP measure and a discussion of factors that could cause actual results to differ materially from those in the forward-looking statements.

And with that, I will hand it over to Charlie.

Charlie F. Lowrey

Chief Executive Officer, Prudential Financial, Inc.

Thank you, Darin, and thank you all again for joining us this morning. This is an exciting moment for Prudential and for Rob, myself and our entire leadership team as we look forward to building upon the consistent strategy, strong track record of execution and robust financial profile cultivated by John and our prior management team, while simultaneously seizing new opportunities to grow our business and operate with greater speed and efficiency. In addition, we remain intensely focused on talent, culture, and execution, as well as technology to generate sustainable long-term positive performance and outcomes for our shareholders.

Turning to slide 2, as you will hear more about from Rob in a few moments, we are well positioned for the future, and our outlook for 2019 and beyond is positive, supported by the strength of our businesses. Our differentiated mix of market-leading businesses complement each other to provide competitive advantages.

By working so closely together, our businesses have a higher growth potential due to greater earnings diversification, increased capital benefits from a balanced risk profile, and providing our customers with integrated cross-business solutions.

Our track record of execution is evidenced by significant growth in earnings and book value per share, an attractive return on equity, and strong cash flow. In addition, we continue to invest in our businesses, especially in Financial Wellness, to enhance our long-term growth prospects.

And finally, our strong financial profile positions us well to respond to opportunities that might emerge. We have historically benefited from turns in the credit cycle, and we are even stronger today than we were going into the last downturn. We have a conservatively positioned investment portfolio and a well-capitalized balance sheet with significant financial flexibility.

Turning to slide 3, we are also well positioned to meet the needs of customers and tap into significant market opportunities with our capabilities in offering protection, retirement, and investment management solutions through our U.S. Financial Wellness businesses, our International business, and PGIM, our investment management business.

U.S. Financial Wellness represents our workplace solutions and individual solutions businesses. We see a tremendous opportunity to address the evolving needs of individual customers, workplace clients, and frankly society at large through our increasingly important financial wellness solutions.

We have the key components to do this successfully, including a workplace platform covering 20 million individuals; individual solutions to cover protection, retirement, savings, income, and investment needs; and a customer-centric approach with different ways to engage with our clients through multiple channels such as meeting with one of our financial advisers, calling or Skype-ing with an adviser, or interacting with us in a purely digital manner. Our goal is to meet our customers' needs when, where, and how they want.

By leveraging technology and our scale, we can significantly expand the addressable market, build deeper and longer-lasting relationships with customers and clients, and make a meaningful difference in the financial wellness of their lives.

Our International business includes our world-class Japanese life insurance operation and investments in high-growth markets with large populations such as Brazil, India, Indonesia, and China. We approach these markets in a differentiated way, and that has led to steady growth, attractive returns, and significant capital generation.

PGIM has also produced differentiated outcomes with strong investment performance that has led to consistently positive annual net institutional flows over the past 15 years. In addition to providing solutions for its third-party clients, PGIM provides our U.S. Financial Wellness and International businesses with a competitive advantage through its investment expertise across a broad array of asset classes, including specialty classes such as real estate, private placements, and commercial mortgages.

In summary, we feel confident about our prospects for the future and an outlook that is supported by our integrated and complementary businesses.

Turning to slide 4, we've generated strong financial returns to our shareholders by way of growth in earnings per share, book value per share, and return on equity over the past five years. This has resulted in significant capital generation, and we've deployed that capital by increasing dividends and share repurchases and reducing leverage. We've achieved all this while investing in our businesses. In addition, we continue to invest in growth opportunities within and across our businesses, including Financial Wellness and digital, data and mobile capabilities.

The near-term growth associated with our 2019 EPS guidance reflects market factors as Rob will discuss, but also our conscious decision to invest for the long-term sustainable growth. We track very closely the investments we are making and the associated return on those investments by means of improved operating metrics, and we're already beginning to see benefits. And let me briefly outline four as examples.

First, since the launch of our Financial Wellness capabilities in 2015, we have experienced about $6 billion of full service retirement plan sales, and over $100 million in group insurance case wins that we can specifically attribute to this initiative.

Second, our Prudential Pathways program has been adopted by over 400 employers, representing more than 4 million employees. Third, in the third quarter of this year, we launched LINK by Prudential, an online experience that helps customers connect to solutions and financial professionals to help them achieve their financial goals, and we've seen good initial interest in and adoption of the platform by those customers. And PGIM's expanding global distribution capabilities have significantly increased the net flows of our investment management business.

Over the intermediate term, we expect to generate high-single-digit EPS growth, reflecting growth in the businesses, capital deployment and some lift from market factors, and we believe that the benefits from the investments we're making can accelerate this growth rate into the low-double-digits over this period. We will provide more detail about these initiatives focused on product development, distribution and technology as well as the specific operating metrics that we track during our Investor Day in June of next year. You could consider this a mid-year check in, if you will, on the progress we are making and we look forward to that opportunity.

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

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Thank you, Charlie. Turning to slide 5, our financial targets and expectations reflect an attractive return on equity, meaningful free cash flow and solid capitalization. As Charlie mentioned, we expect to achieve these targets while investing in the business for long-term growth and increasing capital returns to shareholders.

Here are the key changes from a year ago. We expect our return on equity to be at the high end of our 12% to 13% near-to-intermediate term target. We now target in RBC ratio above 375% versus 400% for Prudential Insurance Company of America or PICA. This reflects the effective tax reform on the regulatory capital formulas and intention to hold more of our excess capital at the parent company.

As we noted on our third quarter earnings call, our targeted operating range for cash and liquid assets of the parent company is $3 billion to $5 billion. The low end of the range is equal to approximately 2 times our annual fixed charge coverages – fixed charges. And finally yesterday, our board approved a 33% increase in the share repurchase authorization for 2019 to $2 billion.

Turning to slide 6, we expect our 2019 earnings per share to be in the range of $12.50 to $13 a share. To develop a pro forma baseline earnings level for 2018, we start with reported results, excluding notable items. For the nine months ended September 30, 2018, this totaled $9.55 a share. We then added a bridge to the baseline to get to about $12.35 a share. The bridge to the baseline reflects the following items. Our third quarter results, excluding notable items, and an adjustment for elevated fourth quarter expenses that are expected to be at the high end of $125 million to $175 million typical range. This should not be viewed as a projection of our full-year results, rather we presented as a useful frame of reference for our 2019 guidance.

The key assumptions to support our 2019 guidance are included in the appendix. However, I will address the market factors as these are a net headwind to EPS growth for 2019. Our guidance is based on an assumed year-end 2018 S&P 500 level of 2,700. Appreciation in the market is assumed to be 4% during 2019, consistent with our actuarial assumptions. As a result, the daily average S&P level for 2019 is actually about flat from 2018. You can see this on the assumptions slide on page 13 in the appendix.

While the majority of our separate account equity investments are tied to the S&P 500, a significant portion, particularly in our annuities separate accounts, are tied to the Russell 2000 and EAFE indices. We also assume a 4% market appreciation for these indices in 2019, which results in daily averages for 2019 that are lower than in 2018 by about 4% for the Russell and about 6% for EAFE. As a result, equity market performance is assumed to have a modest negative impact on fee income in 2019 when compared to 2018.

In addition, we assumed lower than usual non-coupon income in 2019 as a result of the lag effect from the equity market decline in the fourth quarter of 2018 on private equity investments. The combined impact of equity markets on fee income and non-coupon income is about $0.25 per share.

While the headwinds from interest rates are diminishing, particularly in the U.S., continued low interest rates have a modest negative impact on 2019 earnings compared to 2018, partially offsetting these items is a benefit from the hedged rate for the yen going from ¥111 to ¥105.

For benchmarking purposes, we have also provided an EPS guidance range, which reflects an alternate equity market assumption that is more consistent with the average expectation in analyst earnings models. Using this assumption, which reflects a year-end 2018 S&P 500 level of 2,800 and a 6% market appreciation in 2019, would result in an estimated EPS range for 2019 of $12.75 to $13.25 a share, or an increase of $0.25 a share to our guidance range.

We've also included earning sensitivities to key market factors. You should note that we have added a sensitivity of non-coupon investments to the equity market. This item represents a one-time EPS effect based on the mark-to-market impact rather than a change to the run rate level of earnings. I would like to caution that these sensitivities are not necessarily linear nor entirely symmetrical and should not be extrapolated over more severe shock levels in either direction. That said, we believe these sensitivities, along with the business level sensitivities contained in the appendix, provide a useful frame of reference for some of the key assumptions that affect our results.

Turning to slide 7, our strong financial profile positions us to perform well and capture opportunities that typically emerge from a turn in the credit cycle. We have a high quality and broadly diversified investment portfolio that benefits from PGIM's strong investment management capabilities and multi-manager platform. We also have a well-capitalized balance sheet with significant financial flexibility, including low financial and credit asset leverage, and significant liquidity that can be used opportunistically. More details on our credit asset leverage can be found in the appendix.

Historically, the mix, stability and operating strength of our businesses, combined with our financial strength and flexibility, have allowed us to benefit from turns in a credit cycle, including acquiring businesses at attractive valuations, acquiring talent and capabilities and investing at attractive returns. We also experienced an increase in demand for our offerings of guaranteed financial outcomes involved to markets.

To conclude, our complementary mix of high-quality market-leading businesses provides differentiated advantages. We have a long-term track record of delivering solid financial results, and our strong business and financial profile positions us well to support growth, demonstrate resilience, and seize opportunities.

Now, I will turn it back to the operator to take the questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question will come from the line of Ryan Krueger. Your line is open.

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

Q

Hi. Thanks. Good morning. Could you discuss any portfolio de-risking actions you've been taking to prepare for a potential cycle? And then also, if any – if you could make any comments on kind of how you view your portfolio today, maybe in comparison to going into the last cycle?

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

A

Sure, Ryan. It's Rob. So, I think we have a heightened depreciation for potential of a credit cycle, although I would add that, that view is not unanimous across our various investment managers that we have in the PGIM portfolio of Asset Management. Our views reflected in the positioning of the portfolio, it's – and that portfolio begins as being typically more defensively postured in any event when we look at it sort of vis-à-vis the benchmarks for the industry.

Government bonds are about 35% of the general account and actually about 45% of fixed maturities and the below-investment grade portfolio [ph] is at (00:17:48) little over 4% of the portfolio and 60% of that below-investment grade portfolio is actually in private placements, which benefit from covenant protection and the track record of better performance than comparable publics.

From a bond weighting standpoint, what you would see is we are underweight in energy, finance and telecom. And from an overweight standpoint, we're overweight in the consumer noncyclicals, utilities and transportation. And then if you look at the commercial mortgage portfolio, what you would see is that it is similarly underweight sort of more cyclical areas like office and retail, and overweight in multi-family and industrial, industrial being a warehouse and distribution.

When we look at that portfolio and the composition of it, to answer the question about the comparison to sort of prior to the last cycle, Ryan, what I would say is we have advanced our risk management infrastructure around our portfolio such that you would find that there's probably deeper diversification, not only from an industry standpoint but also from an underlying security standpoint and also with respect to the concentrations [ph] you have – (00:18:59) otherwise have in different types of structured securities. So, generally, very consistent with how we've always managed the portfolio, but more diversified deeper into the asset classes and individual securities.

I made a mention in my opening remarks about the credit leverage analysis that's in the appendix, so I'll just sort of point that out again. They contrast our efforts – our asset leverage to credit leverage. We think credit leverage is a sort of more relevant way to think about the risk of the portfolio or the risk of the overall balance sheet. And when you look through that lens, we believe we compare quite well to the industry when it comes to sort of the relative amount of credit leverage that we have.

And probably the last thing I mention is, as we think about this, again consistent with our opening remarks, we're really not staying up at night worrying about the cycle. When we look at the quality of that portfolio that I just described, the strength and flexibility of the balance sheet that we have, as we talked about, the quality and mix of the business that we had and importantly the level of free cash flow that those businesses throw out, we think that positions us so that we can expect to have a relatively strong performance through any credit cycle. And in fact we'll have the flexibility to be opportunistic as we've been in the past.

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

Thank you. And then, my follow up is on – was actually on free cash flow. Would you – as in credit losses, would you expect that 65% conversion to hold up in most down market scenarios based on your VA hedging program?

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

Yeah. Hi, Ryan; this is Ken. Yeah, our VA program, both the hedging program and the capital framework, are actually very much designed to withstand market stress. As an example, our year-to-date hedging program even in the recent markets has performed very well. Hedge effectiveness through year-to-date is 99% and that includes through last Tuesday.

And our Annuities business is capitalized to absorb market stress as well with capital that's well above what's emerging as the new standard as CTE(98), so that capital in excess of CTE(98) is actually there to absorb market volatility with no need to contribute any more capital or stop cash flow. So we feel pretty good about the resilience of cash flow and Annuities business.

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

Thanks a lot.

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

Jimmy Bhullar, your line is open.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC
Q

Hi. Good morning. First, just – I'm not sure if you've disclosed what your CLO exposure is, if you could just give us an idea of the amount and just the make-up of it.

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

Jimmy, it's Rob. It's about a $7 billion portfolio. It's entirely consisted of AAA-rated securities. And the point that we've made in that is that our analysis that we do on that – in CLO goes beyond just the ratings that are there. We actually look at the underlying securities within the structure and look at the pass-through leverage. So we've been very selective even within the AAA category of which securities or securitizations we participate in.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC
Q

And then, on share buybacks, I think the way you're presenting it, you're just showing it as an authorization. Is it fair to assume that that's what you intend to do, all those sort of in a normal environment next year?

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

A

Yeah. Hi, Jimmy. It's Ken again. Yeah, we feel real good about our capital position. Our regulatory ratio is above our AA objectives, leverage better than our targets, and as Rob mentioned with highly liquid assets at $5 billion at the holding company. So, overall when we put that together, we believe the increase in the share repurchase program made sense.

And you can think of it as very consistent with our capital management philosophy of increasing shareholder distributions as our business grows. And share repurchases will be a little more variable depending on our capital position, but will be sort of a regular way that we will distribute capital. But as opportunities for capital deployment such as M&A will – arise, we'll take that into consideration.

Dividends, you can expect to be more aligned with sustainable earnings and free cash flow growth. So, very much consistent with the way we've done things. We think it's well understood and has worked well for us.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

And then, just lastly on expenses, I guess, partly they're elevated because you are spending on technology. Should we assume that technology spending is going to be fairly high for the next several years? And when do you get to a point when the benefits sort of start to offset the incremental expenses where you actually overall see more of a benefit on your financials as opposed to spending being a drag?

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

A

Well, let me take a first shot. It's Rob. And so, let me take a first shot at that and then Steve would like to jump in to add any additional color. He may want to do that at the end as well. I would first point out that actually if you look at our trend of expenses over a long period of time, to me what you would find is – actually we've had very controlled growth and expense. And we've done that while we've actually been growing the level of investments that we've been making in our business platform in the form of our financial wealth platform, in our digital data and technology capabilities, all of which we think form the foundation for enhancing our long-term sustainable growth potential. You actually haven't seen much of that show up in our expense growth because the earlier investments that we've been making have already begun to pay off. And the returns on those investments are essentially subsidizing or paying for the new investments we're making in our ongoing initiatives.

So, we don't expect at this point that we're looking to throttle that down in any way. We actually think that we're at a level of expense that is very manageable and appropriate to the business and, as I said, positioning us well for long-term growth.

Stephen P. Pelletier
Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.

A

Jimmy, this is Steve. I'll follow up on what Rob said. And point out that we really already are realizing the benefit of a lot of the investments that we've been making in the business.

First of all, in the results of PGIM, which have been very, very strong of late, we see the benefit of investments we've made in – across the business, particularly in distribution and in strengthening our capabilities in different asset classes, and in fact expanding some of the asset classes in which we operate such as a recent acquisition we made in the [indiscernible] (00:26:11) – relatively modest sized acquisition we made in the managed futures space in our in our QMA business. That's just the type of opportunity we're looking for where we're able to leverage our distribution onto the capabilities of a relatively small asset manager that we might acquire.

I also think that the financial wellness capabilities we're building are already driving results at an employer level. Charlie referenced the fact about accelerated sales that we've seen in full service retirement and in group insurance over the last couple of years that are directly attributable to our financial wellness efforts.

Now, over time, we expect to see the earnings emerge from our deeper engagement with individuals who come to us via the financial wellness platform, individuals who come to us primarily through the workplace but also directly. Those earnings will take time to develop but we are already seeing very, very positive engagement metrics as we build that platform.

Charlie mentioned, for example, in his opening comments that the Pathways platform and that's the program whereby our financial advisors offer education and planning seminars to the employees of our group and retirement corporate clients. That currently covers 400 employers who collectively employ 4 million individuals. But it's interesting to see, and this is what I mean by these leading indicators that of the people who participate in the Pathways seminar, 25% of them request a follow-on appointment with the financial advisor.

And of those individuals, 20% of them eventually become a fully advised and paying customer. So that's a very robust conversion rate, if you will, and that gives us confidence that, like I say, while the individual earnings will take place – will take time to develop, we think they're going to be a significant driver together with our employer-based success and that impact will be material in terms of picking up the growth rate in our U.S. business earnings.

Jamminder Singh Bhullar
Analyst, JPMorgan Securities LLC

Q

Thank you.

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

Thomas Gallagher
Analyst, Evercore Group LLC

Q

Good morning. The 375% RBC guidance on PICA for 2019, is that your new view of required capital post tax reform versus the old 400%? And can you talk through some of the moving pieces there because I know that obviously the tax reform negatively impacts it, but I think you also contributed $500 million to that sub in 3Q.

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

A

Yeah, hi. It's Ken. Let me give a little background on our decision to adjust our RBC ratio target. First, I just want to mention that we're well positioned to maintain PICA's RBC ratio above 400% if that's what we wanted to do. We made the $500 million capital contributions in PICA in September, and that's in anticipation of the NAIC increasing its risk-based capital factors due to tax reform.

I just also remind that – we've said this a number of times, so we have $5 billion of highly liquid assets at the parent company which gives us a lot of flexibility. But after discussion with our rating agencies and our regulators, we think making a modest adjustment to our RBC ratio target makes sense for a number of reasons. First, a lower corporate tax rate in the U.S. improves our overall profitability and cash flow and generally improves our financial strength. And it also substantially increases the after-tax value of deferred profits that we hold in our reserves, and that's a real meaningful source – a loss absorption resource that isn't reflected in the RBC ratio.

On the other hand, the NAIC is increasing its risk factors. And when we put that all together, we think it's appropriate to slightly reduce the RBC ratio target that recognizes the improved profitability and the increase in regulatory capital albeit at a lower RBC ratio.

And the other second consideration is, now that we have all of our variable – nearly all of our variable annuity business now resides in Prudential Annuities Life Assurance Company, or what we call PALAC. And as we discussed, PALAC is very well capitalized, well in excess of the proposed new standards, and well above an RBC ratio of 400%.

So, when you combine both PICA and PALAC, we'll have a combined RBC ratio again that's well in excess of 400%, both consistent with our AA objectives and consistent with the discussions we've had with our rating agencies and our regulators. And again, we're holding now more highly liquid assets at the holding company, which improves the overall group's capital flexibility. So those are the moving parts in our thinking.

Thomas Gallagher
Analyst, Evercore Group LLC
Q

That's helpful, Ken. And just a follow-up, so PALAC, I believe, at an RBC of north of 1,000% at the end of 2017, and I know there's going to be some meaningful changes from VA reform. Any sense for where that RBC is going to shake out after factoring in the impact of VA reform?

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

Yeah. It's still in motion and I don't think it's quite settled in terms of where all the specifics will land on the reform. But the main components are pretty well understood, and we think again will be well in excess of 400%. And it will be a more meaningful ratio now that it's calibrated to a CTE(98) level.

Thomas Gallagher
Analyst, Evercore Group LLC
Q

Okay. Thanks.

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

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC
Q

Good morning. Thank you for taking my questions. Looking at the corporate losses guidance, you talked about $1.3 billion for 2019. I think that may be a little lower than what have been talked about in the past of roughly $375 million a quarter on average. I was just wondering based on your comments about a little higher expenses related to technology and everything like how do we reconcile the $1.3 billion guidance versus kind of historical in the past.

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

Humphrey, it's Rob. So, on a net basis, we're seeing lower expenses in corporate and other. Even net of – the portion of the initiative spending that's contained, they understand that our initiative spending is both within the businesses and the corporate and other, and substantial amount of this is actually down in the businesses. While there are numerous sources of sort of that reduction in expenses, probably the one thing I want to call out is what you are seeing is the benefit of our dedesignation as a SIFI, and therefore the reduced amount of spending that we need to make with regard to that designation and enhanced supervision.

Humphrey Hung Fai Lee Q
Analyst, Dowling & Partners Securities LLC

Got it. And then, I guess, since you're probably holding a little more asset in the holding company as opposed to in the insurance entity that may help from investment income perspective?

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

Yeah, a little bit, but I wouldn't call that as a material driver.

Humphrey Hung Fai Lee Q
Analyst, Dowling & Partners Securities LLC

Okay. Got it. And then, I think, in the appendix, you talked about for PGIM, you're looking at other related revenue kind of $175 million to $250 million net of expenses. How should I reconcile that kind of compared to what we show in the supplement? I think, in the supplement, it shows on a gross basis based on revenue. How do I reconcile the guidance, the expectation versus kind of what's in the model?

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

The number that you're speaking about, Humphrey, it's a little bit apples to oranges. One is, as you say, a gross number, and the other is net of expenses. But I will emphasize that we don't really look at other related revenue as so much a trendable number that really has an inherent run rate. A lot of the numbers that we've communicated and continue to communicate are more by way of kind of our expectation, our experience, or our expectation of kind of the mathematical averages.

To the extent, we're seeing growth in the net number. It reflects a variety of factors, in particular anticipated growth in our agency business. But to fundamentally get at the point you're making, I just point out that one number is gross, the other is net of expenses.

Humphrey Hung Fai Lee Q
Analyst, Dowling & Partners Securities LLC

[indiscernible] (00:36:07) what you think about [indiscernible] (00:36:10) for this year kind of year-to-date, like what would that be on a net basis?

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

Humphrey, it's Rob. We can follow up with you and get to that specific number. I know we gave the third quarter number. I don't know off the top of my head what the cumulative number is through for the full year. But what we provide every quarter is quarterly results and then we give you sort of a trailing multi-quarter multi-year number that compare that against.

The number that we have incorporated in guidance is not strictly a mathematical formula of averages, it's looking at where our historical experience has been with some judgment put on that with respect to expectations on a go-forward basis. But Darin and his team can follow up with you to give you the cumulative number.

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 Suneet Kamath. Your line is open.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. I want to go back to Charlie's comment about the long-term growth potential of the franchise. And I think he said, high-single digit near-term and then eventually low-double-digit in terms of EPS, but I think some of those are struggling even to get to the high-single-digit EPS. At least that doesn't seem to be what's built in the consensus. So can you unpack that a little bit in terms of where the growth is coming from maybe international versus PGIM versus U.S., just give some high level commentary there would be helpful.

Stephen P. Pelletier
Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.

A

Suneet, it's Steve. I can address your question. And Charlie's comments were grounded in EPS, my comments that I'm about to make will be grounded more in AOI growth. We see near and intermediate term growth expectations for the U.S. businesses' earnings growth expectation to be in the mid-single-digits.

The primary growth opportunities that we see in that the near to intermediate term are consistent with what we've communicated in the recent past as being our most significant growth opportunities. And that represents PGIM and our Pension Risk Transfer business.

Let me talk a little bit about each. In PGIM, Charlie referenced 15 consecutive years of positive institutional net flows. I think it's fair to say that we're closing in pretty tight on making that 16 years. And we continue to feel very, very positive about our ability to continue that really extraordinary type of achievement. The reason I say that is because of the range of opportunities that we can access in our multi-manager platform. We do business on both the institutional and on the retail front. We do business across publics and privates and a range of asset classes in each. We are able to source client dollars both domestically and globally with the latter being a significant contributor to our recent growth. So, as I say, especially in the institutional market, the business comes in chunks. So there will be variability – inherent variability quarter to quarter. But on an annual basis and on a year-in, year-out basis, we feel very positive about our ability to continue to source flows.

On an average fee basis, as we've communicated in the past, we feel our platform has been quite resilient on that front and we've been able to sustain average fees across the entire platform at about 22 basis points. That's not to say that we're immune from secular fee pressure. We do encounter it in some parts of the business, but we're able to offset that by drawing flows into higher yielding strategies and thereby sustaining that average across the platform. And we expect to continue to be able to do that.

On the Pension Risk Transfer front, we feel that the pipeline, as I discussed on the third quarter earnings call, is really as strong as it's ever been and has every prospect of continuing to be that way. Obviously, that could have some impact on capital markets and particularly, the level of interest rates and what that might mean for funding levels. But nonetheless, as I say, our outlook on the pipeline is very, very strong, as is our ability to compete within that pipeline.

Our strengths in terms of our focus, not exclusive focus, but our primary focus on large [ph] case (00:41:06) business, our ability to bring that business to a successful close, our ability to successfully onboard the assets that come with large [ph] case (00:41:20) business and our ability to onboard the clients who come to us and provide them great service. So, all of those factors enable us to compete successfully.

As an example of that, we've communicated before that our annual runoff in this business and PRT is about $3 billion on the funded PRT side and about $1 billion on the longevity reinsurance. Our planning assumption and our actuals for the past several years have been that we should be able to generate sales that are meaningfully in excess of that runoff, and we have every expectation that that will continue.

Some more recent data, our year-to-date sales in Pension Risk Transfer and including some transactions that have been announced here in the fourth quarter is $5.5 billion in funded business and $6.5 billion in longevity reinsurance.

In the fourth quarter so far – of that number in the fourth quarter so far, we've written $2.1 billion in funded business and $3.2 billion in longevity reinsurance. And again, that's business that has been announced either by ourselves or by the counterparty. So all of that gives us, like I say, great confidence that we'd be able to continue to achieve success in the growth of that business.

So that's for the near to intermediate term. Over the longer term, we feel that the increasing results from our Financial Wellness investments and our financial wellness value proposition will enable us to pick up that growth rate from the mid-single digits to the mid to upper-single digits, along just the ways that I expected, the acceleration of our results with employers and the increasing – gradually increasing visibility of our results with individuals.

Charlie F. Lowrey
Chief Executive Officer, Prudential Financial, Inc.
A

And, Suneet, this is Charlie. Let me just pick up on this part of the question for International. At the Investor Day we held in Japan, we said that the growth rate for international would be 4% to 5% on a core basis. You haven't seen that in the past few years just because of the headwinds that have been there, certainly, the FX headwinds and interest rate headwinds. But when you look at the core business and the growth of the book, the existing book in the business, which grows every year and add on to that the sales, you get a consistent kind of mid-single digits return.

This year, we also disclosed in the third quarter call that there's a bit of a tailwind from FX as opposed to headwinds in your past, because we hedged at the [ph] $1.05 level versus $1.11 (00:44:21) before. There's still a modest headwind from interest rate – from reinvestment given the interest rates, but that's becoming more modest as we go. So on the international side, think about sort of a mid-single digits return.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.
Q

Got it. That's helpful. And then, maybe just a quick one for Steve on PRT. So [ph] you (00:44:46) saw this week a pretty large deal that did include some active lives. So, the question is, I think historically you've avoided that part of the market, at least, on the jumbo case side. So is that something that you're interested in pursuing? And is it something where you have to take on that kind of business in order to get some of these jumbos going forward? Do you see that as a potential outcome for this PRT business?

Stephen P. Pelletier
Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.

A

Suneet, that's a good question. Obviously, without commenting on an individual transaction, I would say that we have written deferred lives. We think that's a necessary part of the business, but we've been able to keep that to a very, very, very modest level. And we expect that to continue. We feel that we can continue to be successful in the business while maintaining our focus, not exclusivity, but our focus on retirees. And any deferred lives that we do take on, we don't feel will impact the overall risk profile of our in-force [indiscernible] (00:45:56). The average age of the individuals in our PRT business is about 74 years of age. And we would look to be able to maintain those in-force risk characteristics in any business we take on, including business with modest levels of deferred lives.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks.

Operator: Thank you. Our next question comes from the line of Alex Scott. Your line is open.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thanks for taking the question. The first one I had was just on capital deployment. I mean you gave a guide for how we should think about cash flow, 65%. Can you give us a feel for how much capital you're deploying into the volume growth though, because it sounds like there's a fair amount of momentum that you're expecting there? I'd just be curious how much you're sort of planning on putting behind that new business growth.

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

A

Yes. Hi. This is Ken. First, we feel really good about the diverse sources of cash flow that we have coming to the holding company and that's driven by our business mix. Our businesses are profitable and generating capital sufficient to support their growth and including the investments to build capabilities. Some businesses need to retain a portion of their capital to support their growth, and those businesses would be our life insurance businesses and retirement, including the growth in Pension Risk Transfer that that Steve just described. But we also have businesses that have very strong and stable cash flow. Steve described a lot of growth in our [ph] PGM (00:47:45) business, but that's a fee-based business that provides a high rate of cash flow, and we're getting cash flow from that business each quarter.

Also, our variable annuity business has very strong profitability and a stable capital profile that I described and that also has generated a high rate of cash flow. And again, we're getting cash flow from that business each quarter. And our International insurance business has also been a very stable source of cash flow. So overall, when we put that all together, we think 65% is about the right cash flow profile to expect. Given our mix of business and our growth opportunities, that might vary a little bit period to period, but over time, we think 65% is about right.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Okay. And the second question I had is just on CLOs, I know you already talked a bit about general account exposure to it .I guess, I'd just be interested in the exposure you have, I guess, in the fees within [ph] PGM and I think sometimes those (00:48:52) fees could potentially be impacted by weaker credit markets. So I'd be interested to know like how that could occur, like are we anywhere close to that or would it – or are we still kind of farther away from any impact there?

Stephen P. Pelletier
Executive Vice President and Chief Operating Officer, U.S. Businesses, Prudential Financial, Inc.

A

Alex, it's Steve. I'll address that part of your question. I think that – while there's some aspect of that in our overall business profile, I think it's pretty manageable level in terms of our overall asset base and our fees. So, certainly, the PGIM business has some degree of exposure to market conditions as it relates to impact of those market conditions on our asset levels and therefore our fees, but we think the particular aspect that you're targeting is a pretty manageable portion of our overall business.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

All right. Thank you.

Operator: Thank you. And our next question will come from the line of Andrew Kligerman. Your line is open.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Hey. Good morning. I'm looking at your ROE guidance, higher end of 12% to 13%, which was pretty much where it was last year, but this year you've performed at about 13.5% plus. And if I look at the midpoint of your guidance, I still get 13% plus. So, one, I'd like to – maybe you could reconcile that guidance for us?

And secondly, historically, you've talked about a 50-basis point ROE decline per year over the next few years and I think that related to international pressures, could you give a little color on that and tie that in?

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

A

Andrew, it's Rob. Sure. So on the first part of your question, I think your math is all directionally correct. At this point, we're not ready to sort of change our guidance around the 12% to 13% we've been asked the question sort of when and under what conditions, and I think the answer has been, while our performance continues to have a bias towards the upper end of that range, we'd like to see a sustained longer period of time of higher interest rates, which has been the principal headwind toward reestablishing the 13% to 14% that we previously had in place or that we believe is sort of the longer-term natural rate of ROE for the mix of businesses that we have.

And so I would just reiterate that that's we're in the sort of the same position. Performance continues to be at the high end of that specified range, but interest rates are jumping around, as you've seen just in the last day or two, by way of example, and so we're not yet prepared to commit to a higher level from a guidance standpoint.

Secondly, with respect to the 50 basis points, we did talk a little bit about that in Tokyo Investor Day, and that was guidance we gave a couple of years ago, when we saw that as the portfolio – as we were reinvesting free cash flows and looking at some level of reinvestment in the portfolio, that we expected that the returns in Japan would come down. They have. So you saw a business that was generating ROEs that were in the 20s to a business that's now generating an ROE that's about 18% or so.

We believe now that given there's been a large – largely that phenomena is behind us, and while we still have some gap, it's not a large – as that gap converges, it's not a large enough delta that it's putting pressure on our ROE. And so, we believe within Japan we'll continue to be able to sustain an 18% ROE in the business. And that 50-basis point guidance that we had given a couple of years ago was appropriate for the last two or so years and is no longer appropriate to how we think about our ROE in that business going forward.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. Thank you. And then just with regard to the Corporate & Other line, your $1.3 billion guidance. Just looking to the fourth quarter, typically, we'd see a lift up in the fourth quarters due to deferred compensation and it would usually be pretty significant. And if I recall correctly, it would be tied to the stock price, unfortunately for PRU and the entire [ph] Life Group (00:53:27), stock prices have not done so well. Looking to the fourth quarter, do we see a number that's in the 300-ish range? And same thing with the fourth quarter of next year, maybe your $1.3 billion guidance for Corporate & Other losses might be a little too heavy if the market keeps acting like it does, so maybe a little commentary about that.

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

A

Yeah. So, obviously, Corporate & Other does service a partial hedge against declining markets and that we have certain expense items, which are sort of inversely linked to the markets. Net-net, I want to make clear that's not a good thing for the business and...

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

No. No.

Robert Michael Falzon
Vice Chairman, Prudential Financial, Inc.

A

...we favor a condition of appreciating markets. So, yeah, there's – we factored in the 2,700 S&P 500, Andrew, into the guidance that we provided that we expect in the fourth quarter that $125 million to $175 million you see of sort of higher level of expenses in the fourth quarter will be at the higher end of that. So, we have things going both ways in the quarter and – but nonetheless even with a lower equity market and our stock included as a component of that, we expect to be at the higher end of the $125 million to $175 million for this year. And then going forward next year, the assumption embedded in there is that equity market returns are at the 4%. And so, you'd have a very different outcome during the course of 2019 than what we might be seeing embedded in the fourth quarter.

Andrew Kligerman
Analyst, Credit Suisse Securities (USA) LLC

Q

I see. Thanks a lot.

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

Charlie F. Lowrey

Chief Executive Officer, Prudential Financial, Inc.

Thank you. I just have a few final thoughts. We're excited about how our businesses can collectively make a meaningful difference in our customers' financial lives and deliver long-term value. As we look forward, we are confident in our strategies and our carefully chosen mix of high-quality complementary businesses. We have a proven ability to execute and we have talented employees with a purpose-driven culture. As a result, we will meet the changing needs of our customers, and by doing so, can deliver attractive returns to our shareholders.

Thank you for your interest in Prudential and for joining the call today. I wish you all a great holiday season and look forward to reconnecting in 2019. Have a good day.

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