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SCSC - Q3 2020 ScanSource Inc Earnings Call

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PRESENTATION

Operator

Welcome to the ScanSource quarterly earnings conference call. (Operator Instructions) Today's call is being recorded. (Operator Instructions)

I would now like to turn the call over to Mary Gentry, Vice President, Treasurer and Investor Relations. Ma'am, you may begin.

Mary M. Gentry - *ScanSource, Inc. - VP of IR & Treasurer*

Thank you, and welcome to ScanSource's Earnings Conference Call for the Quarter Ended March 31, 2020.

Our call will include prepared remarks from Mike Baur, our Chairman and CEO; John Eldh, our Chief Revenue Officer; and Gerry Lyons, our Chief Financial Officer. We will review our operating results for the quarter and then take your questions.

We posted a CFO commentary that accompanies our comments and webcast in the Investor Relations section of our website.

Certain statements made on this call, including our expectations for sales, earnings per share, planned divestitures, the impact of COVID-19 pandemic and the fair value of contingent consideration for the fourth quarter of fiscal year 2020 are forward-looking statements. These statements are subject to risks and uncertainties that could cause actual results to differ materially from such statements. These risks and uncertainties include, but are not limited to, those factors identified in the earnings release that we put out today and in ScanSource's Form 10-K for the year ended June 30, 2019 and Form 10-Q for the quarter ended March 31, 2020, as filed with the SEC. Any forward-looking statements represent our views only as of today and should not be relied upon as representing our views as of any subsequent date. ScanSource disclaims any duty to update any forward-looking statements to reflect actual results or changes in expectations, except as required by law.

During our call, we will discuss both GAAP and non-GAAP results and have provided reconciliations between these amounts in the CFO commentary and in our press release. These reconciliations can also be found on our website and have been filed with our Form 8-K.

I will now turn the call over to Mike.



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Michael L. Baur - ScanSource, Inc. - Founder, Chairman, CEO & President

Thanks, Mary, and thank you for joining us today. We wanted to open our call with some comments on how we are addressing the global pandemic and our business operations during this unprecedented time. Our top priority is protecting the health and safety of our employees around the world.

In mid-March, we implemented work from home for our office-based employees. The global ScanSource team swiftly and seamlessly made the transition to work from home, and we are meeting the needs of our customers and suppliers with the same levels of productivity and service as if we were in the office. Our company culture remains strong because of how we have adapted, using virtual tools and creativity to keep our employees connected. However, nothing replaces face-to-face interactions completely, which is how we have conducted our business relationships for many years, and we look forward to seeing our customers and suppliers when we are able to do so safely.

Our industry is deemed an essential business, which allowed us to continue operations at our distribution centers. I am tremendously proud of how our ScanSource team has operated safely at our distribution centers. This includes adapting to new processes around social distancing, cleaning, sanitation and use of protective equipment. In most cases, we maintained our high service levels, although we have incurred higher expenses from additional staffing and expedited shipping. Amidst the challenges of the global pandemic, we reached our forecasted net sales for the third quarter with growth across almost all of our technologies in North America and in Brazil in local currency. This included accelerated sales for work-from-home solutions from Jabra, Poly, HPE Aruba, 8x8, RingCentral, Zoom and Microsoft as companies made the move to remote workers.

With the acquisitions we've made over the last few years, we invested in significant digital capabilities. And as a result, we've gained great customer-facing software solutions. We recently brought together our software development teams from across the company, including teams from Intelisys, intY, POS Portal and RPM to form a single software development group. This group will put their combined talent and effort into delivering partner revenue growth, partner automation and partner convenience solutions. We believe our software development group will be a competitive differentiator, enabling us and our partners to strengthen customer relationships and drive more growth.

I'll turn the call over now to John to highlight how we are positioning our business and the near-term opportunities we see.

John Eldh - ScanSource, Inc. - Chief Revenue Officer & Senior Executive VP

Thanks, Mike. The quarter started in January and February with consistent and positive results in all areas of our business, except for premise-based communications. Even with the disruption caused by the COVID-19 pandemic in March, we achieved solid Q3 performances as our customers seized on work-from-home solutions as well as cloud and SaaS alternatives. As you heard from Mike, we, too, were able to adapt quickly and pivot to work from home by leveraging many of today's incredible voice, video and collaboration technologies. And we delivered on our net sales forecast for the quarter.

In our hardware business, we saw a significant uptake in our work-from-home solutions, including cameras, speakers and headsets. We also saw increased sales of mobile data collection devices, scanners and networking technologies. We participated in projects directly related to the COVID-19 pandemic by delivering health care scanners for diagnostics and testing, outfitting telemedicine cards, helping equip field hospitals and enabling businesses for curbside delivery and pickup.

In the March quarter, we launched new digital, cloud-based offerings, including Zoom, Avaya Cloud office and Microsoft in the United States. In this challenging environment for our traditional VARs, we are also seeing a surge in new partner recruitment for Intelisys, including more ScanSource VARs starting to sell cloud solutions.

In the third quarter, 50% of new partner recruits for Intelisys were VARs. In addition, in March, we launched our Go Remote campaign, designed to enable partners to deliver end-to-end work-from-home solutions to their customers. These solutions include UCaaS, CCaaS collaborations, hardware, headsets, connectivity and security with offerings from our leading suppliers. As part of our campaign, we were also providing partners with our definitive guide to going remote, and we'll be hosting our Go Remote Virtual Summit on June 4, 2020.

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We have built and are providing enablement programs to support the health and financial wellness of our partner community. We compiled and distributed an extensive COVID-19 resource guide to help our partners better navigate the numerous yet complex government aid programs. We are also introducing a channel recovery educational series to keep our partners informed about sales, marketing and financial programs for our partner community during these challenging times.

We are very pleased that many of our suppliers have stepped up to partner with us and provide significant channel support programs to help our sales partners not only survive, but also recover during and after this crisis. Cisco, Honeywell, HPE Aruba, Extreme Networks, Axis, Epson, Datalogic as well as more than 50 emerging to midsized suppliers are providing a variety of financial assistance programs with and through ScanSource. We are ensuring that our partners are aware of all the ways our suppliers and ScanSource are working to help and support them.

Now, Gerry will take you through the financial results and our outlook for next quarter.

Gerald Lyons - ScanSource, Inc. - Senior EVP & CFO

Thanks, John. I'll open with an overview of our results versus our third quarter forecast. We achieved our forecast range for net sales, while EPS was below our forecasted range. The lower EPS includes a \$4.5 million expense for inventory charges following the conversion to a new inventory management system, which went live last November. These charges increased our cost of goods sold, which lowered gross profit for the third quarter. Excluding this \$4.5 million charge, which negatively impacted our EPS by approximately \$0.11, our non-GAAP operating results were in line with our forecast expectations.

We implemented an inventory action plan to address the warehouse inventory discrepancies and are back to typical warehouse operations during the month of April. In August, we announced plans to divest certain physical product businesses outside of the United States, Canada and Brazil. These businesses had net sales of \$128 million for our third quarter and working capital of \$155 million at March 31, 2020.

We've had no significant loss of headcount during the quarter. We have identified potential buyers for these businesses, and we are in due diligence and purchase agreement negotiations with those buyers.

While the COVID-19 pandemic has slowed down the process and the timing, we still see strong continued interest and anticipate having agreements by the end of the June quarter.

Consolidated net sales for our third quarter totaled \$872 million, down 2% year-over-year and up 0.5% on an organic basis. Foreign currency translation negatively impacted non-GAAP sales by approximately \$13 million. Net sales for our worldwide Barcode, Networking and Security segment declined 2% year-over-year or 0.8% on an organic basis.

We had lower sales in parts of our North America business, partially offset by growth in other areas across our diversified technologies. Net sales for our Worldwide Communications & Services segment declined 3% year-over-year and were up 3% on an organic basis, driven by growth in Brazil in local currency.

We had accelerated growth for work-from-home solutions in March, which more than offset the continued headwinds in our premise-based communications business in North America.

We had a record quarter for Intelisys, where sales increased 12% year-over-year. Starting this quarter, we changed to net revenue recognition for software and service sales for our intY business. Both net sales and gross profit for intY were \$1.7 million for the third quarter.

Excluding the planned divestitures, non-GAAP gross profit dollars for the quarter decreased 12% year-over-year. This decrease included the \$4.5 million expense for inventory that I mentioned previously. As a result, our third quarter fiscal year 2020 non-GAAP gross profit margin was 11.4% below the 12% gross margin we expected in our third quarter forecast.



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SG&A expenses increased \$1.2 million from the prior year to \$79 million for the third quarter fiscal year 2020. We have made investments in our growing recurring revenue and service-based businesses. Our investments also include the digital capabilities we've added with the acquisition of intY. This is part of our strategy around our software development group, which Mike mentioned earlier.

Our third quarter fiscal year 2020 non-GAAP operating income was \$14.8 million or 2% of net sales compared with \$30.6 million or 4.1% in the prior year quarter. We have a \$46 million contingent consideration liability on our March 31, 2020, balance sheet, and this reflects the present value of expected future earn-out payments for our Intelisys acquisition.

For the third quarter of fiscal year 2020, we recorded an expense for the increase in fair value of contingent consideration of \$0.6 million or \$600,000 for Intelisys. For our fourth quarter fiscal year 2020, we estimate the change in fair value of contingent consideration to be an expense of approximately \$1.3 million.

For fiscal year 2020, we estimate the effective tax rate to range from 29.5% to 30.5%, excluding discrete items. This estimate increased from the impact of lower forecasted earnings and changes in the geographical mix.

Now turning to our balance sheet and cash flow. We generated strong operating cash flow of \$32 million for our third quarter and trailing 12-month operating cash flow was \$148 million. Working capital investment declined 5% quarter-over-quarter and 12% year-over-year. The planned divestitures had approximately \$155 million in working capital at March 31, 2020, down approximately \$50 million from the June 30, 2019, balance.

At March 31, 2020, we had cash and cash equivalents of \$35 million and debt of \$321 million. Our net leverage ratio totaled approximately 2.4x trailing 12-month adjusted EBITDA.

With the economic disruption due to COVID-19, we entered the June quarter with uncertainty around near-term customer demand. Accordingly, we are not providing a forecast range for net sales or earnings per share for the fourth quarter fiscal year 2020. We expect our sales and earnings per share to be down sequentially for the fourth quarter as compared to the third quarter. While we are not providing a forecast range, I can share with you that our net sales for the month of April declined 22% year-over-year for GAAP net sales. For the month of April, non-GAAP net sales, excluding the negative impact of foreign currency translation, that's a 17% year-over-year decline.

And now I'd like to turn the call back over to Mike for closing comments.

Michael L. Baur - ScanSource, Inc. - Founder, Chairman, CEO & President

Before we close, I want to take this opportunity to welcome our new Director, Jeff Rodek, to our Board of Directors. Jeff has served as Chairman and CEO of Hyperion Solutions, as President and COO of Ingram Micro and also spent 16 years at FedEx. With Jeff's leadership experience in enterprise software and technology solutions industries as well as his extensive logistics experience, we look forward to Jeff's guidance as ScanSource continues to advance our digital strategy.

With our investments in software and cloud solutions, we are well positioned to deliver digital initiatives through our multiple sales channels. Our world-class team of employees, working with the best group of technology suppliers in the world, positions us well to help our sales partners achieve unusual success. We believe we are prepared to weather the storm of the COVID-19 pandemic.

We will now open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Adam Tindle with Raymond James.



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Madison Suhr - *Raymond James & Associates, Inc., Research Division - Research Associate*

Madison on for Adam. I appreciate the color into April trends, but I was wondering, did those declines moderate as April progressed? In other words, do you think we're kind of through the trough of the declines and the second derivative is getting modestly better?

Michael L. Baur - *ScanSource, Inc. - Founder, Chairman, CEO & President*

This is Mike Baur speaking. So I think the color we gave so far is all we're willing to talk about. It's still early in the quarter, clearly, and 1 month it's not clear yet what that means. And as all of our quarters are, we never know exactly what's going to happen in the first month of the quarter. But certainly, being down 22% has us concerned, and it's something that we're looking at closely as to understand what this might indicate for the rest of the quarter.

Madison Suhr - *Raymond James & Associates, Inc., Research Division - Research Associate*

Okay. I understand it's a very dynamic environment. And then just a follow-up. You mentioned that you had some higher costs related to safety measures as well as some expedite costs. And I was just wondering if you could potentially give us the sense of magnitude of these. And then just to the extent that you have any color, do these types of costs start to attenuate next quarter? Or are you expecting any tailwind or any incremental headwinds from these? Thanks.

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Yes. So Madison, this is Gerry. And I think what we're trying to do there is just give a sense that we had a little bit of increased cost in the March quarter. We're really expecting that to come to more fruition in the June quarter, but we don't really have a sense of exactly what that number is yet.

Madison Suhr - *Raymond James & Associates, Inc., Research Division - Research Associate*

Okay. Understood, I appreciate the time.

Operator

And our next question comes from Keith Housum with Northcoast Research.

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Keith, this is Gerry. If you're -- we can't hear you if you're speaking.

Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Gerry, can you hear me?

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Yes, I can.



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Keith Michael Housum - Northcoast Research Partners, LLC - MD & Equity Research Analyst

All right. I appreciate it. Crazy times that we're all entering into. Gerry, asking about the credit quality. Can you just give me a little bit of color in terms of, I guess, additional steps you guys are taking to make sure that credit quality is maintained? And then just remind us what happened in the, I guess, the recession of 2009, 2010? And how did your credit quality hold up?

Gerald Lyons - ScanSource, Inc. - Senior EVP & CFO

Yes. Sure, Keith. So as you have figured out, as we've all figured out, 2008 and 2009 are completely different than this episode that we're in, right? That was absolutely a financial crisis. We've got a lot more people impacted than we had in 2008 and 2009. And so we're viewing this as being completely different. So what we're doing is we're reaching out to all of our customers and making sure that they're all safe. And that they are -- how their businesses are doing, how they're experiencing. And if they need our help, we are -- along with our suppliers, we are designing programs for those people to be able to continue to do business and to thrive. We really haven't seen -- again, for us, I think, Keith, the impact of COVID really is starting to take shape in this June quarter. It really wasn't taking shape in the March quarter. So -- but we're monitoring people's credit very closely.

Keith Michael Housum - Northcoast Research Partners, LLC - MD & Equity Research Analyst

Got you. I appreciate it. And then as I think about your POS Portal business, is it safe to assume that also was not a big impact to last quarter, and we're probably going to see more of an impact now? Because if I remember correctly, POS Portal's primary customers are more retailers and restaurants, more skewed to a small, medium-sized business owner, correct?

Gerald Lyons - ScanSource, Inc. - Senior EVP & CFO

Well, so there's 2 or 3 different channels that they go through. There's some very large contract customers that we deal with, and they may have small to medium businesses that they deal with. And then we also go through independent software vendors. And yes, those are more small to medium, but I wouldn't say that they're all hospitality or retail. We have seen a little bit of a decline there. Just think about, again, people sheltering in place. Most credit card transactions, I think, are taking place with credit card not present, so.

Keith Michael Housum - Northcoast Research Partners, LLC - MD & Equity Research Analyst

Okay. I appreciate it. And then if I can squeeze 1 more question in here. I guess, can you guys give me a little more color on the inventory adjustment? If I understood you right, you guys put the system in back in November. Perhaps how did you guys come out with the adjustment now? And are we all done with any adjustments going forward?

Gerald Lyons - ScanSource, Inc. - Senior EVP & CFO

Sure. So in the December quarter, Keith, we were -- as with any new system, we're spending time getting acclimated to the new system, new processes and new procedures, and really just trying to take care of our customers, make sure that they were all satisfied. And as we got further into the March quarter, we began to realize that we had some bin-level accuracy issues, which caused us to need to increase the amount of activity that we were doing, whether those be cycle counts or getting our IT and other resources involved. And that's -- those activities have resulted in a number of changes that I think as we are -- not I think, as I indicated, have made better results for April. We're anticipating that that trend will continue, but it just remains to be seen, but we're confident that the worst is definitely behind us.



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Keith Michael Housum - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

So was this an issue where you guys thought you had inventory and didn't or vice versa?

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Yes. Basically, Keith, we would go to a bin. And the system was saying, "Hey, we think we have 10," but we had 6. And so part of what we found out in the March quarter was, we're thinking, "Oh, well, okay, it's not in bin 6, it's in bin 12." Well, as we got further along the process that we do in the warehouse is something called a linear cycle count. So we really have 36,000 bins in our warehouse, and we're literally counting 1 by 1 by 1. So as we got further along, we figured out that the accuracy was -- we weren't going to find it in another bin.

Operator

(Operator Instructions) Our next question comes from Kurt McGinnis (sic) [Chris McGinnis] with Sidoti & Company.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

So maybe we could just start with maybe the impact COVID is having maybe on the different geographies that you're competing within. Is anyone being more impacted? And how do you see that playing out maybe?

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

Keith, this is -- sorry, Chris, this is Gerry. So I think what we saw is kind of what we all read in the newspaper or saw is that Europe was definitely impacted for us sooner. We saw some of our offices need to be closed down or work from home sooner than we did in the U.S., then it was the U.S. for us. And then lastly, really LATAM or Brazil. And so our business has just followed exactly what you've seen in the news.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

Okay. And sales seemingly kind of in the same range of that 22%. Nothing tracked differently in the other regions, really?

Gerald Lyons - *ScanSource, Inc. - Senior EVP & CFO*

I think that's an overall number, but they're all reasonably similar. Maybe Brazil is a little bit better at this point, but they're all reasonably similar.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

Okay. I think last quarter, obviously, there were some issues around the reorganized sales force. Can you just talk maybe a little bit how the -- how that's performing? I thought it would be a little bit longer in terms of maybe them coming back, obviously, a really good quarter reported. So maybe just an update on that sales reorganization.

Michael L. Baur - *ScanSource, Inc. - Founder, Chairman, CEO & President*

Yes. John, why don't you take that one?



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John Eldh - ScanSource, Inc. - Chief Revenue Officer & Senior Executive VP

Yeah, Kurt (sic) [Chris], good afternoon, nice to talk to you. Kurt (sic) Chris, I think the sales reorg...

Michael L. Baur - ScanSource, Inc. - Founder, Chairman, CEO & President

Sorry John, it's Chris.

Christopher Paul McGinnis - Sidoti & Company, LLC - Special Situations Equity Analyst

No, they got it wrong. It's okay. It's Chris. That's okay.

John Eldh - ScanSource, Inc. - Chief Revenue Officer & Senior Executive VP

Okay. But I definitely did hear it Kurt. That makes me feel better, Chris.

Christopher Paul McGinnis - Sidoti & Company, LLC - Special Situations Equity Analyst

Yes. No, no. I know. No, I understood. Thanks.

John Eldh - ScanSource, Inc. - Chief Revenue Officer & Senior Executive VP

I was going to be in real trouble if I'm like I swear I heard Kurt, I wrote it down. Anyway, Kurt -- Chris, we actually are happy with our progress with that reorg that we were in the midst of. And if you remember, we were calling One ScanSource, and it definitely took longer than we were hoping for. But in the last quarter, we worked hard to rebalance the teams to put us in a position of better coverage and better capacity. We were able to do more training. Spend more time in kind of call-outs with those most-affected customers and develop more mature processes that we're missing at the beginning of the transition. And so we think we've made great progress. Clearly, more work to do, but we're very happy with where we've gotten to. And that was seen and evidenced by the results in the quarter in terms of net sales.

Christopher Paul McGinnis - Sidoti & Company, LLC - Special Situations Equity Analyst

Great. And then maybe just a little bigger-picture question. But just maybe you're still a little bit too early in. But can you just maybe talk about some of the opportunities outside the ones you've already seen maybe an opportunity to go take share? How this maybe changes your business kind of going forward in terms of your thought processes for growth and anything maybe trying to attack that quicker?

John Eldh - ScanSource, Inc. - Chief Revenue Officer & Senior Executive VP

Yes. Absolutely. I think from my vantage point, Chris, when I think about it, I think kind of shorter term, if you're looking at kind of verticals, clearly, we're going to continue to see growth in health care and kind of pharmacies and grocery. We will also continue to see positive growth in kind of that barcode and scanning space. I mean we saw that specifically in those industries. You think about when you show up to the grocery store and you go to pick up your items that are now curbside, there's somebody there with a barcode or kind of a scanner checking you out. So all of that, we continue to see growth in. We also continue to see growth in kind of main street retail as it relates to contactless technologies versus the traditional technologies. And obviously, we will continue to see growth just as we did this past month, in particular, in last quarter, in work-from-home technologies. And I think last but definitely not least, I mean, those are kind of on the hardware front. But I think what has us so well positioned is really not only the traditional hardware capabilities but also that ability to move to the cloud with our partners and their end customers. And you heard Mike referencing that earlier with our relationships that we announced with Zoom and Microsoft and things we're doing with RingCentral and others.



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Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

Great. Thanks for that, I really appreciate it. And good luck in Q4.

Operator

Ladies and gentlemen, this concludes our Q&A portion of today's conference. I would now like to turn the call back over to Mike Baur for any further remarks.

Michael L. Baur - *ScanSource, Inc. - Founder, Chairman, CEO & President*

Great, and thank you for joining us today. We expect to hold our next conference call to discuss June 30 quarterly and full year results on Tuesday, August 25, 2020.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect. Everyone, have a great day.

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