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# EDITED TRANSCRIPT

COE - Q4 2019 China Online Education Group Earnings Call

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## CORPORATE PARTICIPANTS

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**Min Xu** *China Online Education Group - CFO*

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**Yanfang Jiang** *The Benchmark Company, LLC, Research Division - Senior Equity Analyst*

## PRESENTATION

### Operator

Hello, ladies and gentlemen, thank you for standing by for China Online Education Group's Fourth Quarter And Full Year 2019 Earnings Conference Call. (Operator Instructions)

Today's conference call is being recorded.

(Operator Instructions)

I will now turn the call over to your host, Ms. Judy Piao, Investor Relations for the company. Please go ahead, Judy.

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### **Judy Piao** - *China Online Education Group - Head of IR*

Hello, everyone, and welcome to the Fourth Quarter and Full Year 2019 Earnings Conference Call of China Online Education Group, also known as 51Talk. The company's results were issued via newswire services earlier today and are posted online. You can download the earnings press release and sign up for the company's distribution list, by visiting the IR section of its website at [ir.51talk.com](http://ir.51talk.com). Mr. Jack Huang, our Chief Executive Officer; and Mr. Min Xu, our CFO, will begin with some prepared remarks.

Following the prepared remarks, Mr. Liming Zhang, our Chief Operating Officer, will also join the call for our Q&A session.

Before we continue, please note that today's discussion will contain forward-looking statements made under the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements involve inherent risks and uncertainties. As such, the company's results may be materially different from the views expressed today. Further information regarding this and other risks and uncertainties is included in the company's Form 20-F and other public filings as filed with the U.S. Securities and Exchange Commission.

The company does not assume any obligation to update any forward-looking statements, except as required under applicable law.

Please also note that 51Talk's earnings press release and this conference call include discussions of unaudited GAAP financial information as well as unaudited non-GAAP financial measures. 51Talk's press release contains a reconciliation of the unaudited non-GAAP measures to unaudited most directly comparable GAAP measures.



I will now turn the call over to our CEO, Jack Huang. Please go ahead.

**Jiajia Huang** - *China Online Education Group - Founder, Chairman & CEO*

Okay. Hello, everyone. Thank you for joining our conference call. We concluded our 2019 with an outstanding fourth quarter marked with multiple financial and operational achievements. On the financial side, net revenues exceeded the top end of our guidance range by 2%, whereas total active students increased 20.2% year-over-year.

Even more notable, we achieved our very first consolidated breakeven quarter in our company's history. As we continue to optimize execution on our strategically focused K-12 one-on-one mass market offerings in non-tier 1 cities. Our K-12 mass-market one-on-one in gross billings increased 37.2% year-over-year to RMB 501.7 million, representing 86.2% of our total gross billings. Our gross billings from non-Tier 1 cities accounted for 74.2% of our K-12 mass-market one-on-one offerings, illustrating our successfully penetration in non-Tier 1 cities.

Over the past 2 months, Chinese people have shown the tremendous courage and resilience, while facing the numerous challenges presented by the coronavirus epidemic. From an educational standpoint, as school campus have remained closed hundreds of millions of students and teachers have turned to online in effort to maintain the educational continuity. We believe that an even more profound and a long-lasting awareness of the power of online education has emerged, and therefore anticipate online education penetration continue to increase, especially in lower-tier cities.

We are confident we can leverage our powerful online platform and our expertise in English language learning to make the high-quality education resources available to more people.

More recently, in February, as part of our efforts to support our offline education partners and others in need through the coronavirus epidemic, we opened access to our online classroom, the Air Class, free of charge until the end of April.

The Air Class, which was established over a 5-year period has offered more than 100 million classes since its inception. The system, which features hundreds of network nodes around the world and international (inaudible) allows for smooth, reliable and high-quality communications and real-time interactions between students and teachers.

With this strong technology platform and with the support of our 23,000 foreign teachers, we were able to effectively offer free online one-on-one English lessons worth roughly RMB 20 million to the students in Hubei province, the most effected province by the coronavirus epidemic. We view this not only as a way to maintain educational continuity for students whose school are closed but also an important step towards building a win-win online merge offline ecosystem with many educational institutions. With that, I will now turn the call to our CFO, Min Xu.

**Min Xu** - *China Online Education Group - CFO*

Thanks, Jack. In the fourth quarter, we continued to establish new historical highs in net income, gross margin and operating cash flow. Most significantly, we celebrated our first profitable quarter, with non-GAAP net income of RMB 5.3 million, driven by a robust top line, coupled with improvements in operating efficiencies. We also achieved the record-high operating cash flow of RMB 167.1 million. Additionally, our cash position increased 47.9% year-over-year and exceeded RMB 1 billion for the first time.

Looking into 2020, we have confidence that our profitable growth strategy and sharp focus on operational efficiencies along with new market opportunities due to developing trends present a continued path to future growth.

Now let me walk you through our fourth quarter financial highlights. Net revenues for the fourth quarter were RMB 397.9 million, a 33.5% increase from RMB 298.1 million for the first quarter last year. The increase was primarily attributable to an increase in the number of active students and, to a lesser extent, an increase in the average revenue per active student. The number of active students in the fourth quarter was 257,200, a 20.2% increase from 213,900 for the same quarter last year.

Net revenues from one-on-one offerings for the fourth quarter were RMB 371.5 million, a 39.4% increase from RMB 266.5 million for the same quarter last year. Net revenues from small class offering for fourth quarter were RMB 26.4 million, a 16.5% decrease from RMB 31.6 million for the same quarter last year.

Cost of revenues for the fourth quarter was RMB 110.6 million, a 1.0% decrease from RMB 111.8 million for the same quarter last year. The decrease was primarily driven by decrease in service fees paid to European and American teachers.

Gross profit for the fourth quarter was RMB 287.2 million, a 54.2% increase from RMB 186.3 million for the same quarter last year. Gross margin for the fourth quarter was 72.2% compared with 62.5% for the same quarter last year.

One-on-one offerings gross margin for the fourth quarter was 73.6% compared with 66.6% for the same quarter last year. The increase was mainly attributable to: one, price increases; and second, the inclusion of the company's audio picture book in course package, which carries a higher margin and is recognized as revenues at the time of delivery.

51Talk's small class offering gross margin for fourth quarter was 52.7% compared with 27.9% for the fourth quarter of 2018.

Total operating expenses for the fourth quarter were RMB 288.4 million, an 8.5% decrease from RMB 315.2 million for the same quarter last year.

Sales and marketing expenses for the fourth quarter were RMB 202.5 million, a 4.5% decrease from RMB 212.2 million for the same quarter last year. The decrease was mainly due to lower branding expenses.

Excluding share-based compensation expenses, non-GAAP sales and marketing expenses for the fourth quarter were RMB 201.6 million, a 4.3% decrease from RMB 210.6 million for the same quarter last year.

Non-GAAP sales and marketing expenses, excluding branding expenses were 30.4% of the gross billing for the fourth quarter compared with 35.0% for the same quarter last year.

Product development expenses for the fourth quarter were RMB 37.0 million, a 13.0% decrease from RMB 42.6 million for the same quarter last year. Excluding share-based compensation expenses, non-GAAP product development expenses for fourth quarter were RMB 36.8 million, a 9.6% decrease from RMB 40.7 million for the same quarter last year.

G&A expenses for the fourth quarter were RMB 48.9 million, a 19.2% decrease from RMB 60.5 million for the same quarter last year.

Excluding share-based compensation expenses, non-GAAP G&A expenses for fourth quarter were RMB 46.3 million, a 17.8% decrease from RMB 56.4 million for the same quarter last year.

Operating loss for the fourth quarter was RMB 1.2 million compared with operating loss of RMB 129.0 million for the same quarter last year. Non-GAAP operating income for the fourth quarter was RMB 2.5 million compared with operating loss of RMB 121.4 million for the same quarter last year.

Our GAAP and non-GAAP bottom line turned positive for the first time in our company history. Net income for fourth quarter was RMB 1.5 million compared with a net loss of RMB 140.0 million for the same quarter last year.

Non-GAAP net income for fourth quarter was RMB 5.3 million compared with non-GAAP net loss of RMB 132.4 million for the same quarter last year.

Basic and diluted net income per ADS for the fourth quarter was RMB 0.07 compared with net loss per ADS of RMB 6.9 for the same quarter last year. Each ADS represents 15 Class A ordinary shares.

Non-GAAP basic net income per ADS for the fourth quarter was RMB 0.25 compared with net loss per ADS of RMB 6.45 for the same quarter last year.

Non-GAAP diluted net income per ADS for fourth quarter was RMB 0.23 compared with diluted net loss per ADS of RMB 6.45 for the same quarter last year.

As of December 31, 2019, the company had total cash, cash equivalents, time deposits and short-term investments of RMB 1.05 billion compared with RMB 712.1 million as of December 31, 2018.

As of Q4, we changed deferred revenues account name to advances from students. The company had advances from students of RMB 2.2 billion as of December 31, 2019, compared with RMB 1.7 billion as of December 31, 2018.

For more of our 2019 full year financial results, please refer to our earnings press release for further details.

Looking forward to the first quarter of 2020, the company currently expects net revenues to be between RMB 450 -- RMB 450 million to RMB 455 million, which would represent a year-over-year growth rate between 39.3% to 40.9%.

The above outlook is based on the current market conditions and reflects company's current and preliminary estimates of market and operating conditions and customer demand, which are all subject to change.

This concludes our prepared remarks. We will now open the call to questions. Operator, please go ahead.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) The first question comes from Fawne Jiang of Benchmark.

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### Yanfeng Jiang - The Benchmark Company, LLC, Research Division - Senior Equity Analyst

Jack, Min and Mr. Zhang, congrats on a very solid quarter. My first question is actually on your first quarter guidance. It seems, as Jack mentioned on the call, on education in general and your firm specifically seem to benefit from the virus -- current virus disruption. Again, your guidance suggested accelerated growth trend. So I just wonder whether if you can give us additional color in terms of what you have observed on the ground, including the user traffic demand. And particularly on the user side, for the new user, you are recruiting right now is the profile similar or different from your previous group and your strategy to retain and convert these users going forward.

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### Jiajia Huang - China Online Education Group - Founder, Chairman & CEO

Okay. (foreign language)

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### Min Xu - China Online Education Group - CFO

[Interpreted] So number one, we do see a very positive impact due to the recent events. So near term, we see that because students now have more time, they are more willing to try the online education platforms. And because of that, it did bring some change to Q1. Q1 used to be a softer season. And as you can see, that the guidance we gave between RMB 450 million to RMB 455 million represents roughly 40% year-over-year growth. So it's quite strong compared to a normal Q1.

**Jiajia Huang** - China Online Education Group - Founder, Chairman & CEO

(foreign language)

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**Min Xu** - China Online Education Group - CFO

[Interpreted] So in terms of the new user point of view, we are seeing a strong interest starting from Chinese New Year until now. And we're seeing a lot of growth in the like -- our based in non-Tier 1 cities, which is our targeting audience. And in terms of -- however, we do face a shortage of personnel and a lot of our course consultants are based in Wuhan, and they're forced to work from home because the office is still not open. And so it is -- so I would say that do impact the productivity and efficiency. And so it is hard to turn a lot of the interested students into paying students immediately.

However, we believe the improvement and awareness of online education and willingness to try online education do have a long-term positive impact on the future adoption of the online education.

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**Jiajia Huang** - China Online Education Group - Founder, Chairman & CEO

(foreign language)

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**Min Xu** - China Online Education Group - CFO

[Interpreted] So after Chinese New Year, so we are putting a lot of efforts and resources in recruiting more course consultants and student success personnel. We are seeing very strong future growth in the lower city markets, and we're very happy that we can participate in helping getting the students in the lower-tier city markets more superior education group resources. And as the top -- the leading player in this market, we believe we will play a very important role.

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**Yanfeng Jiang** - The Benchmark Company, LLC, Research Division - Senior Equity Analyst

Really helpful (foreign language)

Air Class is clearly, (foreign language) sustainable open platform. You should do that careful. That's how you get potential to your revenue stream as quickly as been my question.

Second question is really regarding your strategic adoption of changes with the big opportunity ahead, particularly in regards to your course design and teacher recruitment? And on top, on your Air Class' platform, whether you aim to provision that as a sustainable open platform, potentially benefiting from the revenue growth down the road?

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**Jiajia Huang** - China Online Education Group - Founder, Chairman & CEO

(foreign language)

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**Min Xu** - China Online Education Group - CFO

[Interpreted] Okay, so in terms of curriculum and right after the Chinese New Year, we started to offer free open classes to elementary students to help those students to get familiar with the key study content for the coming semester. And also in terms of developing new courses, we are preparing pre-K courses targeting younger students, and we're also developing more H5 based course content to make the study more interactive

and more interesting for our students. In terms of teacher operation, we are putting more resources in recruiting more teachers and also putting more resources in training our teachers to prepare to meet the higher demand from our students.

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**Jiajia Huang** - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

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**Min Xu** - *China Online Education Group - CFO*

[Interpreted] So in terms of the technology platform, our Air Class platform, we're very proud that we're one of the very few company in the industry who owns our own technology platform. And this platform has already delivered more than 100 million lessons and it can meet more than 140,000 students demand in one day. And -- so we're happy to open this platform to help our offline partners. And right now, it's for free. And for the future, if we have the resource to -- further to develop this platform to be more third-party friendly, then we might open this to more partners and to -- it could be a future revenue resource.

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**Operator**

The next question comes from Vincent Yu of Needham & Company.

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**Shenghao Yu** - *Needham & Company, LLC, Research Division - Senior Analyst*

Yes. So my first question is on the regulation. So one, any update on the regulation front, should we expect to see like more regulation or less regulation in 2020, like in your estimation based your assessments or understanding with the policymaking? And the second question will be around the free classes, we had priced like free classes in Hubei, which is about how many CNY 20 million worth of free classes. So are they going to be included in the first quarter sales and marketing expenses?

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**Jiajia Huang** - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

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**Min Xu** - *China Online Education Group - CFO*

[Interpreted]. So -- yes, so we have taken measures to be -- complying to the current government regulations. And these regulations, mostly focus on the selling packages, lesson time and teacher qualification. So we did a lot of work. Right now, most of our teachers have teacher certificates. And our student class is -- for K-12 students, the class will have to finish before 9:00 p.m., and for the selling packages, they are also in compliance with the government regulations.

And -- so we're very confident that these regulations will help make our industry healthier by driving out weaker competitors and kind of restored order and it's actually beneficial to the incumbents and so -- and also, I want to add that we do not see more regulations coming out. And the government will spend more time enforcing the existing regulation instead of making changes regularly.

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**Jiajia Huang** - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)



**Min Xu** - China Online Education Group - CFO

[Interpreted] Okay, So yes -- so we announced that we will donate some of the one-on-one lessons to students in Hubei province. And -- so number one, this will happen over probably a quarter or 2 and so we do not see, number one, the number you're quoting is kind of the value of the lesson, if it is sold at the market price. And as you see, our margin is above 70%. So the real cost will be less than 30% of that number. And also, the numbers of one-on-one lessons taken will probably be a much smaller number happening in Q1. So we do not expect this will significantly impact our operating expenses.

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**Operator**

The next question comes from Bo Pei of Oppenheimer.

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**Bo Pei** - Oppenheimer & Co. Inc., Research Division - Associate

Jack, Min and Judy (foreign language) And I would translate myself. As we can see in China under the coronavirus impact, many students are going to use third-party platforms to get their education from schools like (inaudible), WeChat, et cetera. So my question is about how our cost is interact with these channels or these kind of causes? And then my second question is on sales and marketing. So apart from the free costs we are going -- giving out what is the overall sales and marketing strategy right now and then how does that impact next couple quarters sales marketing costs?

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**Jijia Huang** - China Online Education Group - Founder, Chairman & CEO

(foreign language)

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**Min Xu** - China Online Education Group - CFO

[Interpreted] Okay, so to answer your first question, our target customers are mostly elementary students aged between 5 and 12. And for their parents, like the school study and spoken English, they are totally 2 different things. And so when they get online to follow their school schedule to study their English may be vocabulary, maybe grammar, it's very different from the spoken English training they're getting at 51Talk. And the lessons they are taking at the 51Talk is very supplemental. And so you can see -- also in terms of time and we're totally at different time, when the students are taking the required online lessons for school study content, they will not -- at the same time, they cannot take 51Talk lessons. So again, both in terms of their their goal and their time it's totally 2 different market and we're meaning to very different demand. And so this is why you can see that typical Q1 soft season is now turning a very strong season with people willing to spend time to take more lessons on our platform.

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**Jijia Huang** - China Online Education Group - Founder, Chairman & CEO

(foreign language)

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**Min Xu** - China Online Education Group - CFO

[Interpreted] So in terms of our sales and branding strategy, so we mentioned in some other occasion that for our branding expenses we typically spend more in Q1 and Q3 when the school starts, that's when we do more advertisement and so -- however, for Q1 because of the coronavirus, some of the TV programs we previously decide to putting branding expenses now are canceled. So we were able to move some of these expenses into direct marketing, and we're seeing very good efficiencies from those channels. And we're getting new users better than our expectation.

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**Bo Pei** - Oppenheimer & Co. Inc., Research Division - Associate

Got it. Congratulations on the reassuring guidance.





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**Operator**

The next question comes from Maggie Zheng of Haitong International.

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**Mengqi Zheng** - *Haitong International Research Limited - Research Analyst*

Congratulations for your impressive results. My first question is about your user acquisition costs. Could you please share with us the user acquisition cost before and post the outbreak of coronavirus? And also, I would also like to know how many of your enrollments are coming from referrals and how many of them are coming from new users?

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**Jijia Huang** - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

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**Min Xu** - *China Online Education Group - CFO*

[Interpreted] So our -- among our new users, more than 60% of them are from referrals. And since 2018, we've been focusing on non-Tier 1 city users, and they are more likely to refer their friends and so we believe this is a very strong driver for our strong referral rate.

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**Jijia Huang** - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

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**Min Xu** - *China Online Education Group - CFO*

[Interpreted] So our customer acquisition cost, it has been quite stable recently, and it's been around RMB 3,000 to RMB 4,000 per new user.

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**Mengqi Zheng** - *Haitong International Research Limited - Research Analyst*

And my second question is regarding your -- since you are making profit on first quarter, would you expect this profitability to continue? And what's the normalized profit margin you're expecting long term?

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**Jijia Huang** - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

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**Min Xu** - *China Online Education Group - CFO*

[Interpreted] So I guess, you're talking about what do you -- what we believe could be the future profitable margin. So we would like to take time to explain the gross billing P&L and the gap P&L. So you can see that our gross billing in this quarter is actually much higher than our net revenue. Our gross billing is CNY 582 million, and our net revenue is CNY 398 million.

So typically, when we calculate the gross billing P&L contribution, we will take the gross billing times the current margin then subtract non-GAAP expenses, including S&M, R&D and G&A. And that can get us to a -- roughly for this quarter, we can get a -- for one-on-one business, where we can



achieve 24.8% gross billing P&L contribution margin. And for the consolidated company, we can achieve 23.3% and gross billing contribution margin.

And so that -- if you look at that, that's potentially a long-term operating margin, if you can say this. But now let's get back to our current business. And if you look at the net margin in the near term, we mentioned earlier that we're targeting a profitable growth. So which means we will -- we're trying to maintain our breakeven and once we can breakeven then we will put the gross billing growth at a higher priority, which means we will try to keep our net margin small positive value, and then we will reinvest the profit we get into sales and marketing to expand our market to increase the number of users. And we believe that, that's the where the future profit will be coming from. And so again just to repeat, when we talk about profitable growth, we're talking about maintaining our net margin at breakeven line and trying to achieve as much growth as possible.

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**Jiajia Huang** - China Online Education Group - Founder, Chairman & CEO

(foreign language)

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**Min Xu** - China Online Education Group - CFO

[Interpreted] So just to add one point is that our goal is not to maximize the net margin. Our goal is to trying to improve our operating cash flow. As you can see in Q4, we achieved historical high operating cash flow of CNY 167 million, and for the full year 2019, our operating cash flow is close to RMB 400 million. And so this operating cash flow is very close to free cash flow since our CapEx is a very small number. And so we believe we're one of the top -- we're one of the very few companies who can can achieve very high operating cash flow at this point, and our focus will be continue to improve the operating cash flow for our investors.

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**Mengqi Zheng** - Haitong International Research Limited - Research Analyst

Oh, that's very clear. My last question is regarding the impact from our rescheduling of the new semester. As the new semester has postponed and it's likely that weekends will become only one day and the summer holidays will be shortened. How much would you expect that will impact our second quarter results?

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**Jiajia Huang** - China Online Education Group - Founder, Chairman & CEO

(foreign language)

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**Min Xu** - China Online Education Group - CFO

[Interpreted] So we're not clear that when the school will start, so it is hard to evaluate that how many weekends or how much time -- how much summer time will it take. But it's very likely it will take some of those time. So it is a negative impact on Q2 and Q3 revenue recognition. However, we do see -- as we mentioned, that we do see stronger interest and more willingness and improved awareness of the online education. So we believe that all this positive impact will at least partially offset that negative, so it is hard to see what the impact will be on Q2 and Q3. But we are very confident that as long as we offer a very good product and good service, and we should see students coming to our platform to study.

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**Operator**

The next question comes from Roger Parodi of Silverhorn.



**Roger Parodi**

Jack, Xu Min. I have -- first of all, congratulations for the very good result, congratulations for the strong cash flow generation, as you've explained before, that's outstanding. My question is regarding the impact of the corona virus in regards to the conversion rate, is it more difficult or is it easier now for your sales staff to convert students -- interested students into paying students. Do you see an impact on that? But you already explained to us that you were not running at full capacity in terms of your sales team, but is there more -- is there a more positive -- is there a change in the dynamics of can they sell -- can the people who work on it, can they sell better? And the other question, can you give us some guidance in terms of gross billings, where you're going to -- I know you don't announce it officially anymore, but can you give us some guidance in regards to gross billings?

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**Jiajia Huang** - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

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**Min Xu** - *China Online Education Group - CFO*

[Interpreted] So the first question is about the conversion rate. So if we break down into different steps for those steps do not need to involve people, for example, going from registration to trial lessons, those steps you are seeing a better conversion rate. And however, for those steps which needs customer service, needs help from our course consultant and because -- as we mentioned earlier because of the lack of personnel, and so -- and stronger demand, the conversion rate is actually lower.

So if you combine these 2, our conversion rate stays roughly the same. And however, because of the more students are trying to register and trying to take the free trial lesson. And in general, we're better off.

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**Jiajia Huang** - *China Online Education Group - Founder, Chairman & CEO*

(foreign language)

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**Min Xu** - *China Online Education Group - CFO*

[Interpreted] So in terms of gross billing, because of seasonally the Q4 is a strong season for gross billing. And Q1 is a slow season for gross billing. And so -- and also, we can see that for small-class business, the -- it is typically much stronger in Q2 and Q4 because most of renewals happens in those 2 quarters. So the Q1 gross billing for small class business will be much lower than in Q4. So combined those 2, we can expect our Q1 gross billing will still be lower than Q4 gross billing. However, it will be -- the Q-over-Q decline will be better than normal seasonality.

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**Operator**

As there are no further questions now, I'd like to turn the call back over to Judy Piao for closing remarks.

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**Judy Piao** - *China Online Education Group - Head of IR*

Thank you, once again for joining us today. If you have further questions, please feel free to contact 51Talk's Investor Relations through the contact information provided on our website or the Piacente Group's Investor Relations. This concludes the conference call. You may now disconnect your lines. Thank you.



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