November 5, 2019

Phibro Animal Health Corporation (PAHC)

Q1 September 2019 Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Phibro Animal Health Corporation's First Quarter Financial Results Conference Call. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Richard Johnson, please go ahead, sir.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Well, thank you, operator. Good morning, everyone, and welcome to the Phibro Animal Health earnings call for our first quarter ended September 2019. On the call today are: Jack Bendheim, our Chief Executive Officer; and myself, Richard Johnson, Chief Financial Officer. We'll provide an overview of our quarterly results and then we'll open the lines for your questions.

So before we begin, let me remind you as usual that the earnings press release and financial tables can be found on the Investors section of our website at pahc.com. We're also providing a simultaneous webcast of this morning's call, which can be accessed on the website as well.

Today's presentation slides and a replay and transcript of the call will also be available on the website later today. Our remarks today will include forward-looking statements and actual results could differ materially from those projections.

For a list and description of certain factors that could cause results to differ, I refer you to the forward-looking statements section in our earnings press release. Our remarks today will also include references to certain financial measures, which were not prepared in accordance with Generally Accepted Accounting Principles or U.S. GAAP. I refer you to the non-GAAP financial information section on our earnings press release for a discussion of these measures.

Reconciliations of these non-GAAP financial measures to the most directly comparable U.S. GAAP measures are included in the financial tables that accompany the earnings press release. And before we get into the numbers, let me remind everyone that we present our results on a GAAP basis and on an adjusted basis. We present adjusted results that exclude acquisition-related items, unusual, nonoperational or non-recurring items such as stock-based compensation and restructuring costs and other income or expense items that are separately reported in our consolidated statement of operations including foreign currency gains and losses, and lastly, the income tax effects related to any pretax adjustments and in addition, any unusual or non-recurring income tax items. So with that out of the way, let me introduce Jack Bendheim with some introductory comments. Jack?

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

Thank you, Dick, and thank you, everyone, who is joining us on the call. Much has happened at Phibro in the 10 or so weeks since our last call and I'm pleased to be able to give you an update this morning.

Our September quarter largely hit our top line and bottom line expectations as we reported declines compared to the previous year, as we guided in August. We knew that the sales impact of the hit to our China business due to African Swine Fever, coupled with the final full quarter overlap with the exited U.S. vaccine distribution agreement, would be too much to overcome.

The balance of our core Animal Health business was relatively strong with nice growth in the poultry and dairy sectors for our nutritional specialty products and despite some continuing macroeconomic headwinds in key countries, growth of approximately 5% in our vaccine product line excluding the loss of the previously mentioned distribution agreement.

The overall growth we have seen in our dairy nutritional specialties business includes some very encouraging performance in our OmniGen line in the U.S. Our sales of OmniGen in the U.S. steadily increased throughout the quarter and that strength has continued into October. This performance has no doubt benefited from the improving economics for our dairy customers and nicely sets the table for us to accelerate our growth with the revamp of the OmniGen franchise being launched early in 2020. Our revamped product will deliver a ton of value to the dairy industry, so we have high expectations with industry uptake and financial performance beginning in the second half of this fiscal year.

We have also seen strongly positive initial sales of our Provia Prime direct-fed microbial, or DFM, product for poultry. We believe Provia Prime is the best-in-class DFM available today and will have an important benefit to our current fiscal year results as it continues to gain share. As we discussed on our last call, it was through our work to develop Provia Prime that we got to know the people at Osprey Biotechnics. I'm really pleased with how we are integrating the Osprey business. Being basic in microbial production creates numerous opportunities, both in the traditional DFM space as well as with novel emerging technologies that rely on a microbial backbone. This acquisition will be of strong benefit to Phibro in the short and the long-term.

Turning to our projects that we expect to materially affect our company in the years to come. Over the last 2 months, we have begun testing our new pHi-Tech vaccine injection device with a number of major poultry integrators across the USA. The feedback has been exceedingly positive, with integrators recognizing that the device will lead to better flock health with fewer missed or partial injections as well as enhanced worker safety with the device's safeguard against self-injections.

We have an aggressive rollout plan across the globe with pHi-Tech product introductions being planned for 5 additional major poultry-producing countries over the next few months. We anticipate getting our first commercial order shortly in the U.S. and expect that pHi-Tech will be a meaningful part of our growth in our next fiscal year and beyond.

Turning to our other announced vaccine initiatives. We continue to be on plan with our Ireland vaccine manufacturing facility and continue to anticipate our first sales of product from that facility to occur approximately June 2021.

Updating the African Swine Fever vaccine we're working on, we made incremental progress over the past few months. We are one of the several companies and institutions working to develop a vaccine for ASF and I truly have no idea whether our initiative will play a role in coming up with a preventive cure for this devastating disease, however, it is my belief that the financial markets have not fully digested the financial impact of successful vaccine or a series of vaccine would have on the animal health industry as a whole. This is a multibillion-dollar opportunity that for the most part didn't exist 18 months ago.

Finally, turning to our new Rejensa canine joint health product, we continue to run tests in several metro areas, determining the best way to reach the customer and are encouraged with the reception from vets and the feedback we are getting from the consumers.

Perhaps most tellingly, while our sample size is small, we are seeing repurchase rates significantly better than typical levels for consumer goods. I anticipate being able to share more about our Rejensa plans later this fiscal year.

I want to thank my colleagues who are at Phibro for their hard work, which is seen in the progress of the initiatives I just discussed as well as many other areas not covered in the call.

Despite the headlines and the headwinds, this is a great time to be in the Animal Health business. With that, we look forward to answering any questions you may have at the end of the presentation.

Dick, back to you.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Thanks, Jack. So let me just briefly review our results for the quarter and then we'll get to the Q&A session.

Our consolidated sales were about $190 million for the quarter, a 5% decline versus the same quarter last year. Animal Health sales declined due to African Swine Fever in China and the overlap with a U.S. vaccine distribution arrangement we exited in October last year. Mineral Nutrition saw a volume growth, but revenues declined due to lower selling prices driven by lower raw material costs.

Our reported net income of $2.5 million was down almost $14 million due to the reduced sales and increased SG&A expenses coupled with increased interest expense and unfavorable foreign currency movements.

That resulted in reported diluted EPS of $0.06 per share for the current quarter and that decline was in line with the change in net income.

And let me discuss the adjusted results on Page 6.

So looking at selected line items from the P&L. I'll discuss net sales in more detail at the individual segment level. In total, adjusted gross profit declined $7.6 million, or 11%, compared to the prior year.

The Animal Health business accounted for more than the entire decline due to the reduced sales, and in addition, unfavorable product mix. Mineral Nutrition gross profit contributed almost $1 million improvement over the prior year despite the lower revenues. Adjusted SG&A increased $3.3 million or 8%, driven by strategic investments in key development projects to position ourselves for future growth, plus the inclusion of the Osprey acquisition in our operational results. All of the year-over-year increase was reported in the animal health and corporate segments.

Adjusted net interest increased about $0.5 million over last year due to higher outstanding debt levels.

Going all the way down to adjusted diluted EPS, it was $0.19 in the quarter compared to $0.39 last year, that was a 51% decline quarter-over-quarter.

So looking in more detail at the Animal Health business. Net sales of about $122 million, declined $9.3 million, or 7%, compared to the prior year. Net sales of MFAs and other were $75 million, a drop of $12 million, or 14%. That drop was primarily due to the reduced demand in China due to African Swine Fever and also some unfavorable customer ordering patterns in other international regions.

In nutritional specialties, our net sales were $30.4 million, an increase of $3.5 million or 13%. We saw volume growth in our poultry and dairy product lines and coupled with sales from the Osprey acquisition that was what drove the increase.

In the vaccine product group, net sales were $16.4 million, a decline of $0.8 million, or 5%, compared with last year. If we exclude the loss of that domestic distribution arrangement from October of a year ago, all other vaccine sales increased 5%.

For the segment, adjusted EBITDA was about $25 million, that was down $10.7 million or 30%, really due to the sales decline, which drove the gross profit decline in addition to increased SG&A costs.

Gross profit declined, as I said, driven by lower sales volumes and by unfavorable product mix with nutritional specialties being a contributor to some growth profit improvement.

SG&A increases, we continue to make investments in strategic growth initiatives and product developments.

And now looking at our other segments, Mineral Nutrition saw volume growth in the quarter, although net sales of $52.6 million, declined $2.2 million, or 4%, due to lower average selling prices.

Our selling prices in the minerals business are directly correlated with movement of the underlying raw material costs.

Segment adjusted EBITDA of $3.5 million increased almost $1 million, driven by the increased gross profit in the business. Performance Products net sales were about $15 million in the quarter and that was about a $1 million increase over the prior year, driven by higher volumes in sales of personal care ingredients.

Corporate expenses were $9.7 million in the quarter, that was an increase of $800,000 over last year, again, primarily due to increase of strategic initiatives as well as increased spending on public company costs.

And now looking at capitalization. Our gross leverage ratio of debt to adjusted EBITDA was 3.7x at the end of the quarter. The higher leverage ratio reflected the Osprey acquisition we completed in the quarter.

We had $79 million of cash and short-term investments on the balance sheet at quarter end. And for the quarter, in total we used $66 million of cash before financing activities, including the $55 million purchase price before the Osprey acquisition.

Looking at our guidance. We've reaffirmed our financial guidance for the fiscal year ending June 30, 2020. It was initially included in our August 27, 2019 press release. And that the guidance included full year expectations for items like net sales, adjusted EBITDA, adjusted net income and adjusted net income per share. We repeated that guidance in this presentation for your convenience.

So that's the conclusion of my prepared remarks. Operator, if you'd please open the line for questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Erin Wright from Crédit Suisse.

Haley Larissa Christofides - Crédit Suisse AG, Research Division - Research Analyst

This is Haley on for Erin this morning. First, I was wondering, how would you characterize the current MFA demand trends in the U.S.? And are you starting to see the impact or offsets from ASF in terms of increased demand from other geographies like in the U.S. or Brazil?

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

Thank you for that. I think we are seeing -- and as we've said now for a long time -- that the shortage of protein in China is affecting protein production around the world, including the U.S. I mean, a lots of choices that people could do to keep their animals healthy and get -- and that healthy animal, obviously, puts on more weight. So we are seeing stronger demand, I think, across the world, both for MFAs as well as nutritional specialties. And we're seeing a strong demand in some markets for vaccines with the same purpose. So I think overall, it's a good time to be in the protein business out of China.

Haley Larissa Christofides - Crédit Suisse AG, Research Division - Research Analyst

And also, could you characterize a little bit the current trends across the dairy market? Are you seeing some stabilization?

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

I think, as I said in the presentation a few minutes ago, we are seeing stabilization of prices, dairy prices across the world and in the U.S. We've seen typically our OmniGen business and our other business that we sell into dairy market increasing, slight increases or at least the declines have stopped. I think we're seeing fewer closings of smaller dairy producers in the U.S. and I think that's stabilizing. And a lot -- it's hard to say it is directly China, but again, milk is a protein as well. And so indirectly, it's been affected by that. So we are seeing stabilization and some growth in our business in the States for that sector.

Operator

Your next question comes from the line of David Risinger from Morgan Stanley.

David Reed Risinger - Morgan Stanley, Research Division - MD in Equity Research and United States Pharmaceuticals Analyst

So I have 2 quick questions, please, for you Jack and Dick. The first is could you talk about African Swine Fever at a higher level, is it spreading beyond China to any notable degree? And then second with respect to the MFA issues that you touched on for Phibro outside of China, could you just provide a little bit more color on the customer ordering issues? And whether that will continue into the December quarter or not?

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

Yes. So we have all read, and you've read as well, that in the Far East, African Swine Fever has, I mean, jumped the borders and it's sort of, I would say, prevalent in Vietnam. It's been reported in South Korea, it's been reported in some of the other countries in that part of the world. It's very, very hard to contain African Swine Fever, but the responses in most of the world using good biosecurity has always been an effective way for limiting the damage of African Swine Fever. It's been in Spain years ago, it's been in Eastern Europe. But you don't see the crisis that we've seen in China. So yes, while it's moving, I don't think we are going to see the effect that it has had in China. At least, we so far have not seen the effect. So I think China is unique. But China is also the biggest country in the world and China's also the biggest consumer of pork in the world and et cetera, et cetera. And if that -- and the amount of pigs that have gone missing in China because of the African Swine Fever and then the fact that people just didn't want to raise pigs, has had this unbelievable economic effect. There was an article, I believe it was in the Journal yesterday, talking about Smithfield and talking about how they've changed, they're all smiling and how they're exporting has gone up a lot to China. So I think it's true for a lot of U.S. companies and it's going to be true for a lot of animal health companies. I didn't exactly understand the MFA business question. Again, as you know from our long -- many discussions over these many years, animals get sick, animals get sick when you raise them together. And now in a time when you're getting more money per kilo, more money per pound, you want to keep your animals as healthy as possible, and there are many ways of doing it. Some of them is use antibiotics, some of it is going to use as a treatment with antibiotics, we have preventive antibiotics, we have pre-antibiotics. Some is going to be in nutritional specialties and some is going to be a vaccine. So there's a whole range of solutions if you want to keep your animals healthy and if you are a producer today, you want to get the most of it out of your animals. So it's not necessarily just MFAs.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Yes. David, just to add a little more specifically on your question, David. No, we wouldn't expect this to carry forward. Our forecast don't show this carrying forward in the rest of our year. This was, as Jack described it to this quarter.

Operator

Your next question comes from the line of Kevin Kedra from G. Research.

Kevin Kedra - G. Research, LLC - Research Analyst

Maybe first, you talked about how your excitement with the Provia Prime and Osprey and how's that going? Can you give us any other insight on to what the pipeline looks like for the Osprey products and when we could start to see some other things coming out of that acquisition? And then secondly, you've kind of alluded to it on Rejensa that it's off to a very good start in these initial trials, should we really be thinking about that as kind of an opportunity next year? Or could we see something in the back half of the year where that product starts to become a contributor to revenue?

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

I take Rejensa first. I think we should see Rejensa being a contributor next year. And we are slowly building up, as I said, we are trialing, introducing the product to the vets and we're trying to discover or find the best channels to get to the vet. So we're seeing successes, small successes and we'll bring you along with us on this journey, next quarter and the following quarter, but I think this could be a product that will have some sort of meaningful numbers in the next fiscal year. Then on Osprey, I think, what, it's going to be a little bit too early. We just sort of got involved with their business. What I can tell you is we are busy installing almost a doubling of capacity of their ability to produce. So our feelings about the growth of that business is very strong, but sort of when we took them over, they were sort of running full out. And you got to have the product before you can sell it. But we're working on both sales growth, sales initiatives as well as production initiatives.

Operator

Your next question comes from the line of Michael Ryskin from Bank of America.

Michael Leonidovich Ryskin - BofA Merrill Lynch, Research Division - Associate

I want to start on some of the new products you highlighted where you talked -- touched on a few of these. But I want to ask about the next-generation OmniGen for the dairy industry. You talked about second fiscal half starting in January contribution. How meaningful are we looking here, just thinking that there's a lot of moving pieces in the guide this year versus the last year between the China MFA reduction and the distribution agreement you talked about. As we look into the second half of the year, is that often mostly coming from these new products coming online? Or is there something else built-in in terms of the pacing as you move through the year?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Yes, I think the new products are going to be a major contributor to that accelerating sales growth in the second half of the year, Mike. And I wouldn't limit it to just the refreshed OmniGen product. We've got various vaccines. We've got the DFM. We've got -- and even in our more traditional MFA category where we're expanding geographically and we've got products that are having good acceptance in some other geographies. So there's a lot of things. The repositioned, the refreshed OmniGen will definitely be a contributor in the second half. I think it will -- like all products, it'll ramp over time, it's not going to be a -- it's not going to be the next-generation iPhone or something like that. But...

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

So we're telling you to don't buy a bag and hold it to your ear.

Michael Leonidovich Ryskin - BofA Merrill Lynch, Research Division - Associate

I'll keep it in the mind.

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

And the other advantage of it is, it will definitely -- your kids won't have a lot of screen time on it either.

I think, we know this business very well. We know the dairy business very well. The market has changed substantially, we've spoken about this often over the last couple of years. We were very successful at OmniGen with the smaller dairies. And the economics of dairy business has closed a lot of the small dairies. The cows have not disappeared. The cows have moved, the number of cows in the United States have stayed pretty steady over these last 5 years. The cows have moved to these larger dairies. And we needed to come up with a product that would be more meaningful in these larger dairies. And I think that's what we have done now. So it's not like we're taking a brand new concept or a brand new product and trying to get into a market. We know this market very well. We know these customers. People have gone from the small farms to the larger farms. So we are giving them more value and it took us a while to reformulate. It took us a while to get through the tests and get the background and get the university tests behind us. We are very comfortable and the launch time is as we said, it's going to be early 2020.

Michael Leonidovich Ryskin - BofA Merrill Lynch, Research Division - Associate

Great. That's helpful. And actually right along those lines around some of the shifts in the dairy industry in other States. And perhaps, more broader than that to the MFA segment internationally as well. With the gross margin declines you saw in this quarter, a lot of it was tied to the volumes, but then also some product mix. As you have these new products coming out over the course of the year and going forward, are you going to be able to offset some of that volume pressure with being able to take a little bit more price potentially?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Definitely, our guidance for the year and our expectations for the rest of the year is to see margins improve from where they were in Q1. I think that that margin improvement will come from new product introductions, product mix. It's not about taking price in the sense of just going out and raising prices, but it's providing more value to your customer with these differentiated products.

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

But I think again, yes, we expect our margins to increase.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Yes. Right. Absolutely right.

Michael Leonidovich Ryskin - BofA Merrill Lynch, Research Division - Associate

Great. And one last one, if I may. On the leverage and sort of the balance sheet you highlighted slightly higher debt level from the Osprey acquisition. Could you talk about your leverage going forward, how high would you be willing to lever up if some assets in either the companion animal or livestock markets came up and there's an opportunity to bolt-on to the business through an inorganic means?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

So I think we are in the market and we look at assets as they come on to the market. I think we're not that comfortable at very high leverage. But we will lever up if there's an opportunity and we can buy right. So we're not going to overpay and just use the available debt capacity. But we will add debt if we could buy an asset at the right prices.

Operator

(Operator Instructions) Your next question comes from the line of David Westerberg from Guggenheim Securities.

David Michael Westenberg - Guggenheim Securities, LLC, Research Division - Analyst

So a question on the African Swine Fever vaccine. It's interesting to hear a multi-billion-dollar market. So can you talk about some of the sizing that market in terms of maybe price versus the average vaccine, kind of the reach of a vaccine like that? And how accommodating do you think regulators would be to getting that product out, sooner rather than later?

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

So that is a great question. I'm not throwing that out as everyone always does. So in China, people are talking that in the excess of 50% of the pigs are gone. And it doesn't mean that they all have gotten an African Swine Fever. If you have a herd, if you have 1,000 pigs and a stall gets it, they will -- it's very, very virulent and they all die within 10 days. And then basically authorities come and you cull -- you kill -- all the other pigs and you've try to not grow them and then if you -- that happens to you, you're not going to go back and spend money and raise pigs again. So subsequently, China grows and consumes approximately 800 million pigs a year, which more or less means it has a standing herd of about 400 million pigs. So if you just pick the number 50% because I can't do advance math, that's 400 million pigs that are missing. The rest of the world altogether raises about 400 million pigs. So this is something that cannot be solved by China just importing pigs. They have to solve it on their own. And pigs, pork is the protein in China. It's the basics. It's in every food and it's extremely important. So if we are successful in coming up with a vaccine. And our approach to this thing is quite unusual because our approach is not using the virus as the source. So I think our product, if we are successful, and again, that's a big if. If we are successful it would be a very safe vaccine. That even if you can help and control and protect the pigs at 20% or something like that, there would be a market and the Chinese government would be very cooperative because this is such a catastrophe for them. No different than the United States would be cooperative, if there was a catastrophe here, something going on with the disease in the animal that the U.S. D.A. would be to allow for it and it would sort of give the green light and not force you to go through many of the hurdles we have to do with the vaccine. So the market is great. Look at the market pricing. Historically, if you have a vaccine that would control the disease that was killing an animal, people come to you, price it at 20% of the value of the animal. Now I won't go into the current value of pigs in China, which is much higher than it has historically been. But if you take value of a pig at $100, just so you can do the math, 20% would be $20. That's so simple, $10 a pig, and you had to vaccinate every pig in China, that's 800 million times $10, it's like $8 billion a year. So let's discount all these things and everything else, it is a huge market. And it's obviously why, as I said earlier, a lot of companies and we are working on this thing and a lot of companies in China. This is not simple. This is a virus, it's been around for 100 years. It's very complicated, but the science is a lot more sophisticated today than it has been. We continue to make some progress. Again, the ultimate proof is going to be, I'm afraid, in the eating of the pig. But until we get there, I think we're optimistic but it's, I don't know, it's still very much up in the air.

David Michael Westenberg - Guggenheim Securities, LLC, Research Division - Analyst

Really appreciate. That is really great color. So then maybe can you just on a high level with poultry, I feel we're all talking about dairy, we're talking about ASF. Can you give us maybe a high level, what's going on with the poultry part of your portfolio? It was slightly down last year. How confident are you in terms of rebounding there in that species?

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

So again, poultry for us is the question of markets. But our biggest markets in the U.S. and Brazil and the Far East and Russia is all quite strong this

year. Again, we have some new vaccines that we're introducing in markets that seems to be quite successful. You are in some herds or out of some herds, it rotates. But overall, poultry business is strong and our business is stronger within that. And then we have this unusual nutritional product, which is strong when people go antibiotic-free in poultry and they increase their vaccines in poultry, we have a very successful nutritional product, we call it Magni-Phi, which has very, very good acceptance in the U.S., and we're now introducing it in Brazil and in some other markets as well. So I know we never talk about poultry, we should. It's -- thank you for raising it.

Operator

There are no further questions at this time. I turn the call back over to Mr. Johnson.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

All right, everyone. We thank you for your time and for listening. And we'll talk again on our next quarterly call. And bye now.

Operator

This concludes today's conference call. You may now disconnect.

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