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DL - Q3 2019 China Distance Education Holdings Ltd Earnings Call

EVENT DATE/TIME: AUGUST 14, 2019 / 12:00PM GMT



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Gregory R. Pandy *Sidoti & Company, LLC - Consumer Analyst*

Christine Li

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the China Distance Education Holdings Limited Third Quarter Fiscal Year 2019 Conference Call. (Operator Instructions)

I would now like to hand the conference over to Mr. Mark Marostica. Please go ahead, sir.

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Good evening, and thank you for joining us for the China Distance Education Holdings Limited Third Quarter Fiscal Year 2019 Earnings Conference Call.

On today's call are Mr. Zhengdong Zhu, Chairman and CEO; and Mr. Mark Marostica, Co-CFO. During management's prepared remarks, all participants will be in a listen-only mode. Following management's prepared remarks, we will open the call for questions.

Before we start, we remind listeners that this conference call contains forward-looking statements. These statements are made under the Safe Harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. The outlook for the fourth quarter and full fiscal year 2019; oral statements from management on this call; as well as the company's strategic and operational plans, in particular, anticipated benefits of strategic growth initiatives, including the promotion of the company's lifelong learning ecosystem, regular class test prep and enrollment growth, cost control and year-over-year improvement of operating margins; among other things, may contain forward-looking statements.

Forward-looking statements involve inherent risk and uncertainties. A number of factors could cause actual results to differ materially from those contained in any forward-looking statement. Further information regarding this and other risks is included in the company's annual report on Form 20-F and in other documents of the company as filed with the Securities and Exchange Commission. The company does not undertake any obligation to update any forward-looking statements except as required under applicable law.

As a reminder, this conference call is being recorded. In addition, the presentation we will be referring to during the course of the call can be downloaded from the company's Investor Relations website. Further, a webcast of this conference call will also be available on the company's IR website at ir.cdeledu.com.

I will now turn the call over to Mr. Zhu. Mr. Zhu, please go ahead.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)



Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] Thank you everyone for joining our Third Quarter Fiscal Year 2019 Earnings Conference Call. Our operating results were distributed earlier via Internet Newswire services and are also posted on our website, where a slide presentation is available as well.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] If you will now refer to the presentation, I will begin on Slide 4 with an overview of our financial results.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] We achieved solid results in the third quarter with revenue and net income growth of 30.2% and 84.1% year-over-year, respectively. Third quarter revenue growth was driven primarily by our industry-leading accounting vertical, a significant increase in revenue from the sale of learning simulation software and revenue from the legal vertical generated by Beijing Ruida.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] Our third quarter cash receipts from online course registration were up 30.7% year-over-year or 39.8% year-over-year on a constant currency basis. Underpinning the healthy growth of cash receipts is the continued popularity of our longer-duration premium and elite classes. Notably, all 3 core verticals of accounting, health care and engineering & construction recorded cash receipts growth between 29% and 36% year-over-year in the third quarter, showcasing the attractiveness of our course offerings across industry verticals.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] We also posted robust total enrollment growth of 29.2% year-over-year in the third quarter driven primarily by strong enrollment growth in accounting and engineering & construction continuing education courses. The growth of our online professional continuing education course enrollments reflects the importance of continuing education to satisfy PRC regulatory requirements for certificate holders and practitioners while enhancing their knowledge and expertise, and demonstrates that continuing education services remain an integral part of our lifelong learning ecosystem for professional education.



Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] In addition to our higher-value, longer-duration premium and elite classes, we believe our relatively lower-priced, shorter-duration regular classes as well as our free trial classes remain important drivers of traffic to our core websites -- course websites. And we expect they will help us improve enrollment growth and further promote our higher-value classes.

Likewise, our efforts to enhance our course websites with enriched content and improved navigation -- website navigation, which we touched on during last quarter's earnings call, are moving forward as planned. Such efforts aim to improve student engagement and learning experience and further increase traffic to our course websites. We believe a highly active and engaged online student community, combined with rich content on our course websites, will help us elevate our brand awareness with new and existing students and drive student enrollment and cash receipts.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] Turning to Beijing Ruida, a leading provider of exam preparation services for participants in China's Legal Professional Qualification Examination. We completed the acquisition of an additional 9% equity interest in Beijing Ruida on August 7, 2019, bringing the company's total equity interest in Beijing Ruida to 60%. Beijing Ruida's third quarter revenue was generally in line with expectations.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] Moving to our mobile platform. As of June 30, 2019, China Distance Education offers 69 mobile apps and recorded cumulative downloads of 57.6 million, up from 54 million as of March 31, 2019. In the third quarter, daily traffic to our mobile website continued to increase daily active users in our accounting, healthcare and engineering & construction verticals, increasing by 15.3%, 11.6% and 50% year-over-year, respectively. With enriched content and various features for dynamic communication and interaction on our mobile platform, we are providing an engaging, convenient and flexible learning experience to our students.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] This concludes my update on our business operations and strategy. I will now turn the call over to Mark, our Co-CFO, to walk through key operating metrics and financials.

Thank you. Before I discuss the details of our third quarter financial performance, I want to provide a few highlights regarding the improvement in our profitability.

In the third quarter fiscal 2019, our non-GAAP gross margin expanded by 230 basis points year-over-year despite \$1.7 million of incremental amortization expenses of intangibles in the third quarter from the acquisition of Beijing Ruida. And our non-GAAP operating margin was 16.8%, a significant improvement from 4.6% in the year-ago period. The improvement in our profitability is the result of strong third quarter revenue growth coupled with the successful implementation of certain expense control measures, including strict headcount and office space control and leverage of our cost structure.

Now let me summarize some of our key operating metrics on Slides 6 and 7. Enrollments in our Online Accounting Test Preparation courses were down 10.5% year-over-year in the third quarter primarily due to declines in Certified Public Accountant, or CPA, enrollments; as well as Accounting Professional Qualification Exam, or APQE, enrollments; partially offset by increasing enrollment in our tax adviser courses.

That said, enrollments in Accounting Test Preparation premium classes were up approximately 130% year-over-year in the third quarter and drove accounting test prep cash receipts growth of 32.3% year-over-year in the quarter. Enrollments in our accounting continuing education courses increased by 115% year-over-year in the third quarter fiscal 2019 primarily due to a resumption of accounting continuing education in certain jurisdictions that began in the second quarter of fiscal 2019. Enrollments in other accounting courses climbed 126.3% year-over-year in the third quarter primarily due to an increase in accounting practical training courses enrollments.

Total online accounting test preparation ASPs increased by 47.9% year-over-year in our third quarter as ASPs increased significantly in our CPA and APQE courses. These ASP increases were mainly due to increased student enrollments in our longer-duration premium classes. ASPs for our other accounting courses declined 75.2% year-over-year due to a higher mix of relatively lower ASP accounting practical training course enrollments.

Enrollments in our Online Healthcare Test preparation courses in the third quarter of fiscal 2019 decreased by 7.3% year-over-year primarily due to enrollment declines in our Medical Practitioner and Physician's Assistant test preparation courses partially offset by enrollment increases in Licensed Pharmacist and Physician Practice Skills courses. ASPs for our health care test preparation courses increased by 36.5% year-over-year in the third quarter mainly due to overall ASP increases and in particular our longer-duration premium classes.

Enrollments in our online engineering & construction, or E&C, test preparation courses increased by 0.6% year-over-year in the third quarter primarily due to enrollment growth in our cost valuator test preparation courses offset by a decline in constructor test preparation course enrollments. Enrollments in our E&C Continuing Education courses, however, increased by 69.3% year-over-year in the third quarter. ASPs for our E&C test preparation courses in the third quarter increased by 8.1% year-over-year.

The ASPs for E&C Continuing Education courses decreased by 9.3% year-over-year in the third quarter. The significant year-over-year increase in third quarter E&C Continuing Education enrollments, and correspondingly, the year-over-year decline in E&C Continuing Education ASPs, was primarily due to a policy change implemented by the E&C professional certification authorities in the second quarter of fiscal 2019. Whereby students are now allowed to purchase continuing education services from multiple providers in order to fulfill their continuing education requirements instead of from a single provider as was the case previously.

Let's turn to Slide 10 to look at some of our financial metrics. To be mindful of the length of our earnings call, I'll focus on key financial highlights and encourage listeners to refer to our earnings press release and financial filings for further details.

Non-GAAP gross margin was 50.5% in the third quarter of fiscal year 2019 compared with 48.2% in the third quarter of fiscal year 2018. The year-over-year expansion in gross margin was primarily due to decreased salaries and related expenses and decreased rental and related expenses partially offset by expenses associated with Beijing Ruida, including lecture fees, cost of books and reference materials and amortization expenses of intangibles of \$1.7 million arising from the acquisition of Beijing Ruida.

Non-GAAP selling expenses increased by 31.6% to \$17 million in the third quarter of fiscal year 2019 from \$12.9 million in the prior year period, driven primarily by increases in advertising and promotional expenses, rental and related expenses and other miscellaneous selling expenses as

well as expenses associated with Beijing Ruida partially offset by a decrease in commissions to our agents. Non-GAAP general and administrative expenses increased by 7.4% to \$4.4 million in the third quarter in fiscal year 2019, up \$4.1 million in the prior year period mainly due to expenses associated with Beijing Ruida. Overall, the non-GAAP operating income from the third quarter of fiscal year 2019 was \$10.4 million compared with non-GAAP operating income of \$2.2 million in the prior year period.

Income tax expense was \$2.5 million in the third quarter of fiscal year 2019 compared with \$1.3 million in the prior year period primarily due to an increase in taxable income. Non-GAAP net income was \$10 million in the third quarter of fiscal year 2019 compared with non-GAAP net income of \$5.8 million in the prior year period.

Now let's turn to Slide 11 to review our cash flow. Net operating cash inflow increased by 41.7% to \$17.6 million in the third quarter of fiscal year 2019 from \$12.4 million in the prior year period. The operating cash inflow was mainly attributable to net income before noncash items generated in the third quarter of fiscal 2019. The increase in accrued expenses and other liabilities, income tax payable and deferred revenue generated from our professional education services segment also contributed to the operating cash inflow. The operating cash inflow was partially offset by the increase in accounts receivable, inventories, prepayments and other current assets and other non-current assets.

Cash and cash equivalents, restricted cash and short-term investments as of June 30, 2019, decreased by 4% to \$124.9 million from \$130.1 million as of March 31, 2019, mainly due to the payment of contingent consideration for the acquisition of 11% equity interest and purchase consideration for further acquisition of 9% equity interest in Beijing Ruida for a total of \$6.6 million, the repayment of loans of \$13.1 million and the capital expenditure of \$1.7 million. The decrease was partially offset by the operating cash inflow generated in the third quarter of fiscal 2019 and the proceeds from the disposal of an investment, Beijing Yousian Technology Co., Ltd, of \$3.6 million.

Of note, after the repayment of loans in the third quarter, our debt to total capital ratio was 26% as of June 30, 2019, down from 36% as of September 30, 2018, and 50% as of June 30, 2018.

This completes my financial overview. I will now return the call to Mr. Zhu for concluding remarks as well as financial guidance for both the fourth quarter and for fiscal year 2019. Mr. Zhu, please.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

Thank you, Mark. (foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] Our third quarter results reflect the healthy development of our business, and we are pleased to see improving margins and strengthened profitability.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] In particular, the popularity of our longer-duration premium and elite classes throughout fiscal 2019 has driven strong growth of our cash receipts from online course registration, which were up 36.6% year-over-year during the first 9 months of fiscal 2019. Likewise, we've achieved a significant increase in our deferred revenue and refundable fees, which have grown to \$143.5 million as of June 30, 2019, a year-over-year increase of 64.4%.

Our growing cash receipt attributable to our longer-duration premium and elite classes and our higher deferred revenue balance lay a good foundation for future growth.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] An important driver of the improvement in our revenue growth and profitability is our continued focus on enhancing our lifelong learning ecosystem across multiple industry verticals.

Our accounting vertical, for example, now encompasses a full complement of services, including professional certification exam preparation courses with multiple class types and learning modalities tailored to individual learning styles and preferences, continuing education services to enable certificate holders and practitioners to meet PRC regulatory requirements, accounting learning simulation software, practical accounting training and employment guidance services, accounting and related advisory services to corporate clients and books and reference materials.

With our accounting vertical as a blueprint, we aim to develop similar ecosystems across our other industry verticals, such as healthcare, engineering & construction and legal, in an effort to expand our overall growth opportunities.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] As we enhance our lifelong learning ecosystem across our core industry verticals, we remain dedicated to carrying out our mission: To be the preeminent learning partner for students in their quest to succeed and advance in their careers.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] As China's trusted leader in online professional education, our vision has remained consistent over the years, which is to cultivate online learning as a lifestyle through the delivery of high-quality educational content and value-added services to our students while integrating best-of-breed learning technologies across our educational platform.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] We believe staying true to our vision will ultimately pave the way for improved financial performance in the quarters and years ahead, and enable us to enhance shareholder value.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] Turning to guidance. For the fourth quarter of fiscal year 2019, the company expects to generate total net revenue in the range of \$63.3 million to \$66.5 million, representing year-over-year growth of approximately 18% to 24%.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] For the fiscal year 2019, the company expects to generate total net revenues in the range of \$206.4 million to \$209.6 million, representing year-over-year growth of approximately 23.8% to 25.8%. The company's prior fiscal 2019 full year total net revenue guidance range was \$210 million to \$218.3 million.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] We lowered our fiscal year 2019 revenue guidance for 2 main reasons. First, the mix of cash receipts from our longer-duration premium and elite classes in the third quarter was higher than our forecast, which has a negative impact on our fourth quarter revenue guidance as revenue from these longer-duration classes is recognized over a longer period. And second, currency, given the recent depreciation of the renminbi versus the U.S. dollar.

Zhengdong Zhu - *China Distance Education Holdings Limited - Co-Founder, Chairman of the Board of Directors & CEO*

(foreign language)

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

[Interpreted] This concludes my prepared remarks. Thank you for your time. Operator, we're now happy to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have a question from the line of Greg Pendy from Sidoti.

Gregory R. Pendy - Sidoti & Company, LLC - Consumer Analyst

Just a couple. First, can you just kind of go into a little bit more detail? I think you mentioned on the SG&A line, advertising was up and you had lower agent commissions. Is that sort of just a catching up to a normalization? Or is that something you expect -- we should be thinking about going forward?

Mark A. Marostica - China Distance Education Holdings Limited - Co-CFO

Yes, with regards to the year-over-year decline in agent commissions, there's a couple of points I'd like to raise there. First of all, as you know, Greg, with the implementation of ASC 606, we are not only able to recognize revenue for our longer-duration premium classes and elite classes over a longer period more radically as compared to in the past, where we had lump sum revenue recognition in the latter part of the service period, we're also able to defer agent commissions that drove the student acquisition for those longer-duration courses, such that there's more of a matching principle between the commission recognition and the revenue recognition. In addition to the deferral of agent commissions, we also benefited from more amenable commission rates as well this quarter and the prior period. So those 2 factors together accounted for a decline in agent commissions. And we feel that, that should certainly play forward for us favorably.

Gregory R. Pendy - Sidoti & Company, LLC - Consumer Analyst

Right. And then also just in light of the revenue guidance, can you kind of give us a little bit of color on how we should be thinking about Q4 margins? Just the underlying health of the business. I think we anniversary, if I'm not mistaken, a benefit from the prior year in Beijing Ruida. So how should we be thinking about sort of the fourth quarter?

Mark A. Marostica - China Distance Education Holdings Limited - Co-CFO

Sure. So the fourth quarter revenue guidance implies that our fourth quarter operating margins, GAAP operating margin, actually should be flat to up slightly year-over-year. Now I want to characterize 1 point you touched on, Greg. Our GAAP operating margins in fourth quarter of fiscal '18 were 22.7%. Having said that, when you look at 1 point in particular, in the fourth quarter of fiscal '18, we benefited that quarter from a nonrecurring item that boosted the operating profit in that quarter by about USD 4 million related to contingent consideration tied to business combination. So this was the quarter where we upped our equity interest in Beijing Ruida to 11% and thus recorded this \$4 million onetime item.

So excluding that item, in fact, our operating margin that quarter would have been 15.4%. So the relevant comparison really between our fourth quarter in fiscal '18 and fourth quarter fiscal '19 is looking back at that 15.4% figure, and that shows you that we're expecting pretty strong margin expansion on a like-to-like basis in our fourth quarter fiscal '19, and I think underscores the profitability in our business that's emerging that we first saw in the -- in the recently completed third quarter.

Gregory R. Pendy - Sidoti & Company, LLC - Consumer Analyst

Right. And then just one more. I guess, you mentioned that the trends right here have been pretty broad based. But is there anything kind of we should be aware of, I think, going forward that could either drive or hinder one of your verticals?



Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

I think looking at our cash receipt growth is a leading indicator of the health of the business. And I think looking at our third quarter cash receipts growth across each of the 3 core verticals, the accounting, healthcare and engineering & construction, where we saw cash receipt growth in and around 30%, plus or minus, year-over-year shows the broad appeal of those courses.

Now every quarter brings with it some additional opportunities and challenges, of course. So that being said, when we look at our fourth quarter fiscal quarter-to-date through last week, our cash receipts from online course registration are up about 31% year-over-year on a constant currency basis. So fairly good growth still. Mind you, slower growth than what we saw in the third quarter where cash receipts on a constant currency basis were up just under 40% year-over-year.

So I think we're still seeing some fairly healthy growth metrics on the cash receipt side in the business. And so I think that viewpoint gives us a sense of what's to come.

Operator

(Operator Instructions) We have a question from the line of [Christine Li] from China Merchant Security.

Christine Li

I have 2 questions. The first one is that I want to know why the ASPs seems -- have large changes this quarter, and what's the normal range of price? And your outlook for next quarter, for example, for the CPA and APQE.

And the second question is that what's the normal range of the contribution of long-duration classes in terms of revenue?

Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Thank you for your questions. First, in regards to ASP changes. You're right in observing that our ASP increases in the third quarter were quite significant. This is not a new phenomenon. We've seen this for the last few quarters in accounting, in particular, CPA and APQE. But what's happening here is we're seeing the results of a mix shift or a pivot to selling successfully, mind you, longer-duration premium and elite classes in accounting, in healthcare and E&C, engineering & construction, that's driving some outsized ASP increases. We think that this will be with us into the fourth quarter as well.

But your other point about normalized price increases. As we start to anniversary the pivot to these longer-duration classes, you'll see us migrate to our normal pricing behavior on a like-to-like basis, which is to increase ASPs between 15% and 20% every other year. We'll stagger that in depending on the course, so you'll typically see a 7% to 10% ASP increase on a like-to-like basis from that standpoint.

In terms of the mix, premium and elite classes from a revenue standpoint, 1 metric I can share with you is proportion of our cash receipts from premium and elite classes in the quarter. So in the third quarter, approximately 2/3 of our cash receipts across the business were derived from premium and elite classes. And that compares to a year ago, about 25-plus percent of our cash receipts were from those longer-duration classes. So a significant change, of course, that we've seen this quarter and consistent with last quarter, second quarter, as well.

Operator

(Operator Instructions) If there are no further questions at this point, I would like to turn the call back to the management for closing remarks. Please take over.



Mark A. Marostica - *China Distance Education Holdings Limited - Co-CFO*

Thank you, operator. On behalf of the management team, we thank you for joining us today, and we look forward to updating you on our progress.

Operator

Thank you. Ladies and gentlemen, that concludes our call. Thank you all for your participation. You may all disconnect now.

[Portions of this transcript that are marked [Interpreted] were spoken by an interpreter present on the live call.]

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