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KE - Q1 2016 Kimball Electronics Inc Earnings Call

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CORPORATE PARTICIPANTS

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Mike Sergesketter *Kimball Electronics - VP, CFO*

CONFERENCE CALL PARTICIPANTS

Andrew Wong *B. Riley - Analyst*

Andy Santos *Gebelian - Analyst*

Donald Charron

PRESENTATION

Operator

Ladies and gentlemen, please stand by. Your Kimball Electronics First Quarter Fiscal 2016 Financial Results Conference Call will be starting shortly. Once again, ladies and gentlemen, thank you for your patience, and please stand by.

Good morning, ladies and gentlemen, my name is Andrew, and I will be your conference call facilitator today. At this time, I would like to welcome everyone to the Kimball Electronics First Quarter Fiscal 2016 Financial Results Conference Call. All lines have been placed on listen-only mode to prevent any background noise.

(Operator Instructions).

Today's call, November 5th, 2015, 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 10K for the year ended June 30th, 2015 and today's release.

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

Don Charron - *Kimball Electronics - Chairman, CEO*

Thank you, Andrew. And, welcome, everyone, to our First Quarter Conference Call. Our earnings release was issued this morning and the results of our first quarter ended September 30, 2015.

We also posted a financial summary presentation to accompany this conference call. The presentation can be found on our Industrial 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.

With the legal separation from Kimball International completed on October 31st, 2014, and the majority of the work required to separate the infrastructure, substantially completed by June 30th, 2015, we were able to take the final steps to achieve full separation this past quarter.

In August, we moved out of the Kimball International world headquarters, located at 1600 Royal Street in Jasper, Indiana to our own new world headquarters, located at 1205 Kimball Boulevard, also here in Jasper, Indiana.



In September, we finished the final preparations and testing of our own network and disconnected ourselves from the Kimball International network, and we have now been running entirely on our own IT systems since October 1st, 2015.

Our teams have done a remarkable job staying focused from the very beginning since the spinoff was announced 21 months ago, all the way through achieving these final milestones. The flawless execution that provided a smooth transition and will now allow us to redirect valuable resources to other important initiatives.

The softness that we felt in the fourth quarter of fiscal year 2015 continued into the first quarter of fiscal year 2016. We were, however, encouraged by the firmer demand that we began to see at the end of the quarter.

It is important to note that when you compare the first quarter of fiscal year 2016 with the first quarter of fiscal year 2015, and factor out the previously announced loss of the JCI business, or hold the currencies constant, sales would have been up 5.2% and 3.7%, respectively.

As we expected, in China, we did see slower year-over-year growth and lower sales, sequentially, as a result of the slowing China automotive market. Our sales in the medical end market vertical were impacted by the transition from a current to next-generation product to one of our largest customers.

We are focused on a successful launch of a number of new business awards for both existing and new customers. Our new business opportunity 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.

This was a challenging quarter for us from an operating income standpoint. In addition to the slowing China automotive market and the ramp up of a significant new product introduction, as previously mentioned, cost related to the Romanian Greenfield startup, and the foreign exchange headwinds also impacted our results.

We remain committed to our 4% operating income goal. We 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 for continuous improvement.

Our global purchasing initiatives drive margin improvement in effective capital utilization. We are making excellent progress in Romania. The construction of the new facility is complete, and we had our ribbon-cutting ceremony on November 3rd, 2015. As of September 30, 2015, we had 31 employees in Romania, and their training and orientation is well under way.

We are entering the next phase of preparing for production readiness. The next three to six months will be critical as we prepare for our quality system certification and customer audits. We will also be completing a number of process validation production builds during this time.

Getting through this phase is required for us to build a more predictable path to revenue ramp-up and profitability. 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 expect to invest slightly more than that in capital investments in fiscal year 2016. With the majority of these capital expenditures directly supporting new business awards.

Our board's recent approval of the \$20 million share repurchase program is a strong vote of confidence in our long-term strategic plan, as well as a meaningful and appropriate way to provide a return to our shareholders at this time.

And, finally, I should mention that our board continues to come together as a strong team, with fresh ideas that's evidenced by our recent appointment of Gregory J. Lampert as our Lead Director. This will provide more efficient and strategic board operation as we move forward into our second year as a standalone public company.

Now, we'll turn over it to Mike to discuss our first quarter results in more detail. We will then open the call to your questions. Mike?



Mike Sergesketter - *Kimball Electronics - VP, CFO*

Thanks, Don. I'll briefly cover our financial highlights for the first quarter, and as Don mentioned, we'll then open the call up to your questions. Our first quarter net sales were \$200.4 million, a decrease of 2% from the prior year first quarter.

The impact on net sales related to the exit of jobs and controls of JCI, compared to the prior year first quarter was \$12.9 million. As Don mentioned, when excluding the JCI related programs, net sales would have been up by 0.2% over the same quarter last year.

In addition, the weakening of the euro and the RMB had an impact on our reported net sales when compared to a year ago. Net sales and constant currencies were up 3.7% compared to the prior year first quarter.

Comparing our net sales by vertical to the same quarter a year ago, our automotive vertical was up 1%, or up 26% when excluding the JCI-related programs, resulting from growth in all markets. Although, as expected, we did experience slower growth in the China market.

Our medical vertical was down 5% on fluctuating demand, and as Don mentioned, impacted by the transition from current to next-generation product for one of our larger customers.

Our industrial vertical was down 8% in Q1 compared to the prior year as a result of lower in-market demand and inventory adjustments for our customers. And our public safety vertical was up 16% compared to a year ago for both increased demand for existing products and new program awards.

Our gross margin in the first quarter was 7.6% which compares to 8.8% in the same quarter last year. The margin difference was partly due to reduced leverage from lower sales and costs associated with new product introduction and foreign currency fluctuations.

Selling and administrative expenses were down \$1.8 million or 90 basis points compared to the prior year first quarter. Incremental cost related to the spinoff in the first quarter a year ago were \$1 million, while spinoff costs in this quarter were, approximately, \$100,000, accounting for about half of the reduction in the selling and administrative costs.

We completed our move during the quarter and are now settled in to our new headquarters building across town in Jasper. The span is now substantially complete, and we do not expect significant further costs related to the spinoff.

Also, contributing to lower S&A costs or reduced cost related to the elimination of the former parent chargeS&Allocations, which more than offset increase public company costs and compensation costs related to additional team members brought on board to support Kimball Electronics as a standalone public company

Other income and expense was in that expense of \$700,000 in the first quarter compared to \$500,000 expense in the prior year first quarter. A \$500,000 loss on the fair value of the investments in our supplemental employee retirement plan, or SERP, was the largest driver of the other expense in the current quarter.

As a reminder, the loss on the investments in the SERP is exactly offset by the normal reevaluations of the SERP liability that is recorded in selling and administration expenses. So the impact from the reevaluation of the SERP is neutral to net income.

Effective tax rate for the first quarter was 28.5%. Net income in the first quarter of fiscal year 2016 was \$4.5 million compared to \$5.4 million in the first quarter of last year. Adjusted net income, excluding spinoff costs, was \$4.6 million compared to net income of \$6.4 million in the first quarter of last year.

Diluted earnings per share was \$0.15 in the first quarter of the fiscal year compared to \$0.18 in the prior year quarter, or \$0.16 cents this quarter compared to \$0.22 cents in Q1 last year when excluding the spinoff cost.

Cash and cash equivalent to September 30th, 2015 were \$52.7 million. Cash flow used by our operations in the current first quarter was a half a million dollars compared to a usage of \$4.5 million in the first quarter last year.

The usage of operating cash during the quarter was primarily due to an increase in inventory and reductions in accounts payable and accrued expenses, including payments for incentive compensation and retirement during the - which are generally heavy in the first quarter.

Capital investments in the first quarter totaled \$11.3 million, largely related to our investment in the Romanian facility and manufacturing equipment to support new product introductions in multiple locations.

We have no long-term debt as of September 30th, 2015 and our short-term liquidity available represented as cash and cash equivalents, plus the unused amount of our credit facilities, totaled a \$112.4 million. Our balance sheet continues to be strong and we're well-positioned for growth.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question comes from a line of Andrew Wong from B. Riley. Your line is open.

Andrew Wong - B. Riley - Analyst

Oh, thank you. Hi, Don and Mike. Thanks for taking my questions.

Don Charron - Kimball Electronics - Chairman, CEO

Hello, Andrew.

Andrew Wong - B. Riley - Analyst

So, first, I was wondering if you could add some color to your comment on the firmer demand towards the end of the quarter?

Donald Charron

Yes, you know, I think just a couple of calls ago, we were talking about how within a quarter, the demand can fluctuate and, in fact, just a few quarters ago, we would get demand dropped in the quarter, unforecasted demand dropped in the quarter, and actually had our sales end up higher coming into the quarter.

Certainly, Q4 was different than that for us, and the start of Q1 was different than that in terms of the softness we were feeling. Towards the end of the quarter, there was a lot of more consistency and the poll rates from our customers, and yes, that's what we were encouraged towards the end of the quarter.

You see that firmness start to develop and let's say, fewer dropouts out of the schedule and poll rates happening on a more consistent basis from our customers.



Andrew Wong - *B. Riley - Analyst*

Does that commentary apply to all year-end markets or maybe some more than others?

Don Charron - *Kimball Electronics - Chairman, CEO*

Well, certainly, some more than others. You know, we talked about the China market for automotive, for example, and, in fact, that we have been keeping a close eye on that with the forecasted lower demand of, you know, for the China automotive market coming from a number of different resources.

So, yes, we obviously keep a close eye there and certainly, the commentary would apply to what we were seeing in the China - from our China automotive customers and their poll rate. But also, we saw in other areas of both the industrial and medical vertical as well, and as you can see, public safety was a pretty good quarter for us in terms of year-over-year growth.

Andrew Wong - *B. Riley - Analyst*

OK. And, with the weaker overall demand environment, are you seeing any customers, kind of, backing off plans to ramp new products?

Don Charron - *Kimball Electronics - Chairman, CEO*

No. No, we really haven't seen any of that. Certainly, as we get to the launch cycle and start to get closer to start a production, I'm sure at that point, as we load up scheduleS&Again, we're following their forecasted demand, we'll get a better view of that.

But, certainly, we haven't seen any behaviors that would suggest backing off of plans, for example, on new product introductions or programs that have been awarded to us.

Andrew Wong - *B. Riley - Analyst*

OK. And then my last question is first, can you remind us what your cutbacks was in fiscal 15. And then, your specific expectations for fiscal 16. I think you said it would be up year-over-year. But, maybe you can share with us why you feel so convicted to add Capex when things like the demand environment's a little bit choppy right now.

Don Charron - *Kimball Electronics - Chairman, CEO*

Yes, well, you're absolutely right. The demand environment's a bit choppy right now. We spent \$37 million in capital expenditures in fiscal year 15 and our outlook for fiscal year 16 is still to be just slightly higher than that in total capital expenditures for this fiscal year, fiscal year 16.

So, yes, and as I mentioned in my comments, the majority of that Capex is directly supporting new program awards. And, so, as Mike mentioned, we obviously have our capacity expansion. The Romanian piece is a part of that. But the equipment that we're purchasing is in direct support of new program. The majority of that is in direct support of new program wins.

So, you know, yes, and I understand, it could seem a little counterintuitive to be investing given the current environment. But I would just remind you, many of these program awards have come to us, in some cases, more than a year ago.

And the launch cycle can be anywhere from two to three years. So, yes, it's equipment that we're putting in place to support new business. But we're quite confident that that business is going to launch.



Andrew Wong - *B. Riley - Analyst*

OK. Actually, if you don't mind, just a one follow-up to that Capex question. For fiscal 15, can you give us a rough idea of how much of that spend was on equipment? And then for 16, is the bulk of that going to be for equipment or is there new, kind of like, facility buildout or anything like that?

Don Charron - *Kimball Electronics - Chairman, CEO*

Yes, we don't have those exact details in front of us, Andrew. We'll get them to you later, get a more specific breakout. I think that \$37 million, we had software piece, that was, you know about 3 million bucks and there's a little bit of Romania in there but not a lot in terms of land and, let's say building construction.

So I think if you take the 37 and net it down by the 3 and a little, the rest was pretty much equipment purchases to support new program launches and capacity addition. But we'll get you those exact numbers after the call.

Andrew Wong - *B. Riley - Analyst*

Thanks very much.

Don Charron - *Kimball Electronics - Chairman, CEO*

Thank you, Andrew.

Operator

Thank you. Our next question comes from a line of [Andy Santos] from [Gebelian] Company. Your line is open.

Andy Santos - *Gebelian - Analyst*

Good morning, Don and Mike.

Mike Sergesketter - *Kimball Electronics - VP, CFO*

Morning.

Don Charron - *Kimball Electronics - Chairman, CEO*

Good morning.

Andy Santos - *Gebelian - Analyst*

Oh, yes, Don, would you like to remind us, like, how much automotive exposure you have to China, Europe and North America?



Donald Charron

Yes, Andy, we don't disclose the detail by geography for market competitive reasons, but as I have said in the past, our goal in the automotive vertical was to diversify our business, you know, by application and by geography.

So our -our goal is over time to see our business in Europe, NAFTA and China to be similar in size. And while that's a bit of a moving target and it's not certainly an exact science, that's certainly our end goal and I think we've been pretty operating around that - around that level to pretty well diversify between Europe, NAFTA and China in terms of our levels of business in each region.

Andy Santos - *Gebelian* - Analyst

OK. And then, any new auto application that you are planning to address in fiscal year 16?

Don Charron - *Kimball Electronics* - Chairman, CEO

Well, as we talked about in the past, we've been, really focused on electronic power steering, and that's been a significant area of growth for us. Of course, we've been doing anti-lock brake systems for more than 35 years now. So we have a broad range of, let's say, newer technologies and more mature technologies.

We did mention also that we were very happy to start business with a new customer, providing assemblies to them that go into the infotainment application of the vehicle. These would be electronics that would go on the center stack of the automobile and really the electronics behind the navigation, the entertainment and connectivity features of the vehicle, that's an area that's quite interesting to us as well.

But I think, for the most part, we also see longer range, a lot of opportunity, you know, in the hybrid and electric vehicle areas. And some of that work is already starting and, in some cases, we're getting some early opportunities to participate but that's certainly an area that we hope to grow in in the future.

Andy Santos - *Gebelian* - Analyst

OK. Got it, that's very helpful. And, Don, in terms of the public safety strength that you are saying in Q3, would you be able to share where do you see strengths in (inaudible) products or end markets?

Don Charron - *Kimball Electronics* - Chairman, CEO

You know, we don't - we don't get in too much detail on those - on those submarket verticals underneath public safety. I would say, though, overall public safe - first off all, the percentage has moved a little quicker because it's our smallest vertical. So, you can see the percentage of growth is quite large. The actual sales growth is not as large in terms of dollars.

But - and, some variation there too, Andy, I would just want to remind you that the way that - the way the public safety customers' orders flow is probably the choppiest we have at all of our verticals, say, for a couple areas within industrial.

You know, I think overall, we are pleased with where the orders came in and the shipments that we had for the quarter. But there's nothing further, really, significant to share there in that vertical.

Andy Santos - *Gebelian - Analyst*

OK. And, then, Don, a couple of companies who have reported claim that they are seeing some micro pressure and the negative effects pressure as well. I'm wondering, like, how much, if you can see that in Q3?

Don Charron - *Kimball Electronics - Chairman, CEO*

Yes, so, as we mentioned in our comments, we certainly felt the effects of the foreign exchange rate differences. As Mike mentioned in his commentary, we don't have exact figures to share with you. It's pretty complicated in terms of getting all the pieces together around foreign exchange and its impact on our business.

I would just want to remind you that we have a very active strategy in this area. You know, first and foremost, doing everything we can to get natural hedges in place, whereas, we're buying raw material in the same currency that we're selling in. That certainly helps neutralize some of that impact.

And then, certainly, as we go forward, we'll continue to utilize our hedging strategy to neutralize the short-term impact. But, even with those activities in place, as a global company and with multiple currencies in place.

And as a global company that has sales distributed in a way that we have a significant base in Europe and a significant base in China, for example, we will continue to watch very closely and improve where we can our strategies, to neutralize the impact of effects in our business. But, clearly, there was an impact in this past quarter.

Andy Santos - *Gebelian - Analyst*

OK. And then, one question for Mike. The incremental costs associated with the startup of the new Romanian facility, should we expect that to continue, and what will be the magnitude?

Mike Sergesketter - *Kimball Electronics - VP, CFO*

Well, certainly, we expect that to continue for another quarter or two. We just cut the ribbon on the facility last week - this week actually - this week. And, so, there's a lot of work to - in front of us to bring that plant online and bring the revenue up.

So, we would expect a couple more quarters of impact. You know, we haven't - we haven't given guidance in terms of what that number might be, but it's certainly out in front of us.

Andy Santos - *Gebelian - Analyst*

Thank you.

Donald Charron

Thanks, Andy.

Operator

Thank you. Looks like we have a follow-up question from Andrew Wong from B. Riley. Your line is open, sir.



Andrew Wong - *B. Riley - Analyst*

Oh, thanks. So just a follow-up to that last question. If you expect to see, kind of, those costs continuing for another quarter or two, is the implication that there's going to be continued pressure on the gross margin?

Don Charron - *Kimball Electronics - Chairman, CEO*

Yes. The short answer, Andrew, is yes. You know, we're, you know, we're really pleased with where we are. And this next phase is going to be critical for us. But, the very nature of bringing new capacity online like this is, you know, we start to ramp up the expenses. And the first part of that you're seeing here in Q1.

We're going to continue to ramp up as we get closer to full approval to start production. So, as I mentioned in my comments, these next three to six months is really critical for us because, we'll be - in the next phase, production readiness, we'll be investing in advance of those qualificationS&Approvals.

And, so expenses will be ramping and it'll be ahead of the revenue. So, as we get through this next three to six months, we will start to get those approvals behind us and have a better idea of how the sales will ramp ahead of us.

But, right now, we're just staying very focused next three to six months on getting through the - this phase of production readiness where, you know, we're seeking customer approvals with our validation builds, we're getting audited by third-party organizations for example, for certification of our quality system and all of that, you know, it takes resource to put in place, which drives expenses, as a I said, ahead of those - ahead of those sales.

Andrew Wong - *B. Riley - Analyst*

Just as a follow-up to that, if you're, kind of, seeing these kinds - these costs, kind of, increase due to these, to the ramp of Romania and new productions, I believe, you said that your Capex for 2016 is going to be up again, year-over-year, because there's more new programs coming.

So, if I'm playing Devil's advocate, does that mean that gross margins are going to go down for a year because you're going to continue your new programs?

Don Charron - *Kimball Electronics - Chairman, CEO*

Well, I - at this point, we have a number of products - new products are going into production this year that will start revenue. So, certainly, I would expect as we start to achieve revenue and those new products come out during this fiscal year, that they will contribute, obviously, to the gross margin then.

And so, there's, certainly - if you look at - if you look historically at our business, and compare it to fiscal year 15 and fiscal year 16, clearly these are two back-to-back years where our Capex is approximating twice that as depreciation.

So, there's certainly and inflection point here with the new business wins that we've had. And, obviously, our long - our medium-range goal of a billion dollars, we -- all of that ties together in terms of this picture we're seeing right now.

In terms of the ramp schedules and how the ramps occur, certainly the macro economic environment would affect that some, but we also have a level of confidence that those programs are going to ramp on time and approximate what we think we want when we're awarded the business. And so, that's the confidence we have in making those capital expenditures.



Andrew Wong - *B. Riley - Analyst*

OK. I think on the SGNA front, you actually did a pretty good job. You were able to cut your SGNA pretty significantly even though your revenue came down quarter-over-quarter. So, on a go-forward basis, can you give us an idea - should we keep that, kind of, flat in dollars or decreasing as a percentage of sales, any (inaudible) would be helpful?

Don Charron - *Kimball Electronics - Chairman, CEO*

Yes, so as I mentioned, we - in the press release - we're taking the appropriate actions that we think are necessary in this environment where sales are a little bit softer than what we've seen. But, at the same time, we're also wanting to stay in close alignment with our long-term strategic plan.

So, certainly, we are looking for ways that we can tighten our spending, but, at the same time, Andrew, we don't want to sacrifice anything we have sitting in our long-range strategic plan because we - we're quite confident.

And, so, we're taking the appropriate actions, and that, you know, I think from our perspective, you know, our spend rate on the SNA or the SGNA side of things is one area that we would like to maintain tight controls on going forward.

Mike Sergesketter - *Kimball Electronics - VP, CFO*

Yes. I think the other good news there, Andrew, is the spin is behind us. You know, all the work into getting the infrastructure prepared and getting the company separated is behind us now. So, you know, we can start to see, I think, a little more normalization in this area.

Andrew Wong - *B. Riley - Analyst*

When you say spend on infrastructure, that's like your IT systems and things like that, for example?

Mike Sergesketter - *Kimball Electronics - VP, CFO*

Right. Yes.

Andrew Wong - *B. Riley - Analyst*

OK.

Mike Sergesketter - *Kimball Electronics - VP, CFO*

Yes, exactly.

Andrew Wong - *B. Riley - Analyst*

OK. Thanks very much.

Don Charron - *Kimball Electronics - Chairman, CEO*

Thanks, Andrew.

Mike Sergesketter - *Kimball Electronics - VP, CFO*

Thank you.

Operator

Thank you. Ladies and gentlemen, as a brief reminder, you can cue up with star then one on your keypad. If your question has been answered or if you wish to remove yourself for the queue, you may press the pound key. We will hold for one more moment to see if anyone else wants to queue out.

And that looks like all the questions that we have in the queue at this time. So, I'd like to turn the call back over to management for closing remarks.

Donald Charron

Thank you, Andrew. 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.

Operator

Ladies and gentlemen, thank you again for your participation in today's conference. This now concludes the program and you may all disconnect your telephone lines at this time. Everyone, have a great day.

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