## Prudential Financial

After some good feedback on recent insights into our stock selection process, I thought I'd share our thinking about another one - Prudential Financial.

A diversified financial services business started in 1875, Prudential is the largest insurance provider in the US, one of the largest asset management businesses globally as well as having significant operations in Japan. Assets exceed $900 billion and funds under management are over $1.3 trillion.

Notwithstanding its size in the US, half of its income is from foreign operations driven in large part from its Japanese division where it has successfully navigated low interest rates and derives a consistent mid-teen return on equity.

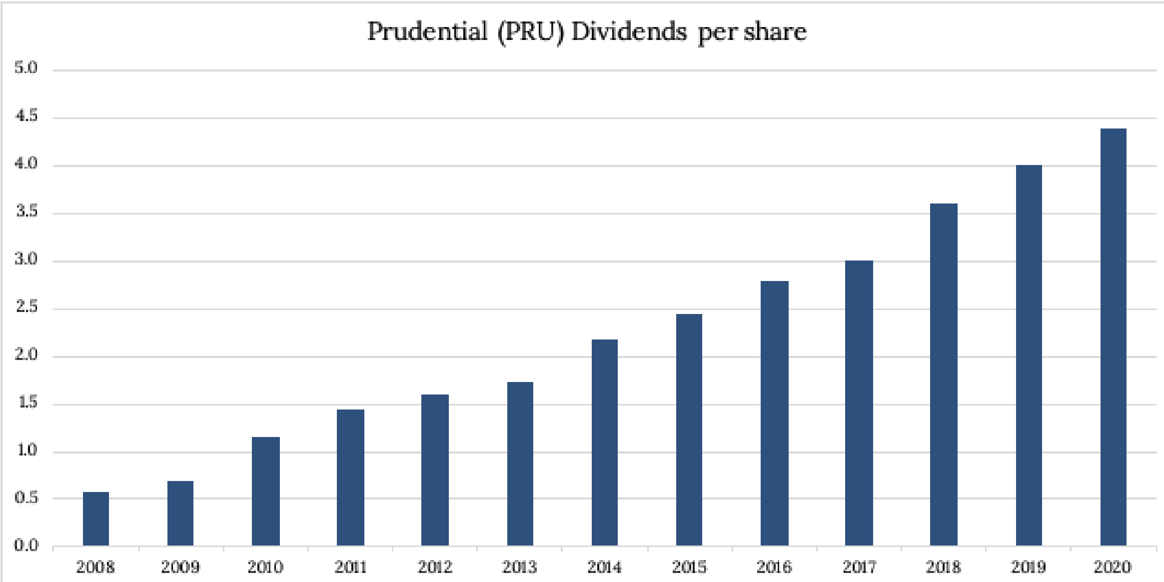
Despite an excellent track record, strong capitalisation, and resilient earnings, Prudential's shares have declined significantly in the post-COVID environment providing us the opportunity to gain exposure.

Shares of insurance companies have been particularly weak in this most recent period and Prudential is no exception. This weakness is broadly due to three concerns: One is COVID related claims of which Prudential is not materially exposed. The other two main concerns are a) risk of credit losses from investments within the insurance business and b) low profitability from depressed interest rates.

We feel comfortable with Prudential's asset base as most assets are well above investment grade, with around 40% being Government backed securities. There is significant diversification, and a strong track record of low impairment. Less than 5% in total exposure is to below investment grade credit, retail and other highly COVID impacted industries. This is further strengthened by Prudential's insurance divisions holding over 3.5 times their required regulatory capital and a AA credit rating.

Historically, insurance company profits have been highly influenced by interest rates as the insurance float is primarily invested in credit instruments. However, when pricing insurance to achieve an expected return, companies can adjust other inputs such as price and terms to compensate for low interest rates. This is exactly what is happening currently, and can be seen in the success of the Japanese business where long-term rates have been negligible for many years.

As a result of its scale and high margin businesses, Prudential has enjoyed a return on equity consistently over 10% notwithstanding very strong capitalisation and operating in a low rate environment. This has allowed significant cash generation to both pay dividends and buy back shares. We estimate its sustainable net income at over $4bn p.a. against a market capitalisation of $26bn, of which approximately 40% is used for dividends and the balance effectively grows book value through increasing capital, buying back shares, or making acquisitions.




Based on the current valuation we expect over 10% p.a. to be returned to shareholders annually via dividends (that continued to be paid in this period) which generate an approximate 6.5% yield, plus buybacks. This excludes any benefit from a reassessment of its valuation or operating earnings growth.

Over the long term, Prudential has traded at an average 1.2x Tangible Book Value vs the current 0.73x. With expected return on equity to continue to exceed 10% we see no reason why the shares cannot re-rate to at least 1.0x Tangible Book Value which alone produces a greater than 35% return.

It is this combination of high and growing dividends, sustainable book value growth and significant valuation upside, alongside its scale and capital strength that explains why Prudential is our largest portfolio holding.