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Q4 2018 Tarena International Inc Earnings Call

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CORPORATE PARTICIPANTS

Lei Song *Tarena International, Inc. - IR Officer*

Shaoyun Han *Tarena International, Inc. - Founder, Chairman of the Board & CEO*

Yuduo Yang *Tarena International, Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Alex Xie *Crédit Suisse AG, Research Division - Analyst*

Kin Man Wong *Jefferies LLC, Research Division - Equity Analyst*

Mariana Kou *CLSA Limited, Research Division - Head of China Education and HK Consumer*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Q4 2018 Tarena International, Inc. Earnings Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today, March 12, 2019.

I would now like to hand the conference over to your first speaker today, Ms. Lei Song. Thank you. Please go ahead.

Lei Song *Tarena International, Inc. - IR Officer*

Thank you, operator. Hello, everyone, and welcome to Tarena's Fourth Quarter 2018 Earnings Conference Call. The company's earnings results were released earlier today and are available on our IR website, ir.tedu.cn, as well as on Newswire services.

Today, you will hear opening remarks from Tarena's Founder, Chairman and CEO, Mr. Shaoyun Han; followed by our Chief Financial Officer, Dennis Yang, who will take you through the company's operational and financial results for the fourth quarter 2018 and give guidance for the first quarter and full year of 2019. After their prepared remarks, Mr. Han and Mr. Yang will be available to answer your questions.

Before we continue, please note that the discussion today will contain certain forward-looking statements made under the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from our current expectations. Tarena does not assume any obligation to update any forward-looking statements, except as required under applicable law.

Also, please note that some of the information to be discussed includes non-GAAP financial measures as defined in Regulation G. The U.S. GAAP financial measures and information reconciling these non-GAAP financial measures to Tarena's financial results prepared in accordance with U.S. GAAP are included in Tarena's earnings release, which has been posted on the company's IR website at ir.tedu.cn.

Finally, as a reminder, this conference is being recorded. In addition, a webcast of this conference call is available on Tarena's Investor Relations website.

I will now turn the call over to Mr. Shaoyun Han, Tarena's Founder, Chairman and CEO. Mr. Han will speak in Mandarin, and Mr. Yang will translate.

Shaoyun Han *Tarena International, Inc. - Founder, Chairman of the Board & CEO*

(foreign language)

Yuduo Yang *Tarena International, Inc. - CFO*

Thank you, Lei, and welcome, everyone, to our fourth quarter 2018 earnings conference call.

Shaoyun Han *Tarena International, Inc. - Founder, Chairman of the Board & CEO*

(foreign language)



Yuduo Yang Tarena International, Inc. - CFO

I am very pleased to report that our net revenues in the year of 2018 increased year-over-year by 13.5% to reach RMB 2.2 billion. The fourth quarter revenue contributed RMB 615 million, which is consistent with the same period last year. During this quarter, our kid programming education business has once more achieved a rapid growth in both student enrollment and revenue recognition. We enrolled 15,233 students during this quarter. The total K-12 business recognized revenue of RMB 67 million and received cash of RMB 159 million during this quarter, both of which achieved a year-over-year increase more than 300%.

For our adult education business, we saw a rapid growth year-over-year in student enrollment via our university partnerships, which contributed to an acceleration of enrollment growth in overall adult education business, achieving year-over-year increase of 6.3%, reaching student enrollment of 36,394. Meanwhile, we continuously improve the profitability of underperforming centers as well as optimize the staffing structure which led to improvement in many efficiency indicators.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

2018 is a year of achievement for both the new and the traditional business. Also, it is very challenging year for us. I would like to present 2018 performances by the following 3 areas, and I will share with you our 2019 plan.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

Let's look at retail channel assessment first. In 2018, the company operational costs have increased, which resulted in a decrease in profitability. The main reason was that we opened more than 40 centers in 2017, many of which were impacted by market economy and IT training market environment and did not meet our expectations in 2018. We have closed or merged underperforming centers in the second quarter to respond to the unfavorable market conditions. At the same time, we continuously optimize the cost structure, staffing structure and acquisition channels. These measures significantly lowered the number of nonperforming centers. In addition, we also put a lot of efforts to improve teaching quality, which led job placement result even better. Based on the recent business data, 6 months post-graduation job placement rate was improved to 97% and employment speed also improved. We gain widely recognition from our students with good teaching service quality, which helped us to recruit more students through student referrals.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

In 2019, our retail business will focus on recovering profitability. Operating KPIs should not limited to contract revenue and contract profit, it will also emphasize on operating cash flow to encourage cash collection and to improve operating efficiency. We believe that our retail business will regain its profitability gradually.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

For university channel, 2018 is a year of transformation and capital investment for our university partnership business. With support from government policy encouraging cooperation between schools and companies, we successfully explored a Featured Program business model that schools provide teaching venues and academic credit collectability, while Tarena provides (inaudible) resources and teaching facilities. Both parties operate the training center together on-campus. Different from joint major programs. The enrollment of Featured



Program is up to student's decision and does not need government approval. In 2018, we have established Featured Program partnership with more than 100 universities, and we've built more than 100 learning centers on-campus. Upon completion of the centers, we expect to have steady annual student enrollment in coming years.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

Student enrollments through Featured Program business model will become the main driver for our adult business growth. In 2018, we recruited approximately 20,000 students through this model. The students are currently in their first year or second year. However, our training is provided in the graduation year. Therefore, the corresponding revenue is going to be postponed to be recognized in the year of 2020 and 2021, so the university business net revenue grew lagged behind its enrollment growth and also lower than the operating cost increases, which brought losses of university channel business in 2018.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

Looking forward into 2019, university channel business is going to bear fruit. From 2019, there will be revenues contributed from the students enrolled in the year of [2017] (corrected by company after the call) university programs. We will also enroll more students in their final year on campus. We believe that these matters will significantly reduce losses from university business.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

Let's move on to kid business. 2018 is a year of rapid growth for our kid education business. By the end of 2018, after adding 118 new kid centers in the year, we operated 148 learning centers covering 53 cities. Kid business recorded a full year net revenues of RMB 176 million, and the total cash received from tuition fee were RMB 455 million, achieving more than 400% year-over-year growth.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

Looking forward into 2019, kid education business is going to enter the period of steady growth. We plan to open about 80 new centers and expect to receive cash of more than RMB 850 million with a 100% annual growth. At the same time, we're going to improve existing learning centers' operational efficiency. The KPIs for core management team will include those business growth achievements and profit target completions. We're confident that these changes will gradually improve profitability of kid centers.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

To sum up, through the adjustment, optimization and the investment in 2018, Tarena is entering a period of steady development. Our operation will focus on profitability improvement.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

With that, I will now turn the call over to our CFO, Dennis Yang, to discuss quarter operational updates and financial results and outlook for the first quarter 2019 and full fiscal year.

Thank you, Han, and hello, everyone on the call.

First of all, I'm very pleased to see the higher-than-expected results in our kid education business. We believe that the kid technology education will become widely known in China, forming a huge market with significant potential and rapid growth. The market size of kids programming education in China is expected to reach approximately RMB 40 billion in the next 3 years, with a CAGR of over 50%. In this quarter, Tarena's kid education business delivered outstanding results in student enrollment, centers layout, course development, revenue contribution and profitability growth for older centers. The student enrollment of kid education business continued rapid growth, achieving over 300% year-over-year increase, reaching 15,233. The company will continue the investment in kid education business.

We newly built 31 centers for kid education in the quarter. By the end of the fourth quarter, the kid education business reached 148 centers. On top of that, there are also 20 shared learning sites with adult education business, which provides additional classrooms. Our kid education business expanded into 53 cities by the end of this quarter.

According to this quarter's financials, kid education business has made greater contributions to the group. On one hand, the cash received from enrollment reached RMB 159 million this quarter, achieving a 400% year-over-year growth and representing approximately 27% of group's total cash received. On the other hand, this quarter net revenue under U.S. GAAP reached at RMB 67.2 million for kids business, taking around 11% of the total. We believe the contribution from kid education business will continue to grow in the future, and we expect it will gradually become one core driver for Tarena's business growth.

In addition, in 2018, the company gradually upgraded and improved the course system. We have built a complete kids programming course system suitable for kids aged between 3 and 18. The course system will be modified and perfected with more and more practical class experiences. We have also accelerated optimization of center operation, improved business process standardization and service quality consistency, by which we won wide and positive recognition from our students and parents and made the business model for kid centers very replicable.

We will continue our investment in this field. With its extensive education experience in IT area and solid talent reserves, Tarena will be able to keep its leading position in kid programming education market by developing diverse courses to maintain its advantage with diversified course system by standardizing operating procedures to improve the success rate of opening new centers by enhanced operational efficiency and increasing the number of students in schools to improve profitability.

We know the recent changes in government regulation related to kid education industry. These policies encourage quality-oriented extracurricular education business in order to promote young people's versatile development. Tarena's kid education program consist of computer programming and a robot programming in the scope of quality-oriented courses. These courses focuses on cultivating kids' interest in information technology, programming skills and other general skills. Therefore, we believe that these policy changes are generally good for kids programming business.

With the greater importance of information technology and artificial intelligence skills, programming courses are becoming more attractive to young people. We believe this industry is going to experience high-speed growth. The company will keep investing in this area in the next couple of years in terms of new course, research and development, network expansion as well as talent recruitment.

Looking into 2019, we expect to continue expand in K-12 business. We plan to open a total of 80 kid education centers in 2019, targeting the student enrollment of approximately 80,000 with a tuition cash of RMB 850 million. The rapid growth of K-12 education business is also bringing certain short-term impact to the financial profit. However, in our view, it is normal that new business generates temporary financial losses. During its rapid growth period, we've closely monitored cash flows and profitability of each learning center. In general, it takes about 6 months for a kid center to have a positive operating cash flow, and reach accounting breakeven in about 1.5 years' period.



We've seen a healthy growth in Tarena's kid education business, and we expect it will start to record the profit in about 2 years, along with more kid learning centers become mature and profitable.

These initiatives require more investments and may affect the margin levels in short term as new centers are still in the ramp-up period before they break even. However, given the broad market perspective and rapid business growth, K-12 business will provide a strong foundation for the companies to grow in future years.

In addition to kid education business, Tarena's adult education business achieved RMB 549 million net revenues in this quarter, representing an 8.7% year-over-year decrease. The year-over-year decrease in student enrollments through retail channel was the primary factor affecting the revenue. The enrollment of adult education business as a whole during this quarter was 36,394, achieving a year-over-year growth of 6.3%. Enrollment through retail channel delivered 26,802, with a year-over-year decrease of 7.3%, while enrollment through university channel reached 9,592 with a year-over-year growth of 81%. Partnership with universities become a main driver for the growth in student enrollment.

With university partnership model, we establish deep cooperation with universities, and we are able to have a long-term student enrollment and with high volume, which will help us to enhance enrollment efficiency and to reduce the student acquisition cost. In this way, our adult education business will maintain a continuous growth. Usually, the courses last 2 to 4 years in the university partnership model, and the revenue recognition period is also lessened accordingly. Certain tuition with time constraints is to be recognized in later years when the education service will be delivered. This result in a gap between the rate of enrollment and the revenue growth.

In terms of course contribution in adult business, Python, big data and the Linux cloud computing courses become popular, contributing a total of 5,953 students in this quarter or 59% year-over-year growth. We expect that artificial intelligence-related courses will continue to grow in the future. Responding to current market changes, Tarena starts to develop continuing education courses to meet demand from the large number of people to upgrade their skills for future career advancements through taking professional trainings. Looking forward in 2019, Tarena plans to meet the diverse needs from different groups of people through a richer curriculum system so that it can be better coped with the fluctuations in the market cycle, achieving steady growth in adult education business.

During this quarter, the company continues to emphasize on resources distribution. At the same time, we made efforts to optimize human resources to improve our operational efficiency. In this quarter, the company closed or merged a total of 12 adult learning centers and entered into 1 new city, Baoding.

By the end of this quarter, we operated 184 adult learning centers in 70 cities. Seat capacity at the end of 2018 were 56,585, which represent 0.7% year-over-year decrease. By optimizing the seat layout, the seat utilization rate improved to 71.6% as compared to the utilization of 69.6% in the same period last year. This quarter, we further optimized the sales and marketing team and saw improvement in enrollment efficiency. For example, the student acquisition cost per student of adult education business was RMB 5,861, which is the lowest of -- in the past 4 quarters. The improvement in seat utilization rate and sales per capita productivity mentioned above improved the effectiveness of center resources optimization strategy. We believe that this strategy will have positive impact to future profit recovery. And now let me address some more key items in income statement.

Firstly, gross margin in first quarter declined by 19 percentage points year-over-year to 53.7%. Such a decline in gross margin is mainly do to the following reasons: First, K-12 business gross margin dropped by approximately 800 bps. The company built up 100 K-12 learning centers in the past 12 months. And by the end of this year, we operated 148 centers, most of which have not yet reached an ideal utilization level. Current gross margin of K-12 business is significantly lower than the margin of our traditional adult business. Second, less revenue recognized from adult business during the quarter dropped around 400 to 500 bps impact on GP margins. Because of slowdown in the retail channel and the referral of contract revenue from the student and the university partnership programs, the revenue of adult business in this quarter decreased by RMB 50 million as compared with the net revenue in the quarter a year ago. We expect the GP margin recovery for both adult and kid business when the company creates profit strategy for adult business, we will focus more on operational efficiency, then business expansion. Meanwhile, we expect GP margin improvement in kid business because more kid learning centers are operated for more than 1 year, and those learning centers start to make profit.



Now let's take a look at G&A expenses. In the fourth quarter, the company recorded a bad debt allowances for doubtful account receivables of RMB 52 million to reflect the difficulties in the collection of account receivables from 2017 students. The company believes that receivable collectability risk around 2017 students have been largely covered by bad debt provisions in our books. As Mr. Han said, cash flow improvement is one of the key performance indicators for our operating team in 2019. Center managers are encouraged to expedite the tuition collections from students. As company maintains a long-term partnership with a group of loan providers, in our view, relatively high risk of account receivables from 2017 students is an isolated case and won't change long-term outlook of bad debt provision levels in our adult business.

Our non-GAAP operating loss in this quarter was [RMB 166.2 million] (corrected by company after the call), lower than non-GAAP operating profit of RMB 99.6 million in the same period last year. On one hand, in the past year's rapid expansion of kids education business, more than 100 new learning centers opened and 21 centers added through acquisition, many of these learning centers not in a mature stage and current loss-making, which led to greater non-GAAP operating losses [of RMB 139.6 million] (corrected by company after the call) for the kids education business in this quarter. We believe that more kids education centers will start making profit along with the number of students in schools increases.

On the other hand, there are non-GAAP operating losses of RMB [29.3 million] (corrected by company after the call) from adult education business. The reason of the year-over-year decrease on the profit was due to the significant decrease in the revenue from adult business caused by the smaller number of students recruited through retail channel and additional market cost to achieve the higher enrollment as well as the greater amount of bad debt expenses to doubtful account receivables.

Looking forward to the first quarter 2019, we expect the total net revenue are between RMB 395 million and RMB 415 million, representing a decrease of 2.9% to an increase of 2.1% on a year-over-year basis. The company also expects its net revenues for the full year 2019 to be between RMB 2,430,000,000 and RMB 2,580,000,000, representing an increase of 8.5% to 15.2% on a year-over-year basis.

So operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question is from Mariana Kou from CLSA.

Mariana Kou *CLSA Limited, Research Division - Head of China Education and HK Consumer*

I have 2 questions. First one is about the kids business. I noticed that I think, in fact, as of end of 2018, we are covering about 53 cities. So just wondering what's our strategy there for the kids business, are we looking to kind of do it more by wider network versus going deeper into existing cities? Because I think some of the leading players in like K-12 children businesses, they are covering a similar range of cities, but definitely got a lot more, like, hundreds of centers. So just a bit more thoughts on that will be quite helpful in terms of how we think about margins, operating leverage, et cetera, from an operational angle. And of course, more of a 1b, a little of follow-up on the kids businesses. If you could also help us understand the breakdown on GP -- because I think just now you shared a bit on the margin drag at group level. But if you could help us get a bit more clarity on GP margins between those 2 businesses, like adult and K-12, for Q4 because I think Q3, there were some disclosures on the cost of revenues for kids so we could kind of calculate that adult business with more in the 70-ish percentage and K-12 loss level for GP. If you could help us kind of get some clarity on Q4 margin for those would be helpful. And I guess lastly is just on the outlook for the full year and also color going forward for revenue. Is -- do we just expect this more of a high single digit to, like, low-teens revenue growth to be the level that we should be thinking about in the next few years?

Yuduo Yang *Tarena International, Inc. - CFO*

(foreign language)

Shaoyun Han *Tarena International, Inc. - Founder, Chairman of the Board & CEO*

(foreign language)



Yuduo Yang Tarena International, Inc. - CFO

Okay, Mr. Han addressed Mariana's first question about our future kids business expansion plan. The kids business for Tarena actually leverage our human resources from other business. As you may know that we operated our adult business in 70 cities. So out of 70 cities, we are very quickly to expand our K-12 business in 53 cities. But look -- if we look into 2019, we plan to focus on first tier cities and those professional capital cities. So we don't expect to expand our K-12 business into more new cities in 2019. So Mariana's second question about the margins of K-12 business, I can share with some data. But beware of those data are mostly based on our management report, that K-12 gross margin, non-GAAP gross margin about -- in Q4, about minus -- sorry, gross profit, negative RMB 90 million. So the GP margin about minus 9 -- 29%. In terms of operating non-GAAP operating losses, which were RMB 137 million for the first quarter of K-12 business. So based on our forecast in the future, we -- it we look at them per learning center, the K-12 -- K-12 per learning center, we are -- expect a high-teens or low-20s margin level when the learning centers get matured. So this is also the long-term perspective from -- management perspective for the K-12 business. Yes, back answering, we have a big portion of other K-12 learning centers operated not reach to the mature level. So we expect still loss-making from K-12 business, but we are -- we expect the operating losses from K-12 business will -- getting narrow over the future quarters. You will see those -- the operating losses getting narrowed happening through the quarter in 2019. Mariana?

Operator

Your next question is from Alex Xie from Credit Suisse.

Alex Xie Cr dit Suisse AG, Research Division - Analyst

Firstly, I would like to ask about our adult business. So after closing down the 12 underperforming learning centers in the fourth quarter, how many learning centers are still underperforming in the non- -- in the adult learning center network? How many are we planning to close, say, in 2019? And my second question is about the K-12 business. So for the overall K-12 business, so when do management expect the business to reach breakeven?

Yuduo Yang Tarena International, Inc. - CFO

Thank you, Alex, thank you for your questions. Your first question talk about how many nonperforming adult learning centers as of now. I -- in my view, that no more than 10 learning centers are still loss-making, were nonperforming. So we're about to further optimize those learning centers where -- if that optimization doesn't have the good result, continue to -- consider to -- consider closing those learning centers in 2019. Your second question about the K-12's business breakeven, as I mentioned that you will see that operating losses from K-12 business getting narrowed in 2019. I expect we will see the quarter -- quarterly K-12 breakeven in 2020. So sooner or later, in 2020 and 2021, our current expectation -- our current forecast shows that 2021 is the first year the K-12 business could be profitable.

Operator

Your next question is from Johnny Wong from Jefferies.

Kin Man Wong Jefferies LLC, Research Division - Equity Analyst

My question is in regards to the traditional adult business. I recall that we had a strategy of hiring more sales people to try to increase the sell-through rate of inquiry. But it seems that I think in the fourth quarter, our adult enrollment, I believe it probably decreased on a year-to-year basis, especially on the retail side. Can you let me know what the -- how the strategy of increasing the sales force is going, and whether or not we need to rethink about that strategy?

Yuduo Yang Tarena International, Inc. - CFO

Thank you, Johnny, for the question about our sales strategy. We initially plan to recruit more sales people to enhance our sales team to drive enrollment. But I've seen -- but the overall IT industry soft-traded recently. So it's pretty challenging for Tarena simply to recruit more people to drive the enrollment. So we -- in -- during that, we try to focus on -- focus more on profitability. So we made some changes in our strategy that we try to make more profit over to keep the business expansion.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)



Yuduo Yang Tarena International, Inc. - CFO

Mr. Han added that the salespeople per learning center actually increased -- increases in the past quarters, but we a bit downsized or closed the centers, so we have chance to -- we have a chance to downsize the overall sales team in Q3 and Q4.

Shaoyun Han Tarena International, Inc. - Founder, Chairman of the Board & CEO

(foreign language)

Yuduo Yang Tarena International, Inc. - CFO

For the general sales and marketing cost per students in our adult business, we've already seen some -- the positive changes and the decrease of those per student acquisition costs. Johnny? Yes. Sorry, I need to make a correction that addressing Alex's question just now. Regarding the K-12 breakeven, I would say the 2020, we'll see the quarterly breakeven. Sorry, yes, 2020, I should say in the 2020, it's likely that we'd see the quarterly breakeven for K-12. And 2021, it's likely that we'll see full year breakeven.

Operator

(Operator Instructions) We don't have any other questions as of the moment. Presenters, please continue.

Lei Song Tarena International, Inc. - IR Officer

Okay. Thank you, operator. If there are no further questions at present, we would like to conclude by thanking everyone for joining our conference call. We welcome you to reach out to us directly by e-mailing at ir.tedu.cn. Should you have any questions or requests for additional information, we encourage you to visit our Investor Relations site at ir.tedu.cn. Thank you.

Operator

Ladies and gentlemen, that does conclude our call for today. Thank you for participating. You may all disconnect.

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