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MTLS - Q3 2019 Materialise NV Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Materialise Third quarter Conference Call. (Operator Instructions) As a reminder, this call is being recorded.

I would now like to turn the conference over to your host, Ms. Harriet Fried of LHA.

Harriet C. Fried - *Lippert/Heilshorn & Associates, Inc. - SVP*

Thank you for joining us today for Materialise's quarterly earnings call. With us on the call are Fried Vancraen, Founder and Chief Executive Officer of Materialise; Peter Leys, Executive Chairman; and Johan Albrecht, Chief Financial Officer.

Today's call and webcast are accompanied by a slide presentation that reviews Materialise's strategic, financial and operational performance for the third quarter of 2019.

To access the slides, if you've not already done so, please go to the Investor Relations section of the company's website at www.materialise.com. The earnings release issued today can also be found on that page.

Before we begin, I'd like to remind you that management may make forward-looking statements regarding the company's plans, expectations and growth prospects, among other things. These forward-looking statements are subject to known and unknown uncertainties and risks that could cause actual results to differ materially from the expectations expressed, including competitive dynamics and industry change. Any forward-looking statements, including those related to the company's future results and activities, represent management's estimates as of today and should not be relied upon as representing their estimates as of any subsequent day. Management disclaims any duty to update or revise forward-looking statements to reflect future events or changes in expectations.

A more detailed description of the risks and uncertainties and other factors that could impact the company's future business or financial results can be found in the company's annual report on Form 20-F filed with the SEC.

Finally, management will discuss certain non-IFRS measures on today's call. A reconciliation table is contained in the earnings release and at the end of the slide presentation.

With that introduction, I'd like to turn the call over to Peter Leys. Go ahead, please, Peter?

Peter E. Leys - *Materialise NV - Executive Chairman*

Thank you, Harriet, and thank you, everyone, for joining us today for our call. As always, you will find the agenda for today on Slide 3. On the right, you will see the pictures of 3 gentlemen who have not changed over the last 4 years since we started using the slides. And on the left, you will find the agenda, which frankly hasn't changed much either.

As always, we'll begin with a brief recap of our results for the quarter, then Fried, as always, will come on. And this time, Fried will discuss some of the strategic and technological drivers for the continued success of Materialise Software. After Fried, you will hear Johan, who will go through our third quarter numbers in more detail. And then I'll come back on to review our financial guidance for the rest of the year. And when we've completed our prepared remarks, we'll be happy to respond, as always, to any questions that you may have.

So turning to Slide 4. You will see the highlights of our third quarter results. Now despite a macroeconomic environment that remains challenging, materialise continued to grow. Our total revenue, as you saw, rose 8%. We realized a quarterly adjusted EBITDA record of more than EUR 8 million this quarter, and we generated EUR 1 million of net profit.

Importantly, Materialise Software enhanced its performance in Q3 significantly, as we forecasted in our Q2 call with a revenue growth of 10% and an EBITDA margin that came back to normal of 35%. Also Materialise Medical performed very well, we believe, with revenues growing 21% quarter-over-quarter and with an EBITDA margin of 18%, including the August-September results of Engimplan. And finally, with Materialise Manufacturing, also grew its EBITDA margin to a solid 16%, and this on the back of stable revenues that grew modestly by roughly 0.5%.

Against that background, I would like to turn the call now over to Fried who will, among other things, expand on our software strategy.

Fried, go ahead.

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Thank you, Peter. Good morning and good afternoon to everyone. Thank you for joining us today. While we are heading fast to the big gathering of the 3D printing industry at Formnext in Frankfurt starting November 19. I would like to use the opportunity of this quarterly call to give an update on the Materialise Software strategy.

Our strong Q3 software results demonstrate that Materialise Software tools remain key productivity drivers for the majority of the professional 3D printer users. At Formnext, we will introduce several new upgrades of our products that increase productivity further. These tools have been built along 2 major axes. Firstly, our development teams have come up with solutions that dramatically increase the speed at which our tools can process data. For 3D nesting, a crucial tool to make selective laser sintering and Multi Jet Fusion technologies more cost effective. Our development teams managed to increase the processing speed by a whopping factor of 30. Importantly, customers can translate the amazing increase in data processing speed directly into productivity gains.

As you know, as printed parts become more and more complex, build platforms become larger and larger and packing becomes more and more dense. As a result, the associated data files increased significantly in size, which impacts the time that is required to process the data that must be imported into the machine.

In such an environment, the ability to process data significantly faster and thus keep the data preparation time as short as possible becomes a major driver to increase the productivity of 3D printing facilities. That is exactly what our newest generation of nesting tools do.

In addition to saving time, our highly efficient nesting also saves power, which decreases both the production costs and the environmental impact of the 3D printing process.

Secondly, the new generation of products include significant enhanced automation functionalities. Automation is particularly important for environments where customized products or wide varieties of different parts are made. In these situations, the work planning is a major cost factor and automation saves considerable working hours of the people that are involved in the planning process.

Very importantly, from a software architecture perspective, our new product releases are based on a set of internally developed underlying software APIs that allow us to integrate new functionality seamlessly with existing functionalities that have been fine-tuned and stabilized but didn't materialize for over 30 years of software development. These APIs operate both in our cloud-based solutions and on distributed devices.

This new generation of APIs will allow us to significantly shorten the time to market of new functionalities that we are currently already testing within our own end part production. All those new software tools will be addressing the major hurdle that the 3D printing industry is facing today.

The transition to real manufacturing of end products. This transition has been going slower than many market watchers and consultants initially predicted. One of the major reasons is that it takes much more effort than most engineers ever estimated to make the transfer from a product development environment, where just 1 prototype is printed to a genuine manufacturing environment, where many end parts are printed consistently and reliably over a long period of time. Take the famous example of the GE fuel nozzle that took multiple years of new product introduction or NPI process before it would really be launched in commercially successful circumstances. The same painstaking NPI process happens over and over again for every new application of a 3D printed end part. Within our own production, we witnessed it for multiple meaningful applications in different sectors, such as health care, aerospace, automotive and wearables.

Based on this painstaking experience within Materialise, we have developed a new suite of NPI software products that are all built on a new Materialise core API and that will help the new product introduction of 3D printed parts significantly.

I would like to compare the use of the APIs within Materialise Software with the introduction of scripting within Materialise Medical segment approximately 2 years ago. Scripting allowed our medical segment to accelerate the development of new planning and designing tools to the benefit of many companies dealing with patient-specific data. Just as scripting contributed to the good growth numbers of software sales within our Medical segment, we expect that the new generation of APIs can contribute similarly to the continued growth of our Software segment.

Let me conclude by stating that for Materialise, Formnext will also be again a celebration of the partnerships, partnerships we have with many players in the 3D printing industry, machine manufacturers, material manufacturers, and of course, the key -- the key users of additive manufacturing technologies. A good example of various partnerships that come together in the commercial launch of the new TPU material from BASF on the HP MJF printers within Materialise Manufacturing in September.

At this point, Johan will come on to give you more details on our third quarter financial results.

Johan Albrecht - Materialise NV - Executive VP & CFO

Thank you, Fried. I'll begin with a brief review of our consolidated revenue on Slide 6. As a reminder, when we refer to sales in our presentation, we mean revenues plus deferred revenues. Also, please note that unless otherwise stated, all comparisons in this call are against our results for the third quarter of 2018.

As Peter mentioned in his opening remarks, in this year's third quarter, we generated an 8% increase in revenue, driven by our Medical segment and an acceleration of sales performance in our Software segment, which returned to double-digit growth.

Deferred revenue from annual software sales and maintenance contracts increased EUR 1.4 million compared to year-end 2018. For the quarter, Materialise Software accounted for 21% of our total revenue, Materialise Medical for 31% and Materialise Manufacturing of 48%. Cross-segment, revenue from software products accounted for 31% of our total revenue.

Moving to Slide 7. You will see our consolidated adjusted EBITDA numbers for the third quarter. Consolidated adjusted EBITDA increased almost EUR 1 million from EUR 7 million to EUR 8 million. Our EBITDA margin increased from 15.1% to 15.9%. Unlike the previous periods, the third quarter



2019 EBITDA included a positive effect of EUR 632,000, resulting from the new IFRS 16 accounting standard that requires us to capitalize certain lease expenses as of 2019. This new accounting standard has little impact on our operating profit as depreciation expenses increased by the same amount. The improved gross margin and a moderate increase of operating expenses resulted in a 25% increase of our operating profit.

Slide 8 summarizes the results of our Materialise Software segment. Here, revenue grew by 10% or almost EUR 1 million. The rebound from the softer first half of the year was reflected in the Q3 sales growth of 16.4%. Recurring revenue was up 5.3%. Nonrecurring revenue was up 14.4%, boosted by OEM sales. The segment's EBITDA increased to EUR 3.8 million from EUR 3.4 million in last year's quarter. The EBITDA margin also increased to almost 35%, despite the continued expansion of our software sales and marketing capacity.

Moving now to Slide 9, you will see that total revenue in our Materialise Medical segment grew 21% for the quarter to EUR 15.5 million. Revenue from medical device solutions rose 25%, accounting for 68% of the total segment's revenue.

This quarter's report includes the results of the Engimplan acquisition that we consolidated since the first of August 2019. As Engimplan manufactures and sells orthopedic and craniomaxillofacial, CMF implants and instruments, its revenues are reported under medical device solutions. Engimplan's August and September 2019 revenues amounted, in the aggregate, to EUR 1.029 million. Excluding Engimplan, total revenue from Materialise Medical still grew by a very solid 12.7% and medical devices and services revenue grew by 12.8%. Revenue from our medical software, which accounted for 32% of the segment's revenue, which was not impacted by the Engimplan acquisition, grew equally strongly by 12.7%. EBITDA for the Medical segment was EUR 2.8 million compared to EUR 2.5 million. The EBITDA margin was 18% as compared to 19%.

Now let's turn to Slide 10 for an overview of the Q3 performance of our Materialise Manufacturing segment. Their revenue was up by 0.5%, reflecting a small increase in both our traditional manufacturing and ACTech businesses. In light of the soft macroeconomic environment, we think this is a good performance. EBITDA rose 13%, resulting in an EBITDA margin of 16%. The solid EBITDA growth in the context of a low top line growth -- of a low top line growth reflects the results of a continuous efforts to improve operational excellence. In the third quarter of 2019, we added 1 printer as compared to the previous quarter, which brings the total amount of printers that we have in production in our Manufacturing and Medical segments to 193.

Slide 11 provides the highlights of our income statement for the third quarter. Revenue grew -- revenue rose 8%, and gross profit rose 10% compared to last year's period. In total, sales and marketing, G&A and R&D spending rose by 11.2% over the prior year period. Sales and marketing rose 20%, mainly by a continued capacity expansion in our software and medical segments. G&A increased 7% and R&D was flat. This R&D cost excludes expenditures in Q3 2019 of EUR 301,000 that were capitalized as intangible assets from the tracheal splint initiative.

In total, the intangible assets related to the development initiatives amounted to EUR 1.480 million on our balance sheet at the end of the third quarter 2019.

Net other operating income increased by EUR 760,000 to \$1.3 million compared to \$600,000. As a result of all these amounts, the group's operating profit increased 25% to EUR 2.9 million compared to EUR 2.3 million. The net financial result was negative EUR 966,000 compared to a positive EUR 268,000 last year. The decrease primarily reflects the negative exchange rate variances that were particularly positive in last year's period.

To a minor extent, the interest of the European investment bank drawing of EUR 25 million has also a negative impact on the financial results.

Income tax amounted to EUR 908,000 compared to EUR 230,000 in the third quarter of 2018. And in this quarter, it includes a negative variance in deferred income tax of EUR 466,000.

Net profit for the third quarter was EUR 1.001 million compared to EUR 2.316 million for the same period in 2018. Net profit for the quarter includes the 25% noncontrolling interest profit of EUR 72,000 related to Engimplan.

Now please turn to Slide 12 for a recap of balance sheet and cash flow highlights. Our balance sheet remains strong with cash of EUR 131.1 million compared to EUR 115.5 million as of December 31 last year. The increase of cash reflects the strong EBITDA performance, a focus on reducing accounts receivable and the drawing of the second tranche of EUR 25 million from our credit facility with the European Investment Bank. Partly

offset by other loan reimbursements, the Engimplan acquisition and other capital expenditures and the payment of the EUR 2.5 million convertible loan that we extended in Q1 to Fluida and that we referred to in 1 of our previous earnings calls.

The Engimplan acquisition was paid using our U.S. dollar proceeds. Total debt rose EUR 25.6 million from year-end 2018 to \$131.6 million, besides the EUR 25 million tranche drawn by the European Investment bank, this debt also includes EUR 4.9 million of total lease liabilities from the new accounting standard IFRS 16 and EUR 1.3 million debt from the Engimplan acquisition.

Capital expenditures for the quarter amounted to EUR 5.6 million, of which less than 20% was financed. This amount includes EUR 301,000 capitalized development costs for the medical project explained earlier. Cash flow from operating activities for the quarter increased to a new quarterly record of EUR 13.8 million compared to \$7.2 million in Q3 last year. This is a result of the combination of a strong EBITDA and working capital improvements of EUR 6.6 million this quarter.

Total deferred revenue amounted to EUR 29.4 million as compared to \$27.8 million as of end last year. Of the EUR 29.4 million, EUR 24 million were related to annual software sales and maintenance contracts versus EUR 22.6 million as of end last year.

And with that overview, I'll turn the call back to Peter.

Peter E. Leys - *Materialise NV - Executive Chairman*

Thank you, Johan. I wanted to conclude our prepared remarks this morning by touching briefly on our financial guidance for the rest of the year. As you may remember, last quarter, we confirmed our targets for the full year, albeit at the lower end of the range with respect to EBITDA.

As we explained last time, this was based on our view that our medical and manufacturing segments, which continue to do well and that our software segment would do significantly better than the first half of 2019.

Our sales teams lived up to these high expectations in Q3, and we would like to congratulate them for that. As we've just discussed, overall revenues grew by 8% and including, because of the strong performance of our software sales, Materialise turned in a record quarterly EBITDA of more than EUR 8 million. Still, to reach our full year targets, we will need to exceed the already excellent results of Q3 in the current quarter Q4. Our strong showing in the third quarter, and our pipeline for the remainder of the fourth quarter, which is traditionally our strongest period, show that this is indeed possible even in the soft macroeconomic environment that we live in today. Provided, however, that we fully include the EBITDA contribution by Engimplan in the fourth quarter, that our Manufacturing segment does not experience any unexpected downward swing, and that our software sales include the higher level of recognizable revenue for Q4 that we currently expect.

While the key driver for EBITDA generation within Materialise remains top line growth. We also expect some positive contribution from the continuous improvement programs that we have launched within our organization.

And with this, we would like to conclude our prepared remarks. So operator, we are now ready to open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Troy Jensen with Piper Jaffray.

Troy Donavon Jensen - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Johan, congrats on the nice results. Peter, for you, it sounds like the most convictions coming from a software growth, right? When you look at kind of your Q4 forecast here. So just speak, if you can and dive in a little bit? Is it the traditional 3D software versus 3D healthcare? Is it OEM partners that are really ramping? Or is it these new generation of APIs that Fried mentioned in his prepared remarks that are giving you guys a kind of confidence?

Peter E. Leys - *Materialise NV - Executive Chairman*

Yes. The software growth that I referred to, Troy, refers, first and foremost, to the sales of our traditional software tools that are sold within our software segment. But I would like to add, and we -- where we touched upon that during the prepared remarks, that we've seen a fairly strong rebound of our OEM sales, which were soft in the first half of the year. They were much stronger in Q3, and we expect that they will continue to contribute in Q4, and that they will continue to help us, continue the trend of growing sales within the software segment in Q4. That being said, we will need all the help we can in Q4. And we also expect that the medical software sold within our Medical segment will also contribute to what we expect to be a good, solid and strong fourth quarter.

Now the API is a new product introduction tools that Fried referred to. They will not contribute to our top line in Q4. If anything, they explain for a part, our continued investment in R&D. But they are exciting because they show that we are just not relying on the successful products that we have been relying on for such a long time, that we are revamping and actually making that software backbone, fully ready for the next-generation of end part production applications.

Troy Donavon Jensen - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

So then maybe for Fried, just to piggyback off Peter's comments on the strength of the OEM partners for software sales. I'm assuming that's production applications, and be curious to know kind of what Materialise has also seen in their manufacturing for kind of more of an effort to get growth in production?

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Well, the -- first of all, like Peter said, the tools we are currently selling are mostly the -- yes, legacy products of Materialise, albeit they're used more and more for production applications especially on the metal side. We also see in our loan production that there is an increase on demand for metal production components. Their prototyping is playing a much smaller role. But if Materialise can maintain a steady position at this moment in the soft climate, it is mostly because the growth of certified manufacturing in our manufacturing operations. So this is showing that this transition to end part manufacturing continues.

Troy Donavon Jensen - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

How about -- Fried, I'd love to get your thoughts to -- on just European automotive vertical. Have we bottomed here given you, kind of, coming out of Q3 now? Is there any improved visibility kind of going to next year with European auto?

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Well, it remains, let's say, a difficult answer -- a difficult question to answer. At this moment, there are quite some rays of hope that the situation will improve, especially in product development for the automotive sector. Although, the exact timing of that rebound is still questionable. And definitely, as what we are currently generating in revenues in Q4 is based on what was sold before. The impact of the automotive sector in Q4 will still be really, yes, that. But for next year, there is a hope on many levels that the situation will improve. Be it that we don't know whether this start will be as of the beginning of the year or the second quarter or only the second half of the year. That's still very cloudy.



Troy Donavon Jensen - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Right. Understood. All right. Just last question for me. Within Medical, I'm assuming these are roughly stable and most of the growth is coming from CMF and some of the new applications?

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

That's correct.

Johan Albrecht - *Materialise NV - Executive VP & CFO*

Yes.

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Same trends as previous quarters.

Operator

(Operator Instructions) Your next question comes from the line of Jason Celino with KeyBanc Capital Markets.

Jason Vincent Celino - *KeyBanc Capital Markets Inc., Research Division - Associate*

Just a couple of questions for me. First question, it looks like Engimplan contributed a little bit under EUR 2 million to the medical revenue. Is that correct? Or and then I know it's still early, but what has been early feedback like since you both have come together?

Johan Albrecht - *Materialise NV - Executive VP & CFO*

So the revenue that was contributed in Q3 over the 2 months of August and September when we started consolidating 1st of August is EUR 1.029 million.

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Yes. And the operational level, of course, these are the first months now that we are collaborating. We are very happy with the positive mindset and the results of our new colleagues in Brazil. But let's say -- and this is a medical sector, to integrate the product portfolios of Materialise into the Brazilian market and the other way around will take us approximately 1 year because of all the regulatory hurdles that need to be met.

Jason Vincent Celino - *KeyBanc Capital Markets Inc., Research Division - Associate*

Got it. Great. And then thinking about the steps you're taking throughout your organization to maximize effectiveness. Maybe can you talk about what some of those steps are and how those are going?



Johan Albrecht - *Materialise NV - Executive VP & CFO*

It's -- I mean, we haven't launched any particular or specific program, Jason. It's just that we -- as these are difficult and uncertain times, where, from a growth perspective, we are doing well. We are keeping an eye on our cost base and are making today even more sure than we did yesterday that the dollars that we do spend are spent for the right verticals and for the right initiatives. So it's more a matter of being even more focused and disciplined than anything else without losing, of course, sight of the growth drivers that we have identified and that we will continue to invest in.

And I want to add to that. Of course, our operational costs and especially our 3D printing costs is something where we work on continuously to improve the productivity of our machines, and which is the basis for our software tool development.

Jason Vincent Celino - *KeyBanc Capital Markets Inc., Research Division - Associate*

Okay, great. And last question, actually, if I could just build off of Troy's question. The auto OEMs in Europe, relative to maybe a quarter ago, would you describe maybe no change in overall condition or any incremental commentary you'd like to add

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Well, he the key -- why some of the developments are not going faster remains the uncertainty about the regulatory climate for the new generations of cars that exist. And there are many people in the auto sector hope that some clear decisions will be made by the different government and by the European Union with regard what the new emission standards and so on will be. This is holding back some of the developments.

Operator

Our next question comes from the line of Gregory Ramirez with Bryan Garnier.

Gregory K. Ramirez - *Bryan Garnier & Co Ltd, Research Division - Analyst*

Just with more clarification on the question, it's related to your guidance for the full year. You mentioned that it will be at the lower end of the range. After Q2 where you mentioned only, it will be at the low end of the range for EBITDA, adjusted EBITDA, excluding Engimplan. Now, does your guidance includes Engimplan? And do we have also to expect that the low end of the guidance applies to revenues as well? That is to say that total revenues including Engimplan will be more towards EUR 196 million to EUR 204 million?

Peter E. Leys - *Materialise NV - Executive Chairman*

Yes. Thank you. Thank you, Greg, for this good question, and it will allow us to take away any doubt, if there would be any. Now, we maintain that when we guide towards the lower end of the initial range that relates to EBITDA. As I said in the prepared remarks, the biggest EBITDA generator within Materialise is still our revenue growth. And so the main caution really relates to the range for EBITDA and not as much to the deferred revenue range that provided or, more importantly, to the recognized revenue range that we provided.

The second part, Greg, of your question, I think related to Engimplan. Definitely, in the last call, we were still hopeful that we would be able to use the Engimplan contribution to our EBITDA as a kind of safety buffer, let's say, to help us meet -- the bottom of the range is EUR 29 million. If you listened carefully to our prepared remarks, now we really fully also rely on the full contribution by our friends in Rio Claro in Brazil to allow us to get to that bottom end or lower end of the EBITDA range.

Operator

I am showing no further questions at this time. I would now like to turn the conference back to Peter Leys.

Peter E. Leys - *Materialise NV - Executive Chairman*

Thank you. Thank you, operator, and thank you all for joining us today. As Fried already mentioned earlier, Formnext is coming up in the week of November 19. So we very much look forward to being there, and more particularly, we look forward to meeting some of you in the course of those 3 to 4 days. Thank you all, and enjoy the rest of the day and the week. Bye.

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Bye-bye.

Johan Albrecht - *Materialise NV - Executive VP & CFO*

Goodbye.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may all disconnect.

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