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Half Year 2019 Spirent Communications plc Earnings Call

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## PRESENTATION

### **Eric Updyke** *Spirent Communications plc - CEO & Director*

All right. Good morning, all. It's just past time so I think we ought to get started. My name is Eric Updyke, the -- I guess, not so new CEO of Spirent now. But I just want to say that I'm really delighted to be here to have this opportunity to meet you all. I look forward to getting to know you better in the coming months. Take note of the safe harbor statement, I guess. But before I dive into the results, I do just want to give a word of thanks, actually, to Paula and the entire team, really. You come into a new situation and have a lot of difficult things to explain. And I actually feel like we've got a great platform and great momentum as it relates to results. So I'm delighted to be in the position of having this first conversation with all of you with that as a backing. So thank you.

But let's dive in. So I've only been with Spirent for a couple of months, and I'll share my first impressions later in the presentation. But for now, I want to pull out the specific highlights from the first half, particularly as they relate to our strategic priorities. As you know, our first priority is maintain our sharp focus on our target markets: 5G; high-speed Ethernet; positioning in cybersecurity, and we saw good progress against this aim in the first half. We had numerous 5G wins, including our first 5G VisionWorks Service Assurance solution deal. We saw a strong demand for our 100G and 400G high-speed Ethernet test systems, and we achieved robust growth in positioning test systems; and won security deals in our new enterprise and government accounts to expand our enterprise customer base. In terms of innovation, we've developed and released new solutions and services for 5G, cloud performance and cybersecurity. We extended our customer base provision works in Tier 1 service providers in the U.S.A. And we developed and released new features for our high-speed Ethernet and WiFi solutions.

Finally, we have a strong financial and operational platform. We continue to deliver revenue and earnings growth and this is fundamental to allowing us to achieve the 2 priorities I've already mentioned. We grew revenue 4% and earnings grew 22% in the first half. The strong earnings and cash positions bode well for further targeted investments in the future. Paula will now share our financial results and some other operational highlights. Paula?

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### **Paula Bell** *Spirent Communications plc - CFO & Executive Director*

Good morning, all. Thanks, Eric. Okay. So let me take you through our first half performance highlights. We've seen continued momentum, as shown here, and we're clearly delighted to report another period of strong trading performance. Orders were up 7% to just under \$220 million. We are building order book and have won a number of multi-year support contracts in the period. Revenue was up 4%, and together with an effective approach to managing our cost base, profits increased 16%. On the back of reduced working capital, we generated strong free cash flow in the period, maintaining a strong balance sheet. Here you can see from the improved profit and reduced tax charge, we drove EPS up 22%. With our continued confidence in our progress, we are declaring a 10% increase to the interim dividend, which is actually a 19% increase in sterling.

So looking at the financial summary. A good solid set of figures with improvement across the board. As mentioned already, the top line growth, and you can see here robust gross margin at 72%, an improvement on the half -- on the last half in all 3 segments. We benefited from increasing software content, some product mix, and we've also been focusing on pricing policies to ensure our value is captured appropriately. Despite cost inflation, we improved our first half operating margins, and operating profit increased to \$20.7 million and EPS to \$3.03.

So with regard to tax, we continue to ensure we optimize tax initiatives available to us, such as U.K. Patent Box, R&D tax credits. And our



estimated tax charge for the full year is 13% to 14%, and we see that being the same rate for the mid-term. Cash closed at \$141.8 million. And as I mentioned, the Board has declared a 10% increase in the dividend. So I think it's fair to conclude, we've built a strong platform for our second half progress.

So let's just have a little look by our segment and turn it to each of them in turn. Networks & Security, revenue grew 5%, and operating profit improvement followed. In the first half, we continue to see progress and increasing demand for 400-gig Ethernet ports. We saw strong demand in APAC, offsetting the slower pickup in the Americas and that's commensurate with the usual spend profile of our North American customers being more second half, and indeed, Q4 weighted. Lifecycle Service Assurance revenue grew 6% and operating profit improved nicely. Demand for both lab tests and live network assurance is increasing, as we continue to support our customers with their 5G requirements. The Connected Devices revenue remained stable as we expected. And yet again, made another strong profit performance. So we continue made good progress here, both on its strategy, to develop 5G device test capabilities, whilst managing cost effectively. And that was an impressive contribution to the group results there.

Corporate cost movement there, just to give more color on that, a number of small parts on the previous half year costs were slightly lower due to phasing and this half included the CEO transition. So as I said, overall, operating margin up 1% to 9.5%.

Now I thought it was useful to repeat this slide, just to remind how diversified we actually are and the benefits of risk and mitigation that this brings. In a world of geopolitical challenges, which won't be solved in the short term, and it's important we remain alert and agile. The strength of our business model is apparent here when one considers no one customer has more than 7% of our revenues.

Our business model is built on strong respective customer relationships, which is critical. When you wish to transfer emphasis to those customers who are better placed to build networks, are responding to the opportunities for 5G and are affected by U.S.A. and China trade challenges, and despite these trade challenges, we delivered a strong result, as you can see, we increased our sales in APAC.

We are not going to comment specifically in detail on customer-specific business. But as it relates to Huawei, we can see the U.S. directives are complex. We interpret them carefully each time they change, which is frequent, and we continue to work closely with all of our customers to support them. So it's clearly a risk to manage, which is by our regional customer diversity, serves us very well. That also means the top 10 customers are 40% of our revenue.

So turning to operating cost. Following the previous 2 years of rebasing our cost base, where we took out almost 200 heads, which was more than 10% of our staff base. We did that. We did say that we expect our cost to rise in absolute terms into 2019 and onwards, not only because of inflation but to support our strategic growth agenda. And from our press release, you may have noticed quite a number of new leading-edge products and solutions. And therefore, we made sure we've invested sufficiently in our marketing activities and developing all the routes to market.

The administration cost includes inflation, as I said, a number of small items, CEO transition, which is nearly \$1 million and a small doubtful debt provisions. Costs have increased 4%, inflation being 3%. Cash, it remained strong. We generated \$44.6 million of free cash flow in the half. You can see here from the working capital reduction, we benefit from a very strong finish in 2018, where we collected the cash from those sales beginning of 2019.

H1 2018 working capital movement was actually dampened due to payment of previously accrued restructuring costs and movement in provisions that have the effect of reducing the overall creditors. CapEx, you can see here, was \$6 million in the half, mainly around 5G investments. The outlook for the year remains unchanged at \$12 million to \$14 million. And just for information, we did implement IFRS 16, the accounting for leases on the 1st of January this year. It has 0 impact to PBT and EPS. We brought on to balance sheet just over \$30 million of property leases and the corresponding lease liabilities that go with that.

So just to cover a few of the operational highlights for each of our 3 segments. Networks & Security, as you recall, covers our high-speed Ethernet, security and positioning businesses. We are making good progress in all 3. We continue to make market share gains in our areas of expertise. 400-gig high-speed Ethernet has already seen good pickup of customers in APAC, with North American uptick expected in the second half of the year as usual. To enable cloud and 5G transformations in the industry, we have launched world's

leading offerings to support cloud and network functions virtualization rollout. We also recently support the largest-ever test of a high-density 100-gig cluster core router. Our cybersecurity business has just released a new product, CyberFlood, which is called data breach assessment. And this allows our customers' operations and IT teams to validate the security of their networks through ultimate assessments of the ability to stop data breaches, cyberattacks and malware infections.

Positioning business saw good demand from Tier 1 defense contractors for the U.S. government. We've also received interesting projects to work with our Chinese customers to support new aerospace applications. So overall, good traction in the segment, 5% revenue growth and improved gross margin.

Lifecycle Service Assurance, we saw growth in demand for our market-leading Landslide solution to support 5G core network developments in the lab, as our customers accelerate their plans for 5G build-outs. We expanded the installed base for our VisionWorks Service Assurance and analytics solutions winning 5 multimillion deals, saw deals of 3 Tier 1 customers, and in particular, we secured our first strategic 5G VisionWorks Service Assurance win, as Eric said, with a U.S. Tier 1 customer. We continue to support our key North American providers to place more orders to expand the benefits they receive from existing Spirent Service Assurance deployments. And we are focused on on-boarding and supporting new customers to be able to take advantage of VisionWorks operational network solutions. We remain positive in our ability to help customers globally, accelerate the deployment of their complex networks and services, ensure performance and reliability and, of course, reduce the costs. So good progress in the half with a 6% revenue growth there.

Now turning to Connected Devices. As you saw from the figure, a good performance in the half. We continue to progress our strategic partnership with National Instruments to develop 5G device testing solutions. The plan is on track. The partnership is working very well and we are looking to identify further collaboration opportunities across other segments. We developed a new channel partnership with Connected Devices in the half to expand our penetration of the U.S. military and government market, and we continue to be relied on by our global customers. And that's evidenced by the high support contract renewal rate for the embedded base of our Connected Devices solutions. So segment is on track. We don't expect revenue growth in 2019, as we previously said, yet well positioned for continued progress.

So we've continued to deliver revenue growth. We're building order book. We are in the early stages of 5G and 400-gig upcycles with leading products to help our diverse customer base. We have an agile operating model. We are quick to respond to customer requirements. We've improved every financial metric in the first half and retain our strong balance sheet, which gives us options to support our strategic growth agenda.

So with that, let me pass back to Eric.

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**Eric Updyke *Spirent Communications plc - CEO & Director***

Thanks, Paula. Yes, I really am delighted to have joined Spirent at this moment in time. I really think opportunity abounds for us, so our challenge is really to make timely decisions and execute on our strategy. It's early days for me so our thinking and discussions with the board are still evolving. But I thought it'd be helpful to start by sharing some first impressions. Having been in the industry for many years, I've obviously been aware of Spirent in its strengths as a business. The impression I had from the outside the firm was of an organization, which is well known by its loyal customer base, for its technical expertise and its commitment to great customer service. A company with engaged, passionate and experienced employees.

Since arriving in April, I've spent a lot of time with the business and with customers. And I've been delighted to see that the picture is very much the same from the inside. If anything, the market shifts I've seen from the outside of the business have been even more apparent from inside. I believe that they are accelerating. New and emerging technologies are having a profound impact on our customers and therefore, on us. Cloud, virtualization, automation, artificial intelligence offer new challenges and opportunities and our customers expect us to lead with value-added services and expertise. All this adds a real sense of urgency for us.

For all the positives I've seen at Spirent, I do believe we need to move faster to capture these opportunities and driving the sense of urgency will be a priority for me. There's a huge opportunity for us to move beyond the lab into the live network, to transfer our skills



across from develop to operations, and we have to do so faster. We also need to make more of the opportunity beyond our core customer base in telco, and I see a real chance to expand the solutions we provide, whether that be through our own efforts or through partnerships and M&A. I'm confident we can meet these challenges.

Now I want to give you a few thoughts on our strategy, where we sit in the market and how we take things forward. First, we continue to see a strong alignment between our portfolio and the key market drivers, and we believe that will continue in the coming years. Related to 5G, certainly, projects and investments for 5G development and deployment have a strong impact on all our business segments, and we expect 5G will be the fastest wireless generation to be rolled out on a global scale.

For high-speed Ethernet to support the increase in bandwidth and performance expectations, largely driven by video traffic, gigabit Ethernet is critical. We are the market leader for high-speed Ethernet performance test systems, so we're well positioned to meet our customers' expectations and to capitalize on this business opportunity. Around cloud and virtualization, communication service providers are under pressure to reduce total spend and to introduce new services faster to stay competitive in the data-driven digital economy. New virtualized networks require new test tools and Service Assurance systems.

In addition, enterprises are increasingly moving applications to the cloud. The spending on private and public clouds provide an attractive business opportunity for our solutions and services that we offer today and that we plan to develop.

Needless to say, cybersecurity is a top priority for service providers and enterprises. To address this challenge, more companies are fortifying their sensitive information using security testing tools for better protection. We are increasingly participating in this market with our cybersecurity performance testing products and services, and we recently released our new data breach assessment tool, which will give enterprises a comprehensive view of their vulnerabilities along with strategies to mitigate those risks.

In Connected Devices, the Internet of Things has been widely embraced to reduce costs, improve customer experience and deliver new applications, as indicated by the large and growing number of connected devices. Our business is primarily positively affected by industrial applications where the application must be reliable and secure, such as connected vehicles, smart factories, health care and the financial sector. In addition, the increase in importance of high-quality video over connected devices creates new opportunities for us to test and validate performance.

Let's go a little deeper on 5G. Clearly, 5G is a focus and it's a priority for industry players, whether developing components, equipment, devices, networks or applications. There are challenges to deliver the functionality, the performance and reliability to enable new innovative services and applications and this drives demand for our solutions and services across all our business segments. For example, to support the development, deployment and operation of 5G devices and networks, we're the leading providers of high-speed Ethernet performance test systems. We provide application performance and security test tools and offer cyber services. We're the leading provider of mobile infrastructure performance test tools for development or field trials. We have a leading Service Assurance and analytics system. We have automated 5G and IoT device tools for location and video applications. We have user experience assessment tools and services to understand how devices and applications operate on networks.

Bottom line, we believe we have the leading set of solutions and services to tackle the 5G challenges and capitalize on the business opportunities in our space. But don't just take my word for it, we actually have some evidence. The best evidence is some wins in the marketplace. We've already had some wonderful successes demonstrating we're well positioned to capitalize on this 5G investment cycle. We have more than 60 5G deals across 33 unique customers and of those, 30 are for the Vertex Channel Emulation for 5G radio development, and more than 20 are for our Landslide test system for core network emulation and evolution. And we won the Leading Lights Outstanding Test & Measurement Vendor award for the second year in a row.

Let me shift gears and talk about a direction around broadening our portfolio. As I referenced earlier, I think we can do a lot more to broaden our portfolio and to expand our customer reach, but I'll first discuss broadening our solution portfolio. As depicted in this diagram, we have a broad range of products and services today in all our business segments that target our customers' developing devices, applications and network equipment and for our customers' operating networks and services. Although we have substantial offerings for network operations today, we need to develop broader services and solutions offerings for network operations.

These solutions are complex and mission-critical. They're generally higher software content. They require ongoing service and support and are increasingly subscription sales, especially for enterprise security testing. In this segment, after we land an initial deployment deal, there's the potential to expand the footprint of applications and use cases and scale the system. This creates long-term business relationships and repeat business with our top customers. As we move forward, our focus, priority and investment will target creating new innovative solutions for developers, communication service providers, enterprises and governments.

The second thrust is to expand our customer reach. We have a broad, deep and loyal customer base today, ranging from wireless and positioning device manufacturers and application developers, network equipment makers, communication service providers, enterprises and governments. Going forward, we see tangible opportunities to expand our business in cloud service providers, enterprises and government, developing the right solutions and services to meet their needs and expand in both our direct sales force and our channel partner program. These are 2 of my priorities in the short term and I look forward to coming back to you in due course to provide more detail on our plans.

So in summary, we retain the same strategic priorities to guide our business. We have a sharp focus on our target markets. The target markets and disruptions drive all our businesses positively, and we expect that to continue for many years. We have clear technology leadership positions and with our focus on 5G, we have a broad offering and key deals that demonstrate early success. Innovation is critical to our business and our customers' business. And in this half, we developed and released new solutions and services for 5G, cloud performance and our cybersecurity data breach assessment.

We recognize the importance of deep client relationships to focus our innovation on meeting customers' needs and expectations. And we also see the need to expand our customer reach to deliver sustainable, profitable growth. We have a strong financial and operational platform. We delivered revenue and earnings growth again this half, and we believe we can capitalize on this new technology developments and investments globally.

In closing, our outlook can be summarized as, we believe we're well positioned to capitalize on the business opportunities associated with 5G, cloud and cybersecurity, and we continue to invest in market-leading technologies. As in the past, we expect our business performance to second half weighted. Our outlook remains unchanged. And we expect to deliver sustainable, profitable growth.

Now we'll be happy to take some questions. Thank you.

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## QUESTIONS AND ANSWERS

### **Kai Folker Korschelt *Canaccord Genuity Corp., Research Division - Analyst***

It's Kai from Canaccord. The first one was just on the sort of pace the nature of 5G rollouts. I think most of the deployments at the moment are for nonstand-alone, meaning they run on the 4G cores. And I think next year, many carriers are planning to do the nonstand-alone version. So if some of the momentum you're seeing for your Landslide product, sort of, are you anticipating that? Or we have to see the benefits of that trend come through?

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### **Eric Updyke *Spirent Communications plc - CEO & Director***

Yes, we're really pleased with the momentum. I think it's great validation that our core network emulator, the Landslide is really the leading solution in that space and to solve that particular problem. I think many of the service providers at the moment where they are trying to select who their network equipment providers are going to be in their core network. And so as they want to test and do some early trials, having a solution such as ours, either for initial field trials or for the lab work is really important.

I think there's actually quite a bit more opportunity for us to keep selling Landslide solutions. So I think it's still early days. And hopefully, it will continue through the investment cycle. It's -- we're still at the beginning of the 5G investment cycle. So we think for Landslide and for the rest of our portfolio, there's more -- certainly a lot more opportunity ahead.

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**Kai Folker Korschelt *Canaccord Genuity Corp., Research Division - Analyst***

And then a follow-on, if that's all right. On the -- on Connected Devices, so that business seems to have stabilized now. And I think at some point in the second half, you'll have a 5G handset testing solutions. So should we expect some revenue contribution already in the second half of this year? Or is that more of a 2020 story?

**Eric Updyke *Spirent Communications plc - CEO & Director***

Yes, I think it's more of a 2020 impact is the short answer. We do expect it to become part of a viable solution that we can begin selling later this year. So we're hopeful we'll get some real customer wins from that partnership. The NI partnership has actually gone very well, and it's on track, and we're really happy about it. So -- but yes, I think relative to the specific question, that's -- it's more of a 2020 contributor actually, well, with some initial success hopefully later this year.

**David Terence Mulholland *UBS Investment Bank, Research Division - Director and Equity Research Analyst - Technology Hardware***

It's David from UBS. Just following on from some of the commentary you made around looking into the new customer bases going into service providers and so on. Can you just give us a bit of color what -- is there something where you're going to need to develop new products, do you think? Or can you take the products you already have? Or how much reinvestment's required to have a product suite to go after some of those markets more aggressively?

**Eric Updyke *Spirent Communications plc - CEO & Director***

Yes. So some of what we've developed recently, the data breach assessment that we highlighted multiple times that we're pretty proud of in the cyberspace, it's squarely focused on the enterprise space and enterprise customers. In terms of our investment plans, in terms of broad strokes, in terms of spend, we're in the same space that we've communicated and so forth previously. We do have new ideas and new thoughts about capabilities that we'd like to bring forward to have an even increased relevance with cloud service providers, right? So that is a theme that I referenced earlier. But in terms of overall investment levels, you could expect it to be about the same.

**David Terence Mulholland *UBS Investment Bank, Research Division - Director and Equity Research Analyst - Technology Hardware***

That's great. And then just on the Lifecycle Service Assurance, the 5 new contracts for -- that you've announced with Tier 1s. Can you talk geographically where are those located? Because, obviously, it's had a very strong U.S. presence historically. Have you started seeing much traction internationally?

**Eric Updyke *Spirent Communications plc - CEO & Director***

Yes. Most of what we're referencing here is still North American dominated to be honest. It is a push for us to broaden the VisionWorks success globally, and we have some good activity in terms of PoCs and trials elsewhere in the world. But the highlights that we really referenced in the first half in terms of real customer wins were really North American focused.

**William Kirkness *Jefferies LLC, Research Division - Equity Analyst***

It's Will Kirkness from Jefferies. If I could just pick up on your comments around M&A, I just wondered if you have any thoughts on the shape of the balance sheet, and whether you would like to stay in net cash, and if you're happy to push into debt, and what's out there that might be interesting to help you broaden your services, broaden your client reach? And then secondly, just again on LSA, could you maybe quantify the growth rates between VisionWorks and Landside. It feels like Landside's become a greater contributor to the growth over the last 12, 18 months?

**Eric Updyke *Spirent Communications plc - CEO & Director***

Yes. So on M&A and the balance sheet, I think it's great to have strategic flexibility, particularly as a new CEO and looking at the landscape. I'm well aware that M&A can be a risky business. And so I think anything we consider in that space is going to be very tightly tied to looking first at our strategy, and will it really help us execute our strategy? And I think we'll be really prudent about looking at alternatives. So I think it's important that it be kind of an arrow in our quiver. That's something that we look at, and we use in a judicious way and in the right way and in the right time. So there's a bunch of conditions that need to be met, and make sure that we can execute upon it. So yes, we'll scan the market, and we'll see what can really help us accelerate our strategy is sort of the approach and the thinking around M&A as a lever.

Around the LSA family of products. I think if you look at the investment cycle, particularly around 5G, it's kind of natural that Landslide is where we would enjoy the first success. The driver for live network, Service Assurance solutions, you need traffic and customers on the network. And so if the stage we're at is one where it's initial field trials, a lot of work in labs, there's not the very immediate impetus for 5G Service Assurance deals. We're quite convinced it's coming. That need is going to come and that as networks virtualized, and certainly, 5G network -- the 5G network architecture is much more cloud-based, then it is going to create a real opportunity and real lift for next-gen Service Assurance solutions. So we're still quite bullish on that opportunity that lies ahead for us. But I think in the short term, it's kind of natural that Landslide is where we would see the momentum first. And frankly, we're hopeful that with those initial engagements, we can really leverage them into longer-term wins on the operation side of the network.

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**Janardan Nedyam Menon *Liberum Capital Limited, Research Division - Technology Analyst***

Janardan from Liberum. Just going back to your answer to David's question. So are you suggesting that if you're going to sell something to a cloud service provider or enterprise, you can use your current existing suite of products and develop those new customer bases? And if so, can you give us any examples of what could be sold to, I don't know, I presume, you're referring to companies like Amazon on the cloud service provider side? So what would be applicable outside of security? What will be applicable to an enterprise or a government? And then I have a follow-up.

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**Eric Updyke *Spirent Communications plc - CEO & Director***

Yes. So I think these are just extensions of our current portfolio and current capabilities. So I mean, an example, increasingly, enterprises are moving applications -- business applications that were on-prem to the cloud. And so if there were solutions that we could bring around cloud testing, cloud performance testing that wouldn't necessarily be sold to Amazon or Microsoft directly, but were actually to benefit and give assurance to those enterprises that what worked on-prem is going to work in the cloud or in a hybrid environment even. Those are the sort of notions that we think have applicability in that space.

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**Janardan Nedyam Menon *Liberum Capital Limited, Research Division - Technology Analyst***

And on the Network & Security, you grew 5%, which given that your Ethernet testing business is now sort of in an upcycle mode seems a little bit lower than what I would have thought. I was just wondering was there any effect there from the situation of Huawei, which probably brought it down by a percentage or so in the first half? Or was it a headwind from the \$10 million positioning order that you pulled out last year? And is that what is causing perhaps a slightly lower growth than what was expected?

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**Paula Bell *Spirent Communications plc - CFO & Executive Director***

To be fair, the \$10 million positioning exceptional project was more H2 in 2018, if you will. So that's not relevant in this particular question. The high-speed Ethernet business was -- did a good uptick in APAC, as I mentioned. I'm still waiting to see more of that uptick in North America, second half weighting.

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**Janardan Nedyam Menon *Liberum Capital Limited, Research Division - Technology Analyst***

Got it. And positioning, do you think is going well enough for you to overcome the headwind in the second half? Or is that -- so are you still seeing that as a headwind in the second half?

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**Paula Bell *Spirent Communications plc - CFO & Executive Director***

They're doing really well. I keep saying it's a one-off and they keep proving me wrong. So we've had a really good half. So we'll see. The demand in the U.S. government has been quite positive in the first half. If it tails off second half remain to be seen. So at this juncture of the year, we haven't called out what that full year position might look like, but it's doing quite well. And they are picking up some new test orders in China as well. So that's really quite good. Yes, we're doing really well.

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**Eric Updyke *Spirent Communications plc - CEO & Director***

Okay. Thank you very much.

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