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PRESENTATION

Katharine Amanda McShane - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Good afternoon, everyone. Thank you for joining us for our fireside chat with O'Reilly. This is Kate McShane again, the retail, hardlines and broadlines analyst here at Goldman Sachs. And it's my pleasure today to introduce Tom McFall, Executive Vice President, Chief Financial Officer of O'Reilly Automotive.

For those that don't know, O'Reilly is one of the largest specialty retailers of automotive aftermarket parts, tool supplies, equipment and accessories in the United States, serving both professional service providers and do-it-yourself customers. The company operates over 5,500 stores in the U.S. and 20 stores in Mexico. The company also just reported a very strong second quarter comp, and we'll be going through some of that today.

So Tom, thanks so much for joining us.

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

My pleasure to be here.

Katharine Amanda McShane - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

So I wondered if we could just start out with walking through what your business has looked like from January up until this point in time. If you could maybe walk us through what happened during the height of the pandemic and then walk us through the very remarkable swing in growth -- comp growth that you saw from Q1 and Q2 despite miles driven still being down.

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

Sure. So January and February were softer months than we expected as winter was pretty mild across the U.S. When we look at January and February, they're not ideal times to fix your vehicle. So it's really a need-based. Cold weather is a big driver in our business, and cars will fail in cold weather. We had a relatively mild winter, so January and February were below expectations. As spring started to hit across our markets in March, we saw sales tick up above our expectations for the first 2 weeks.

Then we started to have -- excuse me. We began to see stay-at-home orders across really the West Coast and then the East Coast and then across the country pretty rapidly, both orders and organizations keeping their people at home in the middle of March. So from the middle of March through the first couple of weeks of April, we saw sales down low double digits, which we talked about on our first quarter conference call.

On our first quarter conference call, we also alluded to the fact that in the third week of April, we started to see stimulus payments go out and the additional unemployment, and that had helped our business, but we were uncertain how long that would be a positive tailwind for our business. So that was through the first quarter call.

On the second quarter call, we obviously put up extremely strong comps, and we gave some more details. At third week, we started to see the DIY business pick up as those payments went out and people had time to do repairs. And we also, within our industry, see a pickup in business as people begin to be concerned about their economic outlook. They will work harder at repairing their vehicles.

In addition to miles driven, which is over the long period of time, the driver of our business is people drive their cars, especially cars outside of warranty. That's the driver of our business, but we have ebbs and flows in what we call unperformed or underperformed maintenance, which our industry estimates at \$50 billion at any time.

And to the extent that people start looking at their vehicle and worry about their economic situation on a go-forward basis, they start thinking, well, I'm not going to get a new car or I'm not going to trade-in and get a newer used car anytime soon, so I better maintain the vehicle I have now. And in the past, when we've gone into potential -- into recessionary periods or down economic turns, we've seen that underperformed or unperformed maintenance go down, and that's a boost to our business. So we started to see that in April.

As we talked about, it was much more of an immediate impact on our do-it-yourself business for, what we believe, a couple of reasons. First is the demographics of our professional customers tend to be a higher demographic. They have the ability to go pay someone to do the work, and those tend to be more -- line up better with stay-at-home jobs. Your do-it-yourself customer tends to be a more hands-on job, so a lot of those are necessary businesses, and they were still commuting.

The other thing that happens when economic times look difficult. There is a certain segment of our customer base that when they feel good about their economic situation, they'll pay somebody to do their automotive repairs. When they're a little more concerned, they'll do it themselves. So we see some shift. But we saw an immediate and strong positive reaction starting in the third week of April, which continued throughout the second quarter on the do-it-yourself side of the business.

As stay-at-home orders started to lift in May and June and miles driven returned, we saw the professional side of the business pick up, finished stronger -- much stronger than it started. And for the second quarter, we commented that our professional business was above our beginning of the year expectations. So it was a driver to our strong comp growth, but it was really led by the DIY side of the business. And on our second quarter call, we commented that, that strong business had continued through the call.

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Okay. Thank you for that recap. That's very helpful. I want...

Thomas G. McFall - O'Reilly Automotive, Inc. - CFO & Executive VP

And then -- sorry, I wanted to...

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Oh, sorry, Tom. Yes, go ahead.

Thomas G. McFall - O'Reilly Automotive, Inc. - CFO & Executive VP

And that's a lot more detail on a shorter period of time than historically we've given, but because of the dramatic shifts in business, we felt it was important to let everyone know what's going on in our business. We have never seen that dramatic of a shift in our business. Sometimes during the winter, if it gets super cold, you'll see business pick up quite a bit, but in the springtime, our business is relatively consistent. So we provided that color, as did our major competitors, just because of the dramatic changes in the environment.

QUESTIONS AND ANSWERS

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Thank you. And yes, they certainly are dramatic changes. One thing that we did notice during the height of the pandemic is there were quite a few garages that were closed or just the business was low because people weren't leaving their homes, as you indicated in your comments.

I wondered if you could comment at all about the health of the garages, the more do-it-for-me customer. Are you hearing or seeing any kind of disruption there at all because of the disruption that happened during March and April and into May?

Thomas G. McFall - O'Reilly Automotive, Inc. - CFO & Executive VP

We feel good about our professional customers. The shock and the real dramatic downturn -- downturn wasn't long enough that most of our shops couldn't sustain it. Obviously, if you look at the restaurant business, much bigger impact, much longer impact. So we have not seen a significant population of our shops not turnaround and do well as the business picked back up.

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Okay. Thank you. One question that we're getting a lot, and it's kind of in the same vein of how do we lap some of the strength that we've seen for categories like food, for instance. In auto part retail, the question we get a lot is how do you view headwinds from more what seems to be maybe permanent work-from-home arrangements versus tailwinds from lesser reliance on mass transit. And then for travel, more perhaps car travel versus plane travel. Does that all add up to an inflection in miles driven anytime soon?

Thomas G. McFall - O'Reilly Automotive, Inc. - CFO & Executive VP

Well, when you look at the trend of miles driven that have come back, it's coming back relatively strong despite the issues that still remain out there. And I think you've hit on great points. More people, at the end of this, will work from home. How many more people will move out of the cities and be in the suburbs as businesses work to mitigate the risk of having concentration of employees is yet to be determined. How many people decide that they're going to want to be in control of their own [travel leisure] is another great point. And I think the leading indicator for us is always what happens with the new car sales.

Now when we look at miles driven, it's a great statistic for our industry, but really, the ideal statistic would be miles driven on cars outside of warranty. So with new car sales being down, you know that more of the miles are being driven on cars outside of warranty. But ideally, what we'd like to see is continued increase in the number of vehicles that are out there.

Just from an industry perspective, we continue to see vehicles age and the population age as vehicles are engineered and manufactured to stay on the road longer. I think what our hope is, is that people will want to control their own transportation more and we'll see a solid SAAR, and we'll have a growing vehicle population as people drive more, but that's yet to be determined.

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Okay. Thank you. I wondered if we could switch gears and talk about the competitive landscape a little bit. It's still a very highly fragmented industry. And -- but it does seem like your -- the comps that you reported in the second quarter outpaced some of your main competitors. So how much of your second quarter strength would you attribute to market share gains? And why do you think perhaps you're maybe gaining more share now than you did in the past?

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

That's a great question that we'll determine over time. But to discuss some of the details on that, when business is good, market shift -- market share doesn't tend to shift around a lot. When business is difficult is an opportunity to acquire new customers and keep those customers.

So within our industry, the #1 determinant of your ability to make the customer happy is to have the part that they want and have the people in the store that can provide the service that keeps that customer coming back. So hard to determine how much market shift has occurred right now because there's geographic differences, there's mix of sales differences. Obviously, NAPA does a lot more government and fleet than anyone else. But our focus has always been on taking care of customers.

And in this environment, we've worked extremely hard to make sure that we are -- have the product. We have the product at the stores, which has been a challenge as we've had suppliers that have had challenges. We've had a dramatic increase in how many parts we need to distribute with sales and demand going up and making sure our DCs are staffed. And at the same time, making sure that our stores are appropriately staffed, which we've gone from a situation where it looked like the business was going to be down low double digits and making staffing adjustments to see the business boomerang back and be up double digits. So making sure that our DC -- we have the inventory. Our DCs are staffed. Our stores are there to take care of customers. That's our opportunity to permanently grow market share by having customers come in that might have been a competitor's customer, competitor didn't have the product or didn't have the store open or didn't have the staffing to take care of that customer and they come into our store, and to win that customer for life. So what the permanent market share changes are will take some time to sort out.

Our average DIY customer shops 3 to 4 times a year, so determining if you've won a lot of those customers or if you've just been fortunate from a geographic standpoint takes some time to determine. But we feel like we've worked extremely hard to make sure that we're there to support people's automotive needs, have had very limited store closures, have maintained very good in-stock rates and have taken care of a lot of customers.

Katharine Amanda McShane - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Okay. Thank you. Stepping back a little bit when it comes to price, before the pandemic, it did seem like because of the tariff situation that the industry was benefiting a little bit from inflation, somewhere in the 2% to 3% range. And as we looked out to 2020, that was something that, on the comp side, you are going to lap. Can you talk at all about what pricing action has looked like since the beginning of the year and then during the pandemic, and what you might expect for the second half of 2020?

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

Pricing has been very consistent throughout the year as we talked about on our fourth quarter call when we provided guidance. Because the tariffs were staggered on different lines, we expected to continue to see positive tailwinds primarily in the first half of the year as we fully anniversaried all the tariff increases that drove sale prices going up and less in the back half of the year. Saying that prices have been consistent through the beginning of the year, it's just a comparative issue. And we haven't seen dramatic changes in pricing or tariffs during the year, which is consistent with our expectation.

Katharine Amanda McShane - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Okay. Thank you. Your gross margin has expanded pretty consistently over the last several years. I do think part of that has been as a result of vendor negotiations. Can you talk a little bit about that? And how much more room is there to go with this particular driver of gross margins?

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

So really over the last 12 years, our gross margins have expanded significantly since we bought CSK Auto in 2008, and a lot of that had to do with just volume. When we bought CSK, we are substantially below AutoZone from a purchase volume standpoint. We were quite a bit smaller than

they were. And a lot of that volume -- it's good when you're chasing #1 because you know there's room to catch up, and there was quite a bit of room if we go back to 2008. So that's been a big driver for us.

The other part has been sourcing and finding the appropriate cost structure with our suppliers to produce parts in the right areas of the world to be the most economical. And the third piece has been use of private label. And for us, it's really more house brands and brands that we've acquired that already have a cache in the market and using that as a way to improve our gross margin. When we -- so that's ramped us up to be pretty consistent with other players in the market, given differences in business mix.

We are continually looking for opportunities to improve our gross margin percentage. But ultimately, as a retailer, what we would tell you is the important thing for us is to be able to increase our comp gross margin dollars. And typically, in retail environment, you see that through same SKU inflation. But for the past decade plus, as our industry has worked to reduce acquisition costs, no one was jumping up and down to raise prices and -- on the same SKUs. We are all driving comp gross margin dollars by reducing acquisition cost per unit.

We've gotten quite a ways down that road. And if we look over the next -- the past 1.5 years, we've driven more comp gross margin dollar growth by raising prices. The impetus for that was the tariffs and other inflationary costs and also that's typically what happens in a retail environment where acquisition costs are going up. And when we look forward, those are both levers for us is the opportunity to have some inflation in our selling price and continuing to marginally increase and optimize our acquisition costs. Obviously, we are not going to see the same level of percentage growth that we've seen over the last 12 years during the next 12 years, but the focus for us is how do we continue to increase comp gross margin dollars to support our SG&A and maintain or grow our operating profit percentage.

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Thank you. I wanted to move on to talk about your supply chain network. You've had a big project underway that entails opening new distribution centers and modernizing the fleet. Wondered if you could talk about what is the optimal number of DCs for you? And where do you stand with using your stores as distribution?

Thomas G. McFall - O'Reilly Automotive, Inc. - CFO & Executive VP

So what our optimal distribution number is, is a moving target. And it really depends on the volume of stores and the number of stores that we have. 15 years ago, we thought, gosh, there's not a lot more room to grow in Texas. We've got a DC in Houston and a DC in Dallas. We're set. And now we've got one in San Antonio and one in Lubbock also because the market continued to grow. We continued to further penetrate the market. So that's a difficult question to answer.

It's more than we have now. And part of it has to do with some of the modernization we've done where we have DCs that we acquired through acquisition. As an example, in Tennessee, we have 2 that we're consolidating to 1 now. And that's really from the Mid-State acquisition, which happened quite a bit of time ago, but it takes a while to reposition distribution centers.

I'm uncertain exactly on your question of using stores as distribution centers.

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Just with regards to super hubs and hubs, is that fully built out? Or is it kind of the same answer when it comes to the hubs as the DC?

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

Got you. We always are reevaluating our hub and super hub network to make sure that we can provide the highest level of service versus our competitors within a market. We have a number of -- you can't have a distribution center in every sizable market. So we're -- continue to add hub stores and really more a focus on super hubs, and that's a work in progress, but you'll see more of them.

Katharine Amanda McShane - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

And in terms of your store growth, can you remind us here -- at around 5,500 stores today, can you remind us what are -- what your target is ultimately? Is there a particular region where there needs to be a little bit more of a build-out? And how should we see the pace of store openings develop over the next couple of years?

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

Mark, what's our current estimate that we've communicated on maximum?

Mark Merz - *O'Reilly Automotive, Inc. - VP of IR, Reporting & Planning*

Sure.

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

What do we -- build-out store numbers?

Mark Merz - *O'Reilly Automotive, Inc. - VP of IR, Reporting & Planning*

Here in the U.S., we think we could have something in the neighborhood of 6,500 stores, coast to coast, north to south.

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

And then on the question of how many stores, we pared back the number of stores for this year. And it's really a construction issue from a -- really less of a construction issue and more of a permitting issue. And we'll see how much that carries into next year, but we are going to continue to be in the 150 to 200 store range.

From our perspective, the most important thing for store growth is finding stores, and building stores and stocking stores isn't the limiting factor. The limiting factor is we're going to go into all competitive markets where our major competitors are. And to win on the street, you've got to have the team to execute. They got to have the inventory. They got to have the team. And it's a very technical business, so making sure that we have the management teams in place to grow the stores and open successfully and put the O'Reilly customer service into action is the thing that limits how many stores we open.

Katharine Amanda McShane - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Okay. Thank you. And when it comes to investments in all those initiatives in order to be able to execute, is there much investment needed in improving your parts availability?

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

Since parts availability is the #1 determinant of being able to provide the customer with what they want, it's a never-ending arms race, right? As our competitors work to enhance their ability to get -- to have the availability or get hard-to-find parts in the customers' hands faster, we continue to push hard to keep our advantage by making other changes, modernize building distribution centers, adding hub stores.

We talked about this year, we had an initiative where, for the first time in a long, long time, our expectation was we were going to grow per store inventory higher than our comps in response to our competitors pushing out more parts to the market. That plan has been somewhat deferred, and we won't add more inventory than our sales growth because our sales growth has been so high, but we will work extremely hard and spare very little expense to make sure that we maintain our parts availability advantage.

Katharine Amanda McShane - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Okay. Great. Thank you. My last question is just on the role of e-commerce. I know O'Reilly has always talked about how e-commerce is more a complement to your stores, and that's just a lot of research is being done online. But I wondered just, again, in the context of the pandemic and people looking for more contactless transactions if you could maybe discuss the role of e-commerce during the pandemic and what you would expect e-commerce growth to be as we emerge from this.

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

Yes. We don't like to refer to it as e-commerce as much as omni-channel. We want to meet our customers where they want to interact with us, how they want to interact and make sure that we're taking care of their requests and providing the value in a way that is important to them.

That said, one of the things -- we worked very hard at what our online presence is, what functionality we have. Again, availability and immediacy of need are the key things that drive our business. And I think to highlight that, and we talked about it on the last call, is we had buy online, pick up in store. We changed it to Buy Online, Pick Up In-Store or Pick Up at the Curb. And we have seen dramatic increases in that business as consumers want to have more touchless. But it's still that immediacy of need, I need the part now, that drives them to the store.

And that business has grown many times more than ship-to-home, even though ship-to-home carries a discount, because our consumers on the DIY side of the business, they don't have an extra car. They need to get the repair done. They need to be mobile. Even if they're not going to work, they're still going to the store. They're going to the doctors. They're going all the other places in life that they go. They need those parts. And that's going to continue to drive customers into the store for the final transaction. Many more are starting online, researching online, maybe even paying online so they can pick up at store, but we have not seen a dramatic shift in the percentage of our business that's finished at the stores.

On the professional side of the business, it's all store-based. They may order online. They may not order online. But they're looking for that local store to deliver inventory into their shop to satisfy their customer.

Katharine Amanda McShane - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Okay. Thank you. We have a couple of questions from the audience that have come and that I'd like to ask. The first question is, over the last few years, comp growth was very similar to SG&A per store growth. Is this a trend that should continue? And if so, should we see deleveraging in operating margins?

Thomas G. McFall - *O'Reilly Automotive, Inc. - CFO & Executive VP*

So again, we're -- our focus is to drive operating profit dollar growth, that's the driver of our -- value of our business. When we look at this -- so far this year, obviously, we've had tremendous SG&A leverage as we reduced store staff in anticipation of a down market then boomerang to a significant upmarket.

What we're going to settle in at SG&A is yet to be determined. I will tell you that if we go back to the beginning of the Affordable Care Act, when it was launched, we and other retailers decided that, gosh, we should have more part-time people. Since that time, the Affordable Care Act has obviously changed and the requirements have changed, but we have a big push now to become -- to go back to being much more full-time-based.

We are looking for our stores to be staffed by professional parts people. And to become proficient in our business takes a number of years. There's a tremendous amount of vehicles with a tremendous amount of parts with a tremendous amount of things that can go wrong. And our ability to provide that customer service in the stores and help our customers solve their problem, whether it's a DIY-er walking in or a professional shop calling in to make sure we ship them the right parts as fast as possible and the full job, is what drives customer satisfaction in our industry.

So when we look at just raw expenses, I think that store payroll is our biggest variable expense. We're not going to say what it is, but it's our biggest variable expense. And I think we expect -- and what we've seen is more full-time people are more efficient, take care of more customers. Where we settle out at with that initiative is yet to be determined. It won't be where we were in the second quarter. We ran leaner than we would think is sustainable, but we will take a look and see what the efficiency of having more -- or more full-time people is.

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Okay. Thank you. The next question we received was, given the new car inventory crunch, what is the effect on comps over the next year from very high used car prices and higher year-over-year growth in used car sales?

Thomas G. McFall - O'Reilly Automotive, Inc. - CFO & Executive VP

The transactions of what used cars sell for is really ancillary to our business. To the extent that people are taking care of their cars better because they anticipate holding them longer is good for our business. If we go back to '08, '09, '10 when the star was down for an extended period of time, it creates a short-term opportunity as more of the miles are driven on cars outside of warranty, but 5 or 6 years down the road, it creates headwind for our business as those cars roll off of warranty.

As we talked about earlier on the call, I think it's too early to assume that the SAAR is going to be down for a while because of those -- are people's workplaces going to change? Are people going to want to control more of their transportation? So that's why I think watching the SAAR now is a good -- will give us some insight 4 or 5 years from now.

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Okay. Thank you. And the last question, and this is one that we get fairly often and would love to hear your view, is just as you look forward to more electric vehicle sales, how do you think this will impact your business? And how do you position your business to adapt to this transition?

Thomas G. McFall - O'Reilly Automotive, Inc. - CFO & Executive VP

So the number of electric vehicles on the road right now is not significant to the total car population. And for many people and many uses of automotive demand, electric vehicles are not at a place right now where they can satisfy those demands, both from a cost standpoint and from a range standpoint. So right now, we're uncertain that the electric -- if electric vehicles are going to be the end solution what they look like. Right now, much more viable is hybrid, which uses gas and electric, and is much more proven and can satisfy the needs that are out there. And for us, that's great because there's more parts to break, but they continue to also increase the mileage per gallon on an internal combustion engine. So the change would have -- we'd have to see a lot more electric vehicles a lot sooner than the plans that are out there for development and production to see a change that's going to be meaningful for the next 10 or 15 years.

That said, the reason that our business exists on the DIY side of the business is people are fixing their own cars to save money, and we don't see that changing. On the professional side of the business, there are not enough dealer base of any type of vehicle to maintain the vehicles that are

out there. So that's the reason for the aftermarket. And we wouldn't anticipate that dealers would build enough base that it would change the need for the automotive aftermarket on the professional side of the business.

So these changes will take a long time to occur. And ultimately, I think that we haven't determined what the vehicle of 2030 looks like or 2040.

Last item on that is the real catalyst to change from internal combustion engine is the cost per mile to operate, and that continues to be very reasonable.

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

That's great, Tom. I really appreciate all your time today. Thanks for joining us. Thank you, Mark Merz as well from the Investor Relations department for joining us as well.

Mark Merz - O'Reilly Automotive, Inc. - VP of IR, Reporting & Planning

Okay. Thank you very much for hosting us today. We really appreciate it. If anybody has any follow-up questions, please feel free to reach out to me.

Katharine Amanda McShane - Goldman Sachs Group, Inc., Research Division - Equity Analyst

Thank you.

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