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# EDITED TRANSCRIPT

TEDU - Q3 2014 Tarena International Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Christina Zhu** *Tarena International Inc - Investor Relations*

**Shaoyun Han** *Tarena International Inc - Chairman and CEO*

**Suhai Ji** *Tarena International Inc - CFO*

## CONFERENCE CALL PARTICIPANTS

**Jialong Shi** *Credit Suisse - Analyst*

**Leo Fan** *SWS Research - Analyst*

**Fiona Zang** *Oppenheimer - Analyst*

**Shaoyun Hun**

## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by and welcome to the Tarena International Third Quarter 2014 Earnings Conference Call. At this time, all participants are listen only mode. After management's prepared remarks, there will be a question and answer session. Today's conference is being recorded. If you have any objections, you may disconnect at any time. I would now like to turn the call over to your host for today's conference, Ms. Christina Zhu, Tarena's Investor Relations Manager. Please go ahead.

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### Christina Zhu - Tarena International Inc - Investor Relations

Thank you, operator. Hello, everyone, and welcome to Tarena's third quarter 2014 earnings conference call. The company's earnings results were released earlier today and are available on our IR website, [ir.tareni.com.cn](http://ir.tareni.com.cn), as well as on news wire services. Today you will hear opening remarks for Tarena's Founder, Chairman and CEO, Mr. Shaoyun Han, followed by our Chief Financial Officer, Suhai Ji, who will take you through the company's operational and financial results for the third quarter 2014 and give guidance for the fourth quarter and full year of 2014.

After their prepared remarks, Mr. Han and Mr. Ji 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 US 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 statement, except as required under applicable law.

Also, please know that some of the information to be discussed includes non-GAAP financial measures, as defined in Regulation G. The US GAAP financial measures and information reconciling this non-GAAP financial measure to Tarena's financial result prepared in accordance with US GAAP are included in Tarena's earnings release, which have been posted on the company's IR website at [ir.tarena.com.cn](http://ir.tarena.com.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 I will translate.

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### Shaoyun Han - Tarena International Inc - Chairman and CEO

(Interpreted) Thank you, Christina. And welcome, everyone, to our third quarter 2014 earnings conference call. I'm very pleased to inform you another strong quarter with both growth and profitability. We again achieved record revenue and profit in the third quarter of 2014. Our top line revenue grew by almost 41% year over year to reach \$40.3 million, exceeding our previously issued guidance. And our non-GAAP net income increased by almost 87% year over year to reach \$11.6 million.



Our student enrollments in the third quarter of 2014 totaled 17,518 increasing by 30% year over year. Given our business seasonality, the third and fourth quarter are usually our peak seasons, and, therefore, the 30% increase is based on an already very strong enrollment number in the third quarter of last year.

In particular, we have also seen positive results in our strategy to penetrate additional high growth verticals and extend our reach beyond our core strength in IT. Non-IT courses comprise of digital art and on-line sales and marketing already accounted for 38.6% of the total student enrollments in the third quarter. And more recently, on October 31, we commenced our inaugural class in Beijing for our new course in accounting, which is the third non-IT course that Tarena offers.

We will continue to execute on our strategy to diversify our course offerings and revenues to drive sustained growth. In addition to the early success enjoyed by the newly launched, non-IT courses, some newer IT courses, such as Android and iOS continue to perform strongly. Android has become the number two IT course, together with C++ in the third quarter. Our market oriented demand driven approach to identifying high growth verticals, coupled with our proven execution capabilities will enable us to continue our future expansion and growth.

In the third quarter our student enrollment from retail channel increased slightly to 81% of total student enrollments, compared with 80% in the same period in 2013. Together with a tuition fee increase in the second quarter of 2014, this resulted in higher average revenue per student, a 9% increase year over year, and contributed to our revenue growth exceeding our student enrollment growth.

In terms of course offerings, we offered 11 courses in total in the third quarter of 2014, up from 10 in the same period a year ago, and remaining unchanged from the previous quarter. Online sales and marketing was the only additional course that was launched in the fourth quarter of 2014. And, as mentioned earlier, we just commenced our new course in accounting on October 31. So as of now, we offer a total of 12 courses, of which three are non-IT courses.

In terms of new learning centers, we opened three in the third quarter of 2014, one each in [Hefei], [Nancough] and [Daria]. We also merged one learning center in [Guangzhou] into a larger one due to the recently expanded lease area in that center. Thus, effectively, we added a net of two learning centers in the third quarter of 2014, and a net total of 13 in the first nine months of 2014, compared with 29 in the first nine months of 2013. And we plan to open another 10 to 15 new learning centers in the fourth quarter of 2014, compared with 10 in the fourth quarter last year.

Consistent with what was stated in the previously two earnings call, we have taken a prudent approach to alert new learning centers openings in 2014 in order to drive our margins and profitability. I am pleased to say that we are well on track to achieve the objectives we set at the beginning of the year to improve center efficiency and utilization. In the third quarter of 2014, gross margin increased by 215 basis points year over year to 74.2%. And non-GAAP operating margin increased by 319 basis points year over to year to 27.2%. Our overall center utilization rate has reached 77% in the third quarter of 2014, compared to 72% in the same period a year ago.

Also in the third quarter we began to implement a series of initiatives to improve our employee productivity and operational efficiency. These include, first, streamlining our organizational structure. We are separating the management of retail and university channels student recruitment to have dedicated managers responsible for each channel. Second, upgrade our self incentive and compensation scheme. We are changing our self compensation structure and incentive schemes to better attract talent and further align individuals' interests with the company's. Third, set up a centralized employee training system. And, fourth, continue to optimize our advertisement spending. We believe all these initiatives will further enhance our business operations and lay out a solid foundation for our future growth.

With that, I will now turn the call over to our CFO Suhai Ji to discuss the third quarter financial results and outlook for the fourth quarter and full year of 2014.

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#### **Suhai Ji - Tarena International Inc - CFO**

Thank you, Mr. Han and thank you, Christina. And hello to everyone on the call. As Mr. Han mentioned, we are very pleased to have achieved another record quarter with both strong top, and the bottom line results. Now let me quickly review our financial results for the third quarter of 2014. Please note that unless stated otherwise, all numbers I will discuss today are in US dollars.

First, on the top line growth, our net revenues in quarter increased by 41% year over year to \$40.3 million. The increase was primarily due to increased student enrollments and higher average revenue per student, as defined by net revenues divided by student enrollments.

Total student enrollments in the quarter increased by 30% year over year to 17,518, which was driven by the number and popularity of our course offerings. The number of our course offerings increased from 10 to 11 in the third quarter year over year, while the number of our learning centers increased from 86 to 105 in the same period year over year to cater to the increased demand for our courses.

Average revenue per student in the quarter increased by 9% year over year to \$2,299. The growth was mainly driven by the increase of standard tuition fees for our courses, and, to a lesser extent, a slightly higher percentage of retail channel in our student enrollments channel mix.

Before moving on to the cost of revenues and operating expenses, I want to refer you to our disclosure on non-GAAP financial measures, which was included in our official press release. The only difference between our GAAP and non-GAAP numbers are share-based compensation or SBC expenses. SBC expenses include the cost of revenues and operating expenses on a GAAP basis, but excluded to derive our non-GAAP numbers. We have included a reconciliation table in our earnings release showing the detailed calculation.

In the third quarter of 2014, total SBC expenses were \$1.2 million, up from \$0.2 million in the same period in 2013. More than 95% of the total SBC expenses this quarter fell in the general and administrative expense line with the rest being relatively insignificant across the other expense lines.

Cost of revenues in the third quarter 2014 increased by 31% year over year to \$10.5 million. The increase was mainly due to higher personnel costs and the welfare expenses resulting from increased number of teaching and advisory staff at our learning centers and higher average salary, higher rental costs resulting from increasing the number of learning centers and expansion of the existing learning centers, as well as higher depreciation expenses for our learning centers.

GAAP gross profit increased by 46% year over year to \$30 million. GAAP gross margin increased by 215 basis points year over year to 74%. The improvement in gross margin was mainly due to increased operational scale and efficiency for our learning centers in terms of lower personnel costs and welfare expenses as a percentage of net revenue, and the lower rental expenses as a percentage of net revenues.

Now, moving on to operating expenses. Selling and the marketing expenses increased by 28% year over year to \$11 million. The increase was due to higher personnel costs and the welfare expenses related to the growth in our selling and marketing headcount and higher average salary and expanded marketing effort, primarily as a result of increased spending or advertising as we expanded our network of learning centers.

Non-GAAP general and administrative expenses increased by 63% year over year to \$6.5 million. The increase was mainly due to higher compensation costs for our increased number of general and administrative personnel to support our growing operations and higher [bad debt] allowance.

Research and the development expenses increased by 28% year over year to \$1.3 million. The increase was mainly due to higher personnel costs and the welfare expenses of our instructors allocated to their content development activity for our courses.

Our operating income increased by 47% to almost \$10 million in the third quarter of 2014. Non-GAAP operating income increased by 60% to \$11 million. Non-GAAP operating margins increased to 27.2% in the third quarter of 2014 as compared to 24% in the same period in 2013. In the third quarter of 2014, we had a decrease in effective income tax rate to 9.6% from 18.1% in same period in 2013. The decrease was primarily due to a tax holiday enjoyed by one of our wholly-owned subsidiaries that is qualified as a newly established software enterprise under the PRC Enterprise Income Tax law, which provides a two year full exemption from enterprise income tax from 2014 to 2015, followed by a three year 50% exemption from 2016 to 2018.

Our net income for third quarter increased by 74% to \$10.5 million, from \$6 million in the same period in 2013. Non-GAAP net income for the quarter increased by 87% to \$11.6 million from \$6.2 million in the same period in 2013.

In the third quarter of 2014, our GAAP basic and the diluted earnings per [ADS] were \$0.21 and \$0.18, respectively. Non-GAAP basic and the diluted earnings for ADS were \$0.23 and \$0.20, respectively.



We had a significant increase in cash, cash equivalents, and time deposits balance from \$38.3 million as end of 2013 to \$163.1 million as of third quarter of 2014 because of the IP proceeds of \$109 million and cash flow generated from operations.

Looking forward to the fourth quarter of 2014, we expect total net revenues to be in the range of \$39.2 million and \$40.4 million, representing an increase of 38% to 42% on a year over year basis.

The company also expects its total revenues for the full year of 2014 to be between \$135.8 million and \$137 million, up from its previously guided range of \$134.5 and \$136 million, representing an increase of 46% to 48% on a year over year basis. This guidance reflects the company's current expectations, which is subject to change.

So this concludes my remarks, and I will now hand the call over to the operator and open the line for questions. Operator?

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## QUESTIONS AND ANSWERS

### Operator

Thank you, Mr. Ji. (Operator Instructions).

Your first question comes from the line of [Fan Lu] of Goldman Sachs. Your line is open. Please go ahead.

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### Unidentified Participant

Hi, (spoken in foreign language - Mandarin). Congratulations on a great [rate down]. It's good to see that revenue is up by 41%, while sales and marketing only up by 28%. So regarding to the optimization of the advertiser spending, could management show us how is the marketing budget allocated across different channels, i.e., search engines and the job verticals? And second question is could management add more color on the progress of accounting courses. How is the enrollment given the overall class has commenced end of October? Thank you.

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### Suhai Ji - Tarena International Inc - CFO

OK. I would address your first question, and I will have Shaoyun maybe address your second question on accounting.

The first one is our advertising dollar spending among different channels remain essentially unchanged between the last quarter and this quarter, so there's about 80% to 90% is all on search engine marketing, and the rest, 10% to 20%, spread over, you know, among the job recruiting websites and, you know, such as 51job.com or [jaoping].com, or [58].com those websites, and also some of the off-line advertising that we do in terms of university channel.

What's improved is really the efficiency in the advertising dollars. So, basically, if we spend \$100 on Buy-Do before versus now, and we are more efficient in generating more traffic, though on a per dollar basis, you know, we realize the benefit of the scale, which would drive our enrollment and revenue and also, you know, the utilization rate. So that's the answer to your first question.

Second question. (Spoken in foreign language - Mandarin).

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### Shaoyun Han - Tarena International Inc - Chairman and CEO

(Interpreted) So we started our, you know, accounting course October 31, so we actually have, you know, two classes, you know, one full-time and one part-time, totaling about 100 students. So we're on track, as we stated in the previous earnings call, and the initial results were very encouraging. Actually, slight, you know, exceeded our original expectation.



You know, we only started to do advertising, you know, for the accounting course in October, so within one month we had a full class already, you know, commenced. And so we, you know, we hope to deliver, you know, similar kind of results as some other non-IT - the other two non-IT courses that we launched in 2013, you know, digital art and on lines sales and marketing, and this is consistent with our strategy to expand, you know, beyond our core IT courses into some other high gross verticals that's in the non-IT area. And, you know, hopefully, we'll be, you know, proven that we have another successful non-IT course offering.

I just want to add that we just started our first class end of October and we plan to - this is only in Beijing, in one center, so we plan to commence, you know, the second class end of November and third one end of December and the third one in the end of January, so we would not roll it out to the rest of the country probably until March next year, so that's the singular strategy we adopted with the new IT course as well, the digit art course.

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**Operator**

Your next question comes from the line of Jialong Shi of Credit Suisse. Your line is open. Please go ahead.

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**Jialong Shi - Credit Suisse - Analyst**

Hi. Good evening, management. Thanks for taking my call. I have a question about the policy. I remember [Wang Hu], the Chinese state council issued a policy to encourage the development of professional education industry. Just wonder, you know, two quarter have passed, if you guys have seen any, like, sort of, positive impact on your business from these policy tailwinds? Thank you.

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**Unidentified Company Representative**

(Spoken in foreign language - Mandarin)

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**Shaoyun Han - Tarena International Inc - Chairman and CEO**

(Interpreted). Yes, so we have already seen some positive results benefited from the policy. We have been talking with, roughly, five universities to offer joint major programs with the universities. And, also, regarding our university channel, both year over year and quarter over quarter, this quarter student enrollment from the university channel has increased.

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**Suhai Ji - Tarena International Inc - CFO**

That's another reason we are actually separating the retail channel and the university channel because we see potential, you know, in [gross] in our university channel as well, so we are assigning dedicated managers to responsible for this particular channel, for drive the cost.

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**Jialong Shi - Credit Suisse - Analyst**

Thank you. Thank you for the detailed answer. I have a follow-up housekeeping question. Could you give us a breakdown of your cost of sales for Q3 and how was it compared to year ago? Thank you.

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**Suhai Ji - Tarena International Inc - CFO**

The breakdown of what? Sorry?



**Jialong Shi** - *Credit Suisse - Analyst*

Cost of sales.

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**Suhai Ji** - *Tarena International Inc - CFO*

Oh, the breakdown of the - of the costs?

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**Jialong Shi** - *Credit Suisse - Analyst*

Yes.

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**Suhai Ji** - *Tarena International Inc - CFO*

OK. I will address this question. For the total, you know, cost of sales, the percentage, you know, our gross margin, which is - basically, in the third quarter this year is 26% of the total revenue, and the same quarter year ago was 28.1%. And we think the costs, the personnel costs and the welfare as a percentage net revenue in Q3 is 9.7%, compared to 10.1% in the same period a year ago. And in terms of rental costs as a percentage revenue, in Q3 this year it's 69% and Q3 last year was 8.7%. So you can see that we are realizing, you know, more leverage from the - you know, the general cost space. And the depreciation - the third largest cost remain unchanged, 4% of the total revenue, so most of that leverage coming from personnel costs and rental costs.

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**Jialong Shi** - *Credit Suisse - Analyst*

Got it. Thank you very much. I'll get back into the queue. Thank you.

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**Operator**

The next question comes from the line of Ella Ji from Oppenheimer. Your line is open. Please go ahead.

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**Fiona Zang** - *Oppenheimer - Analyst*

Hi, Suhai Ji and Christina. Thank you for taking my question. This is Fiona Zang calling on behalf of Ella, and I have two questions today. Firstly, I just wanted to follow up on the previous question on the non-IT verticals. I was wondering longer term for these verticals, what revenue contribution level are you expecting? Thank you.

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**Unidentified Company Representative**

(Spoken in foreign language - Mandarin).

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**Fiona Zang** - *Oppenheimer - Analyst*

(Spoken in foreign language - Mandarin).

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**Shaoyun Han** - *Tarena International Inc - Chairman and CEO*

(Interpreted) All our non-IT courses growth momentum is pretty strong. The target market, the potential market for non-IT courses is also larger, so the percentage of total revenue contributed by non-IT courses will continue to increase. For next year we are expecting roughly over 40% revenue contribution from the non-IT courses.

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**Fiona Zang** - *Oppenheimer - Analyst*

All right. Thank you. That's helpful. My second question is on the 2015 outlook. Are you still targeting to open about 25 to 30 learning centers for the coming year and how many will be open in the first half? And, also, given this nice improvement of your learning center utilization, how should we think of the margin trends for the year 2015? (Speaking in foreign language - Mandarin).

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**Suhai Ji** - *Tarena International Inc - CFO*

Thanks. I'll have Shaoyun to address the learning center numbers and I will address the margin issue.

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**Shaoyun Hun**

(Interpreted) So we are planning to open 10 to 15 new learning centers in the last quarter of this year. There's some seasonality in terms of new learning center opening schemes, so some of the centers opening last quarter of this year is preparation for the next year. For the first half of 2015, we are planning to open, more or less, 20 new learning centers during the first half.

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**Suhai Ji** - *Tarena International Inc - CFO*

Yes. And, also, in terms of margins, you can see that in Q3 this year we're already at 74% in gross margin and 27.2% in non-GAAP operating margin. So those are very healthy metrics, and our utilization, overall utilization of the [seat] occupants and rate is already at 77%, so we think we are ready to step on the gas a little bit to open more centers to cater to the demand as our existing center already is renting out to a more mature stage. That's why, you know, in Q3 we only had net of opening of two new learning centers, and in Q4 we plan, you know, 10 to 15, probably close to 15 new centers in this fourth quarter this year.

And a lot of them, actually, most of them would be open in December, you know, basically getting ready for next year. And the next year, overall, we're targeting, you know, 35 plus learning centers, of that, probably around 20. As Shaoyun mentioned, we'd be open in the first half. So, obviously, you know, as you saw in the past, you know, quarters, you know, there's always balance in-between the gross and the margins. You know, the faster we open the learning centers, you know, it will dilute our margins, so we expect slighter decrease in margins, but the impact would not be as great as in the past year when we have a fewer, more mature learning centers, because now we are ready to have, you know, over 100 learning centers. So, on top of that, open another 30, the impact won't be as great as, say, we only had 50 learning centers adding another 30.

So we expect the margin to come down a little bit in Q4 compared to Q3 because Q3 is really typically our high season, but we are already on track to achieve the, you know, full year, the profit target. We're quite comfortable with that, and that's why we are, you know, stepping on the gas and opening more learning centers. And the next year, we hope the margin will be similar, at a comparable level as the level, you know, of this year.

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**Fiona Zang** - *Oppenheimer - Analyst*

All right. That's helpful. (Inaudible) Suhai Ji and Christina.

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**Suhai Ji** - *Tarena International Inc - CFO*

OK. Thank you. Next question.

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**Operator**

The next question comes from the line of Leo Fan of SWS Research. Your line is open. Please go ahead.

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**Leo Fan** - *SWS Research - Analyst*

(Speaking in foreign language - Mandarin).

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**Christina Zhu** - *Tarena International Inc - Investor Relations*

(Interpreted) I'll translate a question. So Leo asked two questions. The first regarding our 10 to 15 new learning centers in the fourth quarter, in which cities and which course offerings will be the center base.

And the second question is regarding our new course development plan, whether we're expecting any new IT courses.

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**Suhai Ji** - *Tarena International Inc - CFO*

I will talk about this. (Spoken in foreign language - Mandarin).

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**Leo Fan** - *SWS Research - Analyst*

(Spoken in foreign language - Mandarin).

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**Suhai Ji** - *Tarena International Inc - CFO*

So in October, we basically are going to open that new accounting center in Beijing and another one in [Wang Fa], and in November we'll have two in [Kenjing] and [Chindow]. And in December we'll have more. So in [Chindow]. (Spoken in foreign language - Mandarin). Also, maybe another one in Thailand, so that's about 15 in total.

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**Leo Fan** - *SWS Research - Analyst*

(Spoken in foreign language - Mandarin).

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**Shaoyun Han** - *Tarena International Inc - Chairman and CEO*

(Interpreted). OK. So in October we will open one new IT center in [Wang Fa], one new accounting center in Beijing, and for [Chinsing] and [Chindow], new learning centers will be expansion of current course offerings, JAVA and UID because we ran out of our space, full capacity in our current centers. And in December we'll open accounting learning centers in (spoken in foreign language - Mandarin). So there's nine new learning centers we'll be preparation work for the rollout of our accounting course next year.

OK. So one minor correction. The (spoken in foreign language - Mandarin) is a new city, so we'll have the new JAVA course in [Guaya].

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**Shaoyun Han** - *Tarena International Inc - Chairman and CEO*

(Spoken in foreign language - Mandarin).

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**Shaoyun Han** - *Tarena International Inc - Chairman and CEO*

(Spoken in foreign language - Mandarin).

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**Suhai Ji** - *Tarena International Inc - CFO*

So even, as we mentioned earlier, we won't commence our classes in accounting until the beginning of March next year, but we need to set up those centers and get them, you know, decorated and ready for, you know, the incoming class. And because the Chinese New Year next year falls in February, so we need to get prepared ahead of the time. So that's why in Q4 our margin could potentially - you know, should come down a little bit because once those new centers are open, you know, we need to incur the rental costs and all the other, you know, costs associated with it. But we have not started enrolling students in those centers.

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**Operator**

Thank you. Now I will refer the call back to Christina Zhu, Tarena's Investor Relations Manager, for any additional or closing remarks.

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**Christina Zhu** - *Tarena International Inc - Investor Relations*

Thank you, operator. If there are no further questions at present, we'd like to conclude by thanking everyone for joining us on the call. We welcome you to reach out to us directly by emailing [ir@tarena.com.cn](mailto:ir@tarena.com.cn) should you have any questions or requests for additional information. I encourage you to visit our investor relation website at [ir.tarena.com.cn](http://ir.tarena.com.cn). This concludes Tarena's earnings conference call. Thank you all and have a good night.

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**Operator**

That concludes the conference for today. Thank you for participating. You may all disconnect.

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**Editor**

Portions of this transcript that are marked (interpreted) were spoken by an interpreter present on the live call. The interpreter was provided by the Company sponsoring this Event.

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