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# EDITED TRANSCRIPT

KE - Q2 2016 Kimball Electronics Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Don Charron** *Kimball Electronics, Inc. - Chairman and CEO*

**Mike Sergesketter** *Kimball Electronics, Inc. - VP and CFO*

## CONFERENCE CALL PARTICIPANTS

**Andrew Huang** *B. Riley & Co. - Analyst*

**Hendi Susanto** *Gabelli & Co. - Analyst*

**John Racotto** *Flauret Asset Management - Analyst*

## PRESENTATION

### Operator

Good morning, ladies and gentlemen. My name is Carmen, and I will be your conference call facilitator today. At this time, I would like to welcome everyone to the Kimball Electronics second-quarter fiscal 2016 financial results conference call. All lines have been placed on listen-only mode to prevent any background noise. After the Kimball speakers' opening remarks, there will be a question-and-answer period where Kimball will respond to questions from analysts. (Operator Instructions)

Today's call, February 4, 2016, will be recorded and may contain forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995. Risk factors that may influence the outcome of forward-looking statements can be seen in Kimball's annual report on Form 10-K for the year ended June 30, 2015, and today's release.

The panel for today's call is Don Charron, Chairman of the Board and Chief Executive Officer, and Mike Sergesketter, Vice President and Chief Financial Officer of Kimball Electronics. I would now like to turn today's call over to Don Charron. Mr. Charron, you may begin.

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### Don Charron - Kimball Electronics, Inc. - Chairman and CEO

Thank you, Carmen, and welcome, everyone, to our second-quarter conference call. Our earnings release was issued this morning on the results of our second quarter ended December 31, 2015. We have posted a financial summary presentation to accompany this conference call. The presentation can be found on our Investor Relations website within the Events and Presentations tab, or, if you are listening via the webcast, you can find it in the Downloads tab on the webcast portal.

I will begin by making a few remarks on the overall quarter, and then I will turn it over to Mike for the financial overview. After that, we will answer any questions that you may have.

While our sales in the second quarter of fiscal year 2016 were basically flat when compared to the same period last year, it is important to note that when you compare the second quarter of fiscal year 2016 with the second quarter of fiscal year 2015 and factor out the previously announced loss of the JCI business, net sales would have been up 4.2%. Also, when holding currencies constant, net sales were up 4.1% compared to the prior-year quarter.

The firmer demand that we began to see at the end of the first quarter continued for the most part into the second quarter. Led by China, we saw a significant uptick in demand in our automotive vertical.

Our medical vertical for the second quarter was down year over year. However, it was up slightly when compared to the previous quarter as we continue to make progress on the launch and transition from a current to next-generation product for one of our largest customers.



Our sales in the public safety end market vertical were relatively stable when compared to the previous quarter, and our sales in the industrial and market vertical were down a disappointing 13.6% sequentially and 14.3% when compared to the same period last year as we experienced lower demand from two of our largest customers.

We are making good progress on the launches of a number of new business awards with both existing and new customers, and we are expecting sales from these launches later this fiscal year. Our new business opportunities pipeline remains healthy, and we continue to work diligently to achieve our medium-range goal of \$1 billion in annual sales by fiscal year 2018.

From an operating margin standpoint, this has been a challenging quarter for us. In addition to incremental costs related to the Romania greenfield startup, foreign exchange headwinds and higher-than-expected healthcare costs in the US also impacted our results. We remain committed to our 4% operating income goal and are responding with the appropriate short-term actions while maintaining alignment with our long-term strategic plan.

Our business and operations teams remain focused on our lean six sigma projects and our global purchasing initiatives to drive margin improvement and effective capital utilization.

We continue to make excellent progress in Romania. Since completing the construction of the new facility in November 2015, we went live with our ERP system and passed our ISO 9001 quality management system certification audit. We also hosted our first customer audit, and the facility received approval to begin production once validation units are produced and pass testing. We expect production to begin in the fourth quarter of our fiscal year, with a steady ramp-up of revenue over a multi-quarter period.

We continue to take advantage of the flexibility provided by our strong balance sheet, making investments that will drive future growth in sales and profits. After investing \$37 million in capital expenditures in fiscal year 2015, we are on pace and expect to invest slightly more than that in capital investments in fiscal year 2016, with the largest portion of these capital expenditures directly supporting new business awards.

During the second quarter of fiscal year 2016, we also returned \$3.8 million to our shareowners by purchasing 343,000 shares of our common stock under the \$20 million share repurchase program approved by our Board in October of 2015.

Now I will turn it over to Mike to discuss our second-quarter results in more detail. We will then open the call to your questions. Mike?

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**Mike Sergesketter** - Kimball Electronics, Inc. - VP and CFO

Thanks, Don. Our second-quarter net sales were \$207.1 million, which came in relatively flat compared to net sales of \$207.6 million in the prior-year second quarter. As Don mentioned, our sales were impacted by the exit of Johnson Controls, or JCI, and the weakening of the euro and RMB compared to last year.

Comparing our net sales by vertical to the same quarter a year ago, our automotive vertical was up 12%, or up 30% when excluding the JCI-related programs. The improvement in the automotive vertical was led by the China market.

Our medical vertical was down 4% from a year ago from fluctuating demand within various programs, although we believe the medical market remains stable.

Our industrial vertical was down 14% in Q2 compared to the prior year as a result of lower end market demand, and our public safety vertical was down 5% compared to a year ago.

Our gross margin in the second quarter was 7.8%, which was down from 8.6% in the same quarter last year. However, we did see sequential improvement from the 7.6% gross margin reported last quarter. Foreign currency fluctuations, costs associated with new product introductions, and increased healthcare costs in the US impacted our year-over-year gross margin comparison.



Selling and administrative expenses were \$9.2 million in the second quarter, which was flat compared to the prior-year second quarter. Selling and administrative expenses in the current-year quarter included incremental costs of \$700,000 related to our greenfield startup in Romania. Costs related to the spinoff in the second quarter a year ago were \$1.3 million. No spinoff costs were incurred in the current quarter -- current-year second quarter. As we mentioned in our last-quarter call, the spinoff is substantially complete.

Other income and expense was \$600,000 in the fiscal year 2016 second quarter compared to income of \$200,000 in the second quarter of fiscal 2015. Included in other income and expense during the current-year second quarter are net losses of \$700,000 related to foreign currencies and derivatives as a result of exchange rate fluctuations. The prior-year second quarter included net gains of \$100,000 related to foreign currencies and derivatives.

The effective tax rate for the second quarter dropped slightly to 28.1% from 29.6% for the same quarter last year. Net income in the second quarter of fiscal year 2016 was \$4.6 million compared to \$6.2 million in the second quarter of last year. Adjusted net income, excluding spinoff costs, was \$7.4 million in Q2 of last year.

Diluted earnings per share were \$0.16 in the second quarter of this fiscal year compared to \$0.21 in the prior-year quarter, or \$0.25 in Q2 last year when excluding the spinoff costs.

Cash and cash equivalents at December 31, 2015, were \$60.5 million. During the quarter, we did draw \$3 million from our foreign credit facility in China for local working capital needs, which was outstanding at December 31.

We had strong cash flow provided by our operations during the current-year second quarter of \$16.8 million compared to \$8 million provided in the second quarter last year. The strong operating cash flow during the quarter was primarily the result of earnings plus noncash adjustments, along with the reduction in inventory and increased accounts payable.

Capital investments in the second quarter totaled \$8.2 million, largely related to our investment in new manufacturing equipment to support new product introductions in multiple locations in the new Romania facility. As Don mentioned, we also repurchased \$3.8 million of our common stock during the quarter.

Our short-term liquidity available, represented as cash and cash equivalents plus the unused amount of our credit facilities, totaled \$117.1 million. Our balance sheet continues to be very strong, and we are well positioned for growth.

With that, I would like to open up today's call for questions from the analysts. Carmen, do we have any analysts with questions in the queue?

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Andrew Huang, B. Riley.

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### Andrew Huang - B. Riley & Co. - Analyst

Thanks for taking my questions. So I know you don't provide guidance, but if you could give us a little bit of color on revenue for the March quarter, that would be helpful.



**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Well, yes, you are right. We do not provide guidance, especially short-term kinds of guidance. But, Andrew, I could say a few things, as I reiterated in the webcast script.

I think we were pleased to see the strength that we saw as we were ending Q1 carry into Q2, for the most part. There were areas where the softness continued. For example, industrial was probably the area that continued to have the most softness that carried over into Q2.

The demand that we saw going into Q2 stayed relatively firm throughout the quarter, and so we were pleased with that. And to the extent that we can continue to see that base be relatively stable, and growing a little for us, we are encouraged, especially in light, as I mentioned, of the NPI activity that we have going on in the Company that has been going on for a couple of quarters now and will be going on for the next several quarters ahead of us as we ramp several new programs with both existing and new customers.

We do expect to see some revenue in this fiscal year from that NPI activity, as we stated in the script. So we can't really predict the future in terms of what will happen in the global macroeconomic environment and just the development with our business, with our end markets and our customers, but we are encouraged by, again, the stability we saw throughout the quarter and what we can see coming in the way of NPIs in the future.

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**Andrew Huang** - *B. Riley & Co. - Analyst*

Thank you for that. I think you talked about a particular strength in China automotive in your fiscal second quarter. I am just curious. I know that the March quarter has Chinese New Year, so are you seeing any kind of pause in demand from that particular end market? Or any color would be appreciated.

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Sure. Well, you pointed out the biggest variable that happens in this March-ending quarter, and that being the break that normally occurs for the spring festival holiday.

I really can't comment about that other than it is a variable. Normally, most of the factories are closed for at least a full week in the month of February, and then there is always sort of a gut-check moment when everyone comes back from the spring festival holiday to just see how things will carry on from that point.

I would say, I will say that the double-digit increase that we saw both sequentially and year over year in this quarter pushed us pretty hard. And so we didn't see any let-up as we exited the second quarter. But it is a variable, Andrew. That's all I can do, is say it is a variable. And like you, we watch very carefully going into the spring festival holiday, and we watch very carefully as everyone comes back to work there in China.

You know, our business there is largely China for China. So it is not only dependent upon the work plans of the upstream plants beyond us. It depends on the overall and market demand in China.

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**Andrew Huang** - *B. Riley & Co. - Analyst*

Got it. Okay. In your cost of goods sold, you mentioned a couple different things going on there. I think you mentioned FX and then startup costs for Romania. Then you also mentioned higher expected -- higher-than-expected healthcare costs. Can you elaborate a little bit more on that and whether those costs will show up again in the March quarter?

**Mike Sergesketter** - *Kimball Electronics, Inc. - VP and CFO*

Sure. As we have disclosed, we are self-insured for certain employee benefits, including US healthcare benefits. The timing and the size of the claims are a bit unpredictable and can vary significantly. In our Q4, we did experience higher-than-expected US healthcare claims impacting our quarter-over-quarter comparison of operating income negatively by about 20 basis points.

As to whether we can expect that trend to continue, that is hard to predict, given the variability and the unpredictability of how healthcare claims come through. But it was a bit of an unusual quarter for us.

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**Andrew Huang** - *B. Riley & Co. - Analyst*

I'm sorry. So just to be clear, were those costs included in your cost of goods sold or in SG&A?

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**Mike Sergesketter** - *Kimball Electronics, Inc. - VP and CFO*

A little bit of both, but primarily in cost of goods sold, because most of our employees work in the factories, and that is how those costs would be allocated.

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**Andrew Huang** - *B. Riley & Co. - Analyst*

Okay, got it. And then just one final question, and then I will get back in the queue. It looks like your SG&A jumped up quite a bit quarter over quarter. So I was wondering; I know some of that is due to Romania, but to some extent, that is kind of the cost of you doing business in your normal day to day. So I'm just curious; should we expect another increase quarter over quarter for the March quarter in SG&A?

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**Mike Sergesketter** - *Kimball Electronics, Inc. - VP and CFO*

Quarter over quarter, hard to say. I can't really provide you guidance there, but I can talk a little bit about the increases that we -- the increase we saw quarter over quarter. I assume you're factoring out the spin costs and so forth.

But as we have gotten into the year, there certainly have been some areas where we have added a little bit of headcount, and we have our normal increases in salary costs, and those are some of the kinds of things that you were seeing that impacted S&A. So there may have been a little bit of an unusual blip just sort of filling in some of the gaps, if you will, as we completed our spin year and so forth.

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Yes, I think that the other thing I just would add to that, Mike, is, and as Mike pointed out, the Romania startup costs that are showing up in our S&A line are essentially the lion's share of the costs until we start to generate revenue. So, it really isn't maybe S&A that you would think of in terms of a normal run-rate basis. It is basically the majority of the startup costs until we start to generate revenue, which, again, we expect to happen in Q4.

We are working as hard as we can to get Romania ramped up as soon as we can. If we can get some revenue going in this current quarter, we certainly will. That depends on a lot of things, including customer approvals. But as we start to generate sales in Romania, then those costs that are showing up in the S&A line would then move to cost of goods sold.

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**Mike Sergesketter** - *Kimball Electronics, Inc. - VP and CFO*

Good point.

**Andrew Huang** - *B. Riley & Co. - Analyst*

Okay, thank you.

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**Operator**

(Operator Instructions) Hendi Susanto, Gabelli.

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**Hendi Susanto** - *Gabelli & Co. - Analyst*

I would like to revisit the previous questions about the Romania startup costs. Which verticals will the Romanians still be able to focus on mainly? And when we see revenue increase in your top line, how should we relate that to the startup costs going away, and then whether you can quantify what kind of revenue increase you need to see before the negative impact will go away?

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Yes, let me start, and Mike may follow up on a couple of points. So, in answer to your first question, the two verticals that we are focusing the startup of Romania on are the automotive and industrial verticals. And we have been working with a number of our existing customers, as well as some new customers, on plans to support our ramp-up of Romania.

There are programs with existing customers that we have identified that are currently running in our Poland facility, and so this whole sort of phase 1 of getting revenue ramped up in Romania is more focused on those programs with existing customers. Of course, we had to do the things we had to do, such as build the plant, hire the team, get the ERP system running, get our quality system certification.

As I mentioned, we also withstood our first audit from one of those customers that has a program that is transferring, and so that went very well. And we are in the phase now where we are building validation units and getting those into testing and so they can pass. That is the current update of where we are.

And so it is still a little bit difficult to predict the ramp-up, but we've certainly cleared some variables ahead of schedule, even, in some cases that we needed to clear to even get into position to start to think about ramping revenue and putting a more predictable path to profitability together.

So, I think, at this point, what we can say is that we are ahead of our schedule. The customer audits are going very well. We are building validation units, in some cases that are already in testing. In most cases, these testing cycles take several weeks to complete.

And so the best we can provide for you in terms of our view as far as the future for Romania is that we do expect revenue in our fourth quarter of this fiscal year, and it will be a multi-quarter ramp-up.

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**Hendi Susanto** - *Gabelli & Co. - Analyst*

Got it. And then, Don, would you be able to talk more about your path forward, your 2018 goal of \$1 billion revenue run rate? Which verticals would be the strong drivers toward that goal?

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Yes, sure. We have -- we revisit this goal of \$1 billion by 2018 fiscal year each and every quarter as a management team. Even though we have faced a few headwinds here over the last few quarters, and our revenue has been relatively flat when you look at it in terms of today's exchange rates, even with all of that factored in, we still are maintaining and believe it is achievable for us to be \$1 billion in annual revenue in fiscal year 2018.

Obviously, when we put that goal together, we are looking at a compound annual growth rate of somewhere around 8% to achieve that. We are going to have to grow at something greater than 8% between now and then to make up for the past few quarters, where we have been relatively flat. But we still believe the fiscal year 2018 of \$1 billion is achievable, with the base or book of business we have today and then adding in the new product introductions that we have out ahead of us that we are working on.

You know, clearly, if you look over the last several quarters, automotive, the automotive vertical has led the way for us. It will continue to lead the way. Our bookings there have been strong. Our new business awards have been strong. And so we fully expect those programs to ramp up out ahead of us and contribute to our growth.

But I would also say we are excited about some of the new business that we have won in our industrial and medical verticals specifically. We have been awarded new business in new product categories, for example smart metering in Europe. We are getting involved in some different commercial LED lighting programs. We continue to work a lot of the green-and-clean kinds of technology opportunities. So we are really excited about what kind of contribution we will get from the industrial vertical.

In the medical vertical, we have had a number of new business wins there as well. It takes a while for those to ramp up, but they are in exciting new areas in terms of drug delivery, drug management, patient data collection, etc. We are excited about those areas as well.

So I think the one area that we are not seeing as much traction as we want to and that we are continuing to work is public safety. But as you know, that is a smaller -- the smallest of our four verticals. So the contributing factor there is less anyway.

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**Hendi Susanto** - *Gabelli & Co. - Analyst*

Got it. And then one last question for Mike. Mike, how should we think of the tax rate going forward? Should we think that the first six-month tax rate of around like 28%, 28.5% is representing a future tax rate?

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**Mike Sergesketter** - *Kimball Electronics, Inc. - VP and CFO*

We still believe our effective tax rate will kind of normalize around the mid-20s%, 25%, 26%, somewhere in that range, as we have talked in the past.

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**Hendi Susanto** - *Gabelli & Co. - Analyst*

Okay. Got it. Thank you.

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**Operator**

(Operator Instructions) Andrew Huang, B. Riley.

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**Andrew Huang** - *B. Riley & Co. - Analyst*

Thanks. I just had a follow-up on the new business awards. Can you talk about -- I think, in your press release, you talked about launches later this fiscal year. Would we expect to see some revenue from these new awards in the March quarter?

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Certainly, the variable there is just the ramp-up and getting through the various approvals with our customers, in some cases with our customers' customer, and the end market demand. But towards the end of this quarter, certainly as we stated previously, we expect revenue in our fiscal fourth quarter from some of these NPIs. That is about as close as I can get you, Andrew, in terms of what we are seeing right now, but we expect some contribution this fiscal year.

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**Andrew Huang** - *B. Riley & Co. - Analyst*

Okay.

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

And then, of course, ramping, ramping into fiscal year 2017.

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**Andrew Huang** - *B. Riley & Co. - Analyst*

Right, right. If you look at -- like let's say you have a list of the new business awards in front of you. Can you give us a sense of the range of the annual revenue opportunities associated -- I mean, just kind of high/low/average?

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Yes. I think some of the larger programs that we are awarded are in our automotive vertical. And I can just make a few comments there. The lifecycle of the projects over the last several years has been extending. And so where you would typically see a program award be for four years of serial production, in many cases now we are seeing those awards at five years, and in some cases as long as seven years of serial production.

And so in terms of the total award, it is bigger. It could be in the hundreds of millions, but it is over a seven-year period. So on an annual basis, maybe it would bring it down to something in that \$15 million to \$20 million, \$20 million to \$50 million range on the largest programs. And automotive would be the largest program that we would be awarded.

And you know, when you get down into some of our other verticals like public safety, it is not uncommon for us to receive an award that is valued at \$1 million a year in a high-mix, low-volume kind of project. So that gives you the full range. I would say that many of them end up being that \$10 million to \$15 million to \$20 million range.

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**Andrew Huang** - *B. Riley & Co. - Analyst*

Great. Thanks very much.

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**Operator**

[John Racotto, Flaret] Asset Management.



**John Racotto** - *Flauret Asset Management - Analyst*

I got late in the call, so I apologize if my questions have already been addressed earlier in the call. Yes, I was wondering if you can give some more color about the industrial segment. That side of your business has been a big driver of your growth in the last two, three years, and then it swung in the other side for the last two or three quarters. So any comment around that would be helpful.

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Okay, John. Welcome to the call. Maybe just a few comments. You are absolutely correct. We were disappointed again by this quarter's results in our sales in our industrial end-market vertical. It has clearly been the vertical that has been hardest hit in terms of overall end-market demand in terms of softening. Our base of business there is global, so we can say at least we have seen the softening really around the globe. It has not been one region of the world necessarily.

The other thing I could say is that we haven't lost any business in there. So basically what you are seeing there is the performance of the end market. And we have actually launched some new product introductions already in that space, which really kind of adds to the disappointment.

I think when we look at the customers that we have in that end market vertical and we look at the applications they have and we also look at some of their historical numbers in the end markets they are in, we are looking forward to see this end-market vertical return back to some of the growth figures that we were reporting previously. But certainly the last, as you pointed out, the last four or five quarters have not been the kind of growth quarters that we have seen in the past.

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**John Racotto** - *Flauret Asset Management - Analyst*

Okay, thank you. Yes, I also wanted to touch on your margins. Year over year, your margins lost about [a quantitative beat]. So I was wondering if you can quantify for me the effect of the ramp-up cost in Romania. Was it half of the margin loss? Anything around that also would be helpful.

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Yes, so I think Romania would not quite be impactful number there yet, John. More of what we've seen on the margin line, certainly the FX headwinds have been an area for us to work our way through. Given our business, our footprint, and not only the fact that we have seen significant movements really around the dollar strengthening against especially the euro and the RMB, those affect us in a number of areas. Our hedging strategy is able to keep some of that from impacting us right away. But as you know, eventually those hedges run out and you are faced with the reality of the renormalized exchange rates, and we are seeing some of that.

Also, I think the year-ago comparables are pretty tough comparables. In other words, those quarters, especially last year, were really good quarters for us as we had a number of our lines, production lines, running at an optimized volume level. That is somewhat of an impact.

And then the NPIs. As we mentioned, we've got a heavier-than-usual load with new product introductions right now. You see that in our CapEx numbers, which, again, we had a \$37 million CapEx year last year. We are going to spend somewhere slightly higher than that this year in CapEx. That is roughly about twice the level of depreciation. And the vast majority of those expenditures are manufacturing equipment that is directly supporting new business awards.

So you can imagine we not only have that, but we have the people resources and other resources that we are hiring in and deploying to support the ramp-up of those new programs. And so that is also impacting our margins at this time.

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**John Racotto** - *Flauret Asset Management - Analyst*

Okay. Thank you. Maybe a last one for me. Your balance sheet is really strong right now, and valuations have been coming down all over the map. So I was wondering if there are any thoughts around doing some business development or M&A or anything in that direction.

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Yes, you know, we do have a strong balance sheet, and it gives us a lot of flexibility. And we do have an active acquisition incubator that we are looking at on an ongoing basis. And certainly, to the extent that we could find an ideal acquisition that would help us with our long-term strategy around growth and diversification, we certainly would be in the market for that. That is ongoing.

Our announcement of our share repurchase program certainly was a big move on our part to return some of this cash to our shareowners. We really believe we have the flexibility, obviously, to execute that repurchase program and continue to look at acquisitions that could help us with our strategy.

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**John Racotto** - *Flauret Asset Management - Analyst*

Okay. Thank you. That is all for me. Have a good day, guys.

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**Operator**

I do not see any further questions in the queue. I would like to turn the call back to Mr. Charron for any final remarks.

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**Don Charron** - *Kimball Electronics, Inc. - Chairman and CEO*

Thank you, Carmen. And that brings us to the end of today's call. We appreciate your interest and look forward to speaking with you on our next call. Thank you, and have a great day.

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**Operator**

At this time, listeners may simply hang up to disconnect from the call. Thank you, and have a great day.

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