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PAHC - Phibro Animal Health Corp at Bank of America Merrill Lynch
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PRESENTATION

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

(technical difficulty)

CFO of Phibro Animal Health. We'll do the same format that we did earlier, it will be a fire-side chat for about half an hour, and then open up to Q&A. If you've got any questions, raise your hand. So thank you for joining us. Richard.

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

You're welcome.

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

Always appreciate you coming in.

QUESTIONS AND ANSWERS

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

I guess, maybe to start, same thing, you reported earnings a few weeks back. Give us an update on sort of calendar year 2019? The last couple of months, sort of what were the major moving pieces in the story? What surprised you to the upside, what's surprised you to the downside as the year went ahead?

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

So our December quarter was a decent quarter. I think we were encouraged by the results, both in -- certainly, in our Animal health business, which is kind of really what we're going to be talking about today, it's \$550 million out of the total company. And we were encouraged by our vaccine progress and uptake demand for those products in a number of international markets and additional market penetration. We've launched some new products recently, and we're seeing good uptake on those products. We're also encouraged by the recovery, if you will, and growth in our nutritional specialty category that we're seeing the dairy industry, where we're mostly exposed in the United States. Dairy products did well in the quarter. We had a fairly recent launch of a gut health product. It's a living organism, direct-fed microbial, for the poultry industry that's seeing some good initial acceptance. And then we were pleasantly surprised to see the MFA business be relatively strong. And part of that was the uptake of some additional product going to our customers in China, which we had not anticipated earlier in the year. So that was -- and some of that was in anticipation of some regulatory changes that went into effect January 1, but really a positive for the quarter. So I think looking forward for the second half of the year, we reaffirmed our guidance, certainly, on the profitability side. And we'll expect to see a number of these same trends continue and, I think, strengthened in the second half of our fiscal year. Probably on the downside, our minerals business has been in a competitive market, more so than, historically, we've seen that it's been in the situation now for 4, 5, 6 quarters. And so we're not seeing the profitability growth there that that we might have hoped for, but we're getting some offsets in other places. So we still like that business. It's a good long-term business,



touches the same customers as our Animal Health Business touches and that's just something we have to work through and find some answers to.

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

Great. I appreciate that overview. So maybe just to start on some of the topics you touched on, I think the biggest theme, when we've talked about Phibro in the last couple of quarters, has been the dairy markets and some of the challenges you've seen there. Some of the segments that were your biggest drivers of growth in the past are now seeing a lot of challenges with that market. So could you give us an update on what you're seeing in terms of overall dairy and maybe some of the moving pieces between the consolidation, the larger customers versus smaller customers? And then how you're positioned?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

We're encouraged that the dairy industries is seeing better prices. And when your customer is seeing better prices for his products, he is more willing to open his wallet and add some other products to his mix. So that's been a positive for us. So I think the dairy industry is on an upswing, part of that, Mike mentioned, is consolidation. Consolidation in the dairy industry has been going on, of course, for decades. But it's really accelerated as we're in one of these periods of acceleration where the smaller producer is simply not economical anymore. And production is going to larger and larger farms. I saw a chart the other day, which kind of surprised me that there's about -- it's a little over 9 million dairy cows in the United States, over half of those cows are on -- are with producers who milk at least 1,000 cows. And then there's producers who are milking 2000, 5,000, 10,000 cows. So it's -- that just is an illustration of the amount of where consolidation is heading. And so the -- [ducalic] image of the red barn and the farmer and the greenfields that's -- it's a nice image, but that's not the dairy industry in the United States anymore.

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

And what's your product portfolio? Sort of what's your customer relationship, both with the large consolidators and the smaller farms, you're better positioned for one or the other?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

We were in -- and we've talked about this. One of our flagship products is a -- it's a nutritional specialty product. What does that mean? That means it's not an FDA-regulated drug. It's a sort of lightly regulated, some combination of natural ingredients. But it helps the animal's overall health. In this case, we've been able to show with markers that it really helps the animal's immune system. And just to digress for a moment. When you're -- when you have a dairy cow in production, her job is just to give as much milk as she can. And so your -- and your -- you're pushing that cow by the feed you give, the high energy feed to produce. So that puts a lot of stress on the animal's body. And so this product is -- we've grown this product over 10 years to -- from nothing to a very substantial product for us. The last few years, it's taken a downturn because we were more focused on kind of the mid-sized producer who is in, some measure, gone away or he's had such financial difficulty that he doesn't -- that he's not able to really afford the product anymore. And so we've refocused on the larger producer, refocused our sales force. We've reformulated the product, added more value, which -- and reposition the product to show the large producer of a much more direct relationship between use our product, get more milk. It's -- there's a lot of technical words in between. But that's the fundamental message. We just relaunched the product within the last few weeks, and we think this is going to have a nice benefit to us and bring us some additional sales as we move forward in the coming quarters. A good size portion of our overall nutritional specialty sales is dairy-focused. And most of that dairy focus today is in the United States. Although, we are growing in a number of international markets where there's, obviously, the other parts with other major dairy producing markets around the world.

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

And so the product you're talking about is OmniGen?



Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

That's right.

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

OmniGen and OmniGen Pro?

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

Yes.

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

Are you expecting -- you mentioned that you've had some challenging conditions over the last couple of years, are you expecting OmniGen Pro to return to growth in the second half, when you're off that.

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

Right. We've -- so the start of -- the product had been declining for -- declining slightly, but declining for 1.5 years, 2 years. And then given the turnaround in the industry, we saw stability in the product recently. And now we're definitely expecting growth as this new and improved and better value product is offered to our customers.

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

Okay. And then sticking on nutritional specialties, just while we're in that segment. The other major event there is you have the Osprey acquisition a few months ago. Could you give us an update on sort of what's in that business? Why you're interested in making the transaction and how that's done since then?

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

The Osprey business is a microbials business. So it's living organisms, Bacillus and Pseudomonas, and other words that I don't really have a lot deeper understanding of than that. And it's in the animal health space. It's also in crop protection or plant protection, where you'll coat -- you'll use these organisms to coat seeds to protect them as they're growing and planted, then -- which is an agricultural-related to our main line of business. We got to know this company as we were developing the direct-fed microbial, and I mentioned it earlier, got health for poultry. And as we got to know them, and they make the primary ingredients in the poultry product, we saw a good fit with Phibro and and talk to them about combining our businesses, and we ended up acquiring the company, I think it was in August and moving forward. We continue to be very encouraged about the prospects. We just said in an internal review the other day of all of the prospects that are out there on the near-term horizon for the business. We've seen some short term, I'd say, sales that are less than our initial expectations just because of some customer order patterns. And -- but that's -- we view it as short term, and we think the business is still going to be a real nice contributor as we move forward.



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

Great. I was actually -- I was going to ask you right on that point. So I'm glad you addressed it. I think the contribution from Osprey in fiscal 2Q was a little bit lighter than expected, but it sounds like that's just timing you're mentioning that. And then your initial expectation was \$20 million to \$22 million for fiscal year?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Yes.

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

Great. And then, I guess, turning to the other growth segment, vaccines, you've had a nice little rebound after a couple of challenging quarters. Could you give us an update of what you're seeing in that product class, whether it's by species or geography?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

The -- most of the growth is in our poultry vaccine line. Most of the growth is in emerging markets, whether that's Southeast Asia, Eastern Europe, some of the Middle Eastern countries, other specific markets around the world. We have introduced some, I'll say, new products. And when I say a new product, we're not -- it's a vaccine against an existing well-known disease, and it's not a -- I don't think there's any unknown poultry diseases. But we've come out with an improved version, which works better than other versions. So we've been -- we've seen good additional penetration and very nice demand. So I don't remember the exact numbers. I think we grew around 10% in the second quarter. And we're expecting continued really solid growth moving forward.

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

Sticking on the sort of on the vaccines and on the viral front, and moving on to the end markets. I think the other big theme we've had in this space over the last year, 1.5 years is the African swine fever outbreak in China. It's been a disease that's been around for many, many decades. But popped up in China in I think August 2018, and you saw the impact. It gets worse as we went through the year. As you said, your initial outlook for China for fiscal year '20 was you expect essentially 0 revenues. So in that sense, you surprised the upside in fiscal 2Q. Could you give us an update on how the disease is unfolding based on what you've seen? And sort of what the longer-term prospects are? When we met in Vegas in May, you talked about a potential for a rebound from other markets producing more in Latin America, is it still too early to see some of that?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

There's -- right. So there's 2 -- so this disease left a big supply shortage in China. China, prior to the disease, produced and consumed something around 800 million pigs per year. And depending on the numbers, you believe it's maybe 400 million pigs now. It's maybe 300 million. It's something very significantly less. And as the disease has really decimated the production industry. So in the shorter run, absolutely, the -- there is a hole in the protein supply, which is going to be filled by protein producers around the world. And the big producers are the United States, Europe, to a certain extent, and certainly, Brazil. And Brazil is probably the most agile to have begun to supply some of that need. And it's coming about. There isn't enough swine in the rest of the world really to meet the demand. So a lot of the demand is going to be in poultry. And then there'll be some swine demand. The United States gets a little more complicated and has been complicated with the trade wars and the tariffs, which given recent developments that seems to be loosening. But producers in China are attempting to restore production and bring production back. It's kind of a stop-and-start activity. If you put pigs back on and the disease reappears, because the virus can remain dormant in the environment for some time. And if it wipes you out again, then that's a problem. The government is very actively supporting the repopulation and then trying to do what they can to support additional local domestic production. And that's where it stands. It's -- I think it's still -- this is not going to be an easy and quick recovery. It's going to -- until or if somebody is able to come up with a vaccine that can control or eradicate the disease, it's going to be very difficult.

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

So are you working on a vaccine? And how is that going?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

(inaudible) toss that swap. Yes. We're -- we like I'm sure everyone else in the industry are working on a vaccine. We think we've got some really smart partners and people we're working with and some novel ideas. And we are spending money on one of the -- one of the themes in our discussions have been that as an -- aside that we're investing for the future on a number of initiatives. One of those is investing research dollars into this attempted development of a vaccine against African swine fever. So we like what we're seeing so far. We're encouraged by early results. Can't tell you if it's going to be successful or not, probably by the time we're talking about our year-end results, we'll probably be able to have a much better view of where we're at and what next steps might be.

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

Okay. On that front, I mean, we've seen, as you mentioned, we've seen some positive news elsewhere. I know the USDA Agricultural Research Service, ARS, had a couple of publications end of 2019, and I'd say, about some very early work with the vaccine, but that would seem very positively as people are commenting that out. It's right around the corner, and then they kind of came back and said, well, realistically, commercialization is 3 to 4 years away, by the time you move it from macrophages to the other sell-ins, et cetera. Could you give us a sense of what the vaccine R&D process is? Just because at some place where people are debating. Is it a 1-year, 3-year, 5-year process, sort of how quickly given that it's an emergency, given that there should be a lot of ability to sort of expedite it? What's the time line for something like this?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Right. The standard time line and normal circumstances would be at the longer end. I don't think there's any question. Given the severity of the problem, if somebody came to the Chinese authorities and could show efficacy and a -- I'll say, a good safety profile than the speculation is that the Chinese authorities would likely fast track some -- the testing in the market. And it -- but it's all -- we'll have to see when somebody gets there, what really happens? But those are the -- that's the thinking around it.

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

And what about spread beyond China. We've also -- I mean, it gets (inaudible) sometimes, but if places like Vietnam or the Philippines or South Korea are still major swine producing regions and you've got risk of it spreading into Europe, where it's moving closer to the border of Germany, between Germany and Poland, sort of what's your exposure there? And what have you seen from some of those other areas where it's now becoming much more prevalent?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Our exposure in most of those markets, where it's the neighboring markets or -- and the Eastern Europe, the Poland, Germany border some of those. And I think it's a little bit different, but our exposure from a sales point of view is minimal. So that's not the issue. I would say just the U.S. swine production industry is on the sense this has come about, the industry and the USDA has have been on high alert and are doing and have been successful so far, and they're doing everything in their power to make sure the disease doesn't show up in the U.S. And I think I would say, even if it did show up in the U.S., our biosecurity would keep it, I think, very contained to wherever the outbreak happened to show up. And it would be in my view, probably an unscientific view. But it won't be unlikely to just spread like it spread in China where biosecurity is at a much more fundamental level.



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

Yes. I think that's been one of the questions of what's the doomsday scenario, if it takes foothold in some of the other producing countries, but we've heard the same thing that Western Europe and the U.S., the biosecurity is so much tougher and just the nature of the industry in terms of not having as many backyard farms is so different that it would be knock on wood, hopefully, well contained, hopefully, we're not even there yet. But sticking with the emerging markets just to sort of the wrap-up the conversation there. One of the other things we've noticed is there's been a little bit of a change in practices in some of these regions as far as it goes with medicated feed additives, and cutting down on some of the antimicrobials, and so that's something that used to be only a U.S. and Western Europe phenomenon, but you're starting to see them in some of these pockets in Southeast Asia. Could you talk about what you're seeing there? How that's trended? And sort of how do you see that playing out for the next couple of years?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

So just to review what happened in the United States. So probably 5, 6, 7 years ago, 8 years ago, the FDA along with the industry began working to eliminate what historically were known as growth production, growth promotion -- excuse me, growth-promotion claims or labels, which meant that you would just use the product at a relatively low dose, just prophylactically. And so in the United States, the entire industry, the FDA changed the regulations, growth promotion has now gone, has been gone for 5 years, probably. And there's only therapeutic applications permitted, which means you can use the product to prevent, control or treat the disease and it has to be under the supervision of a veterinarian. The rest of the world is moving in that same direction. They're eliminating the more general growth promotion sort of labels, and they are moving to permitting the product to be used only one with therapeutic reasons. And so as an example to us, that's what's going on. That's what the Chinese authorities are doing. And we said one of the reasons -- we we saw some sales in December into China was they were advanced -- so they were in advance of some regulatory changes that took effect in January, and then that's what we were talking about. So we are in the process of obtaining these therapeutic claims and labels for our products. It's taken longer than we thought it would. And somebody is going to ask me, how long will it take? And we're not exactly sure. And part of the problem is, and now it's been double down with all of the other priorities in China, the changing regulations have been pushed far back on the back burner to some of the other priorities that the Agricultural Ministry has. So...

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

But if you -- I want to ask you how long it's going to take, because you just want me not to, but I'll ask, what parts of your portfolio -- are you going to be able to transition everything to having the appropriate labels of that growth promotion? Or...

Richard G. Johnson - Phibro Animal Health Corporation - CFO

We expect to. Yes.

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

So overtime or overnight, no matter how long it takes?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Yes. It might take a year, it might take 1.5 years, it might take 2 years.

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

But either way on the back end and everything will be a little bit better?

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

Yes.

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

And are you seeing the same in other countries besides China and other parts of Southeast Asia? Or...

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

Yes. And we're seeing -- I'd say we're seeing the same in really around the world. In the -- the other thing I would point out is, in the United States, it was not the change in the regulatory environment that really negatively affected our sales, and I think a lot of sales across the animal health industry, it was consumer preferences. So is the -- all of a sudden, consumers want to see the package in the grocery case that says raised without antibiotics or no antibiotics ever. And that's what has driven the very substantial decrease in the use of this entire -- there's a whole bunch of different antibiotics that fall within that general category. And so what what we've done and, I think, done reasonably successful is, we've come out with some nutritional specialty products that while they're not a replacement or they're not a substitute, they have some effect of offsetting what otherwise would be a continuing problem for the producer. Because as my boss likes to say, nobody told the bacteria that they shouldn't show up just because the consumer preference has changed. So the producer has got the same disease pressures and the same production challenges that he's always had. He's now had a number of tried and to true tools taken out of his tool bag and he's looking for other things. And so we've come up with certain things and so have others, and that's where the industry is headed, and especially in the United States.

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

Are there any questions from the audience? No? All right. I'll keep going. Along that line then, so there's continued pivot from feed additives, from growth promotion into nutritional specialties, vaccines, alternatives, some of these preferred products, this is where a lot of the investment in growth is coming from in the business, both in R&D and then SG&A sort of beyond -- you talked about the direct-fed poultry microbial, talked about Omnicell (sic) [OmniGen], are there any other products we should be monitoring, either that you're selling today that you expect to be growth drivers or that could come to market in the coming quarters?

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

No. It's -- as Mike accurately said, our investments are behind the faster-growing parts of our portfolio, which are vaccines, where we continue to develop and introduce new and the improved products. I know it's cliché, but that's what they are. And in nutritional specialties, the most recent products we've added, that we talked about, it's the gut health product for poultry. It's the enhanced reformulated OmniGen dairy product for dairy producers. So I think we've called out most of the major products.

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

And some of the other investments, you've talked about this for a couple of quarters now is the opportunity to move into companion animal, it's something you've thought about for a while? Occasionally, there's some (inaudible) value that float around, but you've also invest in there organically. You've got the canine joint health product. Could you give us an update on how that's going? And if there's any other opportunities in companion animal?



Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

We've -- right. We've we've taken a page from over time, how we've developed our nutritional specialty portfolio in the livestock or production animal market. And that there's a lot of good ideas out there with smart people who don't have a way to really understand if that good idea can become a commercial product and then get it to market. So we took that model overall and are experimenting on the companion animal side. So as Mike said, we've got a canine joint supplement product that's in test market. It's in a number of markets and a whole bunch of vet clinics around the United States. Good initial acceptance, some good reorders and uptake, and we're hearing anecdotally that the customer is liking the product. So we're still in test mode. We're still investing and developing the product or developing the market overall and bringing the product to market. So we'll see where that develops, but we're encouraged by what we're seeing so far.

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

And is there an opportunity for some following products? Are you going to try to build out a broad portfolio here targeting some of the similar places?

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

We are -- we've got several others. And what I mean by several, a few other products sort of earlier in development. We're always looking at some other things. And so I think there's a possibility of having a portfolio of a few products that could be a nice contributor to the overall growth and profitability of the company as we move forward.

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

And what about complementing some of those organic moves with M&A? I mean you see these offered deals in nutritional specialty between the growth segments and nutrition specialties, vaccines and companion animal sort of, could you give us the lay of the land in terms of what the opportunities are? Where valuations are tracking? Sort of what's your appetite there?

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

The -- there's not a lot of opportunities really in any of those spaces and when they do come about, they tend to be fairly expensive. So we're routinely evaluating opportunities. We obviously don't comment on acquisitions. But if the right transaction of the right asset that adds something that makes sense financially were to come along, well, we definitely will give it a hard look and strong look.

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

And if we look at sort of the rest of the investments that you're making organically, SG&A and R&D in 2020. We thought of this as more of a little bit of a catch-up year and a reposition year, sort of fit the adapting markets that you talked about in dairy markets to readapt the product portfolio. Is this -- what's the longer-term P&L structure and investment structure as you go a couple of years out? Is this a big jump in spend, and it's going to fade over time? Or is this going to be a multiyear runway of -- you've got to invest in the business to grow it?

Richard G. Johnson - *Phibro Animal Health Corporation - CFO*

I think the -- I think we'll see continued spend over time. This was a major step-up in spend this year, which I don't believe we're going to see that same step change or really major increment next year. But I don't see the spending fading for a for a couple, 3 years anyway.

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

Okay. Are there any questions from the audience? There, one in the back.

Unidentified Analyst

(technical difficulty)

that channel for some of the -- sorry, companion animals. Who are the competitors there on the -- that you're seeing in that channel, I suppose?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

The question is, I guess, so who are our competitors? Who are the competitive products in the vet channel? On the -- this is a canine joint health product. There is -- I'm sorry, I don't remember the name. There's a good sized, privately held company that has something similar. It's -- we think the sales are -- the substantial sales around U.S. And so we think there's a lot of room in the market for this kind of a product. And of course, we believe that this is -- our product is better than the existing one out there. So we think we've got a competitive advantage just based on the product.

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

All right. And I don't know if there's any more questions, I think we're running up to the end of our time allotment. So I want to thank you very much. Thanks for coming in.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Yes. Thank you, everyone.

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