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PRESENTATION

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

All right. Great. So and next up, we have O'Reilly at nearly about \$11 billion in revenue. They are our last presenting distributor, but definitely not our least, and definitely, a big part of what this aftermarket conference is about. The company is roughly about 50%, 50% do-it-yourself, do-it-for-me and sells through nearly 6,000 stores across the U.S. and they've entered Mexico, which we'll love to talk about. So 74 million shares at \$450, market cap of \$34 billion, net debt of \$3.2 billion.

Today, we have presenting CFO, Tom McFall; and Mark Merz. Guys, thank you so much for joining us today. We're so happy to have you again this year.

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

Thank for having us in this new format.

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

Yes, absolutely. We appreciate you inviting us.

QUESTIONS AND ANSWERS

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

Terrific. So I think we'll just start with general company question, kind of just discuss your store base and discuss your customer and kind of what's important to that customer.

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

Okay. So we're running over 5,000 stores. Mark could give you the exact number. It changes every day. We have multiple openings a week, and we've aggressively opened over the last 25 years to get to this number, started with 1 part store in Springfield, Missouri.

When you look at our customer base, we implemented and became the first company to really run a dual market strategy in the aftermarket. Historically, companies had either focused on the professional business or on the do-it-yourself business. We [had] about 25 years ago, we opened our first dual market strategy store. Our background was in the professional business, and we added a sales floor to one of our stores here at Springfield, Missouri and started really focusing on both sides of the business.

So when we look at our professional business, they are the installers. They're the folks that are going to fix your cars if you're not going to go to the dealership to get your vehicle fixed. The professional installers started when vehicles became more popular and more popular and the OEs couldn't service all the vehicle fleet. Many of the professionals actually started in the dealerships. Dealership trained and went out on their own to start their own shops. Over time, many of the shops [viewed] -- shops started independent. And over time, they've grown into regional and a few national chains that do installation, running the gamut from basic repairs of tires and brakes to drivability and diagnostic repairs that require a lot of equipment.

So on the other side of the dual market strategy is the do-it-yourself side of the business. So as vehicles became mass-produced and became affordable for the everyday American, thank you, Mr. Ford, vehicles were in the hands of people who demographically couldn't afford to have someone do the repair. The do-it-yourself aftermarket was born, and these are people primarily that are repairing their vehicles out of economic need. And our job is to provide the parts for those folks that -- and the testing equipment, the motor tools and really the expertise to help them do the repair.

When we look at the market in general, the 2 things our customers are looking for are the parts they need to fix their vehicles right now. In the professional side of the business, they're expecting delivery of the parts to finish the job in 30 minutes. And how that works is, they get the car on the hoist or on the rack, as we would call it in the industry, and they get the wheels off and diagnose the problem. The customers told them what they think the problem is, but the mechanic is going to then diagnose it, the technician will diagnose it. They'll come up with a quote and hopefully, the customer will say, yes, let's go ahead and do that repair. And they will order the parts. The faster they can get the parts, the faster the technician can get the car repaired, get it off the hoist, get paid, have a happy customer and start the process again.

So having parts close to the customer on the commercial side of the business is critical, and that's always been the case. As a result, in aggregate, for the automotive aftermarket, we've always had a very robust distribution model with many, many parts locally available, primarily based on the number of vehicles that were manufactured. So every [Italian bird] in the United States has brake pads for a Ford F-150. Now every time a [bird] might not have one for a BMW 750, that's more -- less run, more specialized. On the -- so the backbone has been that driver to get the shops what they need so they can run their business.

On the DIY side, similar issue is I don't have an extra car. I am using this for my daily commuter. Our customers -- in general, we don't sell very many dress up or accessory parts or performance parts. We do, but not a lot. That was a great catalog business, and that was a great online business. Our specialty is in the maintenance and repair parts. Folks need to keep their cars on the road. So I'm a DIYer, I really don't want to get a new set of spark plugs. But when my car starts misfiring, and I've got a plug or a wire out and I've got to fix it, I've got to fix it today. I don't have an extra car. I got to commute to work tomorrow or I've got my kid's soccer game tomorrow, I got to get it fixed. And I want to come in find a OE form, fit and function part at a reasonable price.

Anna Carolina Jolly - G. Research, LLC - Research Analyst

Okay. So that's great detail. One thing you touched on was they need that part.

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

I'm going to see how many times I can sip out of my coffee cup. You like it?

Anna Carolina Jolly - G. Research, LLC - Research Analyst

I'll ask in marketing there.

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

I also noticed the decorations in the background, Tom. I don't know if you would have had that camera focused if not for this past weekend either.

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

It was a surprising victory. For anybody who is on here from Michigan State, Go Green. For anybody from the University of Michigan, I was pretty shocked and was just curious if you were.

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

No dog in the fight. Congratulations.

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

Thanks.

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

I don't know what the fight is about. Okay. So into the do it -- I mean when you talk well the immediacy of that need, what your customer wants, you have a pretty expansive distribution system. Can you just talk about that, the different aspects of it and how it serves that customer and creates a barrier to entry?

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

So as we talked about, the availability of product is the #1 determinant. Can't sell from an empty shelf. People are trying to fix their cars right now. So we've always run a very distribution-intensive model. And we have a very flexible system.

Obviously, you want to have the part in the store to sell right then and there. With the growth of the number of vehicles on the road, with the age as OEs have built better vehicles that stay on the road longer, as the OEs have designed vehicles to be part specific as they attempt to reduce the weight and improve gas mileage inefficiency and with the entry of Asian and European nameplates into the market, there are tremendous amount of vehicles out there, millions of parts.

So we use a proprietary system that looks at the demographics of each individual store. And each individual store has their own set. And they may have 20,000 to 27,000 different parts in the store depending on the store that they're in. But there's millions of parts available. So what do you do when a customer calls and wants to find a part you don't have in the store, you're out of stock of? So the way we distribute is we work on breadth, not depth, of the product and then support it with our robust distribution network. And it's very flexible. Stores could get parts in a number of different ways. They -- there's the average store. The next step up would be different layers of hub stores that may carry 40,000 to 100,000 SKUs. And they'll run daily routes to the surrounding stores 4 to 6x.

Then on top of that is our distribution -- our regional distribution centers. We have 28 currently that stock anywhere from 120,000 to 200,000 SKUs. They will deliver nightly to all the stores they service. And for stores in their metro markets, they will deliver 4 to 8x a day special orders.

When we look at how much service the store has and how many times we touch that store on a daily and weekly basis, we can adjust that. We can open hub stores, sometimes we open them, sometimes we close them, sometimes we consolidate them, sometimes we increase the frequency of routes. We will gear up our distribution to have the best availability in all the markets we serve.

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

Perfect. And I mean, clearly, you guys have done an outstanding job in that. If I look at my estimated 2020 earnings, you've done about a 5-year earnings CAGR of 20%. So very impressive. Can you just talk about financial model there from what you've spoken about already, but down to the bottom line?

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

Sure. So not surprising, gaining market share and retaining market share, growing in new markets and existing markets is about having inventory [brake] distribution locally available and then having the best teams. And we have always focused on a customer service culture from the days that the 13 team members started O'Reilly Auto Parts here in Springfield, and it's our mantra.

We are a very promote-from-within company, very store operations focused. So the majority of our leadership has been in the auto parts industry for decades and many, many of us started pushing brooms and worked our way up through the stores. So that culture of service and mentor leadership and promote from within and taking the best parts person and making them store manager and then replicating their abilities and success and the folks that work for them. And then district manager, region manager, vice president, the same thing. That, that for us has been critical because we run a technical business. It is -- it takes a while. It takes 2, 3 years on the counter to become proficient.

So we want to have people that are mechanically inclined and service-oriented and promote those folks and have them over a larger span where they can mentor and develop people with a similar skill set.

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

Okay. And then I'm just going to ask a question from the audience. Sorry. I have 3, I'll do 2 first.

When you talk about having parts ready at a reasonable price, can you just talk about that price in the industry? And kind of what justifies your 19% margin given the rest of the retail industry, which is probably significantly lower than that?

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

A fine question. So when we look at pricing, we're going to price at good, better, best. Good products meet OE specs, all the way up to the professional grade that installers are going to put on because they pass that price through. And their emphasis is ongoing above and beyond and not having warranty work and have issues come back, so they're willing to pay more. But we obviously have a high gross margin in our industry, high operating profit. But if you look, we also have a tremendous amount of inventory in assets, right, that we need to make return on with super slow churn in our inventory, and it gets back to that.

The most important thing is immediacy of need, having the parts, having them locally and available. As a result, you end up with a lot of brick-and-mortar, end up with a lot of distribution and you end up with an inventory turn that's below 1.5. So when you look at the GMROI in our business, it's not dissimilar from other retailers.

When we talk about what makes our model work, it's investing that capital to be able to provide the value customers are looking for, go out hustling every day to grow market share. It's about using our scale to buy well and stocking the parts that our customers want, whether it's brand names that installers have preferred and do training and our backbone of our professional business or house brands that we have developed that are great -- that really go across the value spectrum, good, better, best. And when we can control our own brands, we can control the price, we control what's in the box, we can use multiple suppliers that, that -- because we're looking at -- if you look at brakes, you're looking at American-made cars, European, Asian, and all the suppliers don't fit that cross section very well. So using different suppliers can be very helpful and helping them reduce their cost to us because they make what they're good at.

And then it gets down to grinding away on expenses. We are a very expense control company. It's always been -- it's actually culture values, which I like as a CFO. So when we talk about reducing expenses, and when we see other people in other industries talk about, they're going to reduce their non-customer-facing expenses, I don't know about Mark, we scratch our head and we say, why do they have them if they're not providing value to start with.

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

I felt that. That's great. I mean, like I said, 5-year earnings CAGR of 20% is pretty impressive. But what else is impressive is a 16.9% comp on top of your 16% comp last quarter. Just very exceptional, especially in lieu of the fact that it looked like miles driven probably averaged down 10% last quarter. Can you kind of talk about the drivers of this growth in response to COVID, categories that did well? And what you think we'll be seeing going forward?

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

Okay. Well, I'll do my best on that. So 16.9% is a big, big number, and it's quite surprising. Obviously, we've talked about it at the end of March and beginning of April when COVID pandemic really started, and people were very unsure what's going on, our sales were down low single -- or low double digits. And we really looked at liquidity and making sure that we have the staffing dialed in for that to weather that storm. And lo and behold, some more was known about COVID. The government sent out stimulus checks, unemployment benefits were bumped up and people were at home with time on their hands, and I think that people took on additional projects. And similar to other DIY businesses, we saw business turn around in a hurry.

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

The color I would add to your comments is in aggregate, miles driven are the long-term driver of our business. The more people drive their cars, the more parts wear, the more maintenance you have to do, it drives demand. But what we would really like to see if we could dissect and [turn it around] statistic would be miles driven on cars outside of warranty. Cars that are inside of warranty, you're still doing regular maintenance, but anything that's failure related or really parts related isn't covered or is -- I'm sorry, it isn't those items that's covered. So if your water pump goes out in 3 years, you're going to go back to the dealer, and they're going to fix it. If your water pump goes out in 7 years, which is the average, then you're going to come to O'Reilly, and we're going to sell you a remanufactured water pump that's got a new bearing in it, and it's going to be -- run like [it has]. So with new car sales being down, we know miles driven on cars outside of warranty aren't down as much.

The other thing we would tell you is that within our industry, and not surprising, is there is a tremendous amount of maintenance that is either underperformed or unperformed. Trying to get your arms around exactly what that number is, but our industry says it's about \$50 billion. So fluctuations in how people look at their vehicles vis-à-vis, am I going to get in a new vehicle next month? Or do I need to fix the one I have now? When we go into recessionary or tough economic times, people say to themselves, gosh, I might keep this car for a while. I better maintain it. Or people who buy a new, a new to them car -- used car, will we do additional work to it. And when you look at the price of used cars, which have skyrocketed, people are holding off and they're valuing their existing car more, which means they're doing more maintenance, less reduced, less underperformed or unperformed maintenance, and that's a big support for our industry.

When we look at categories, I think we've gotten a little bit off here. All the categories did well or we wouldn't have put up such a big comp. Unusual for this tough economic time versus 2008 is discretionary categories, wash, wax, appearance, some dress up, are doing better, which is hot. And when people don't have money and then times are tough, those go down. But in this particular case, they're actually outperforming base categories because people have time in their hands and there's been extra money put into the people's hands from the government. So people are doing those projects.

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

Perfect. And then what about -- is there any structural change you think that may have occurred in how you do business first, but then second, also any structural shift, I guess, on the long-term fundamental growth drivers?

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

Well, our Buy Online, Pick Up In-Store has increased as people have worked to limit their time outside their house, although it's still a very small fraction of our business. I'd say that's -- and we have a lot of cleaning protocols as everyone on these calls does.

What we would tell you is that at 17% comp, the market is not up that much. And one of our competitors will report, and we'll see how they do. One has reported and hasn't done very well. And one has the odd quarter, and they did very well. So there are shifts in market dynamics going on and it's some combination. Mass merchants do a lot of light part sales. And our people not going in and valuing a quicker, easier shopping experience, and has that move. Some people have auto parts competitors. We all have had stress in our supply chains, either from suppliers having COVID issues to us having distribution issues related to COVID, to none of our distribution models. Our distribution models are based on finding individual hard-to-find parts, but the volumes have been so high that you -- we're stressed to inbound and ship enough product.

And then the question is, have we done a better job than someone else? Because at the store, they don't care about all that. They care about, is the part on the shelf and can I sell it to the customer? Because that's the driver of our business. So how have we done keeping up with distribution and managing through this better than others? And the other issue is at the stores, and we kept our stores staffed better than other auto part stores.

So in good times, market shift doesn't happen in aggregate. It's a slow grind. In stress situations where stores aren't open, competitor stores might not be open, might not be staffed, might not have the parts availability at the level they normally would, is an opportunity for those customers to come to O'Reilly, have a wonderful experience and keep those customers for life.

So how much of that -- how much is the tailwinds from underperformed and unperformed maintenance going down, economic stimulus, people having time at home versus market share shifts will be something that is determined over time.

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

Yes. Great. And then also, I think, because you mentioned it in terms of just structural change in how you've done the business, you talked about e-commerce. Another thing you talked about on your call is just you kept your store staff, you kept them open. And even there's more of a transition towards the full-time employees and benefits. Can you talk about maybe SG&A per store or kind of what we should see going forward in more of a maybe stable environment?

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

So third quarter was very volatile. We'll leave it at that. So we went from being concerned that we protected the business and our team members and our shareholders and reduced staff, to having more business than you could [chase] a stick at, which is good with less people.

What I would tell you from a staffing perspective is back when the Affordable Care Act started, we, like everyone else, said, gosh, we should have more part-time people. And as the Affordable Care Act has changed over time, we've looked back at that decision. So gosh, we run a technical business, takes a long time to get cushion on the parts counter, we should go back to more full-time people. And that was an initiative of ours.

Pre-COVID, we were in a very low unemployment environment and finding the right candidates was super difficult. So when it looked like business might be down for an extended period of time, so there was no idea of how long lockouts -- lockdowns would last, and we reduced staff. And primarily part-time people and all performance-based, which left us with more full-time people, which was, in essence, a long-term goal of ours.

But because business went down, we reduced staff and then business went through the roof. The leverage in the second quarter was unsustainable. So what you saw is in the third quarter, kind of wondered if, gosh, in July, when the additional unemployment benefits go away is business is going to go back or down? So we've been very careful in how we've added back staff, making sure that we're hiring right, making sure that we're not getting ahead of ourselves of what might happen to sales, but sales have maintained a very good clip in low double digits in the first 3 weeks of October, which -- gave that color because things have been so volatile.

Typically, we wouldn't comment on 3-week period, but we've seen sustained business. And we're adding SG&A back and primarily store payroll is our biggest variable cost at the appropriate rate to make sure that we're able to capture as much business as we can and provide great customer service, but not building a plan that we're going to do double-digit comps in perpetuity.

Anna Carolina Jolly - G. Research, LLC - Research Analyst

Great. And I'd like to get...

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

I mean we're going to try. We're going to try. Don't get me wrong. But we want to make sure we're being prudent.

Anna Carolina Jolly - G. Research, LLC - Research Analyst

Right. Of course. And I want to get 2 more questions in here. One, just on top of that, as we talked about it, given the categories that you've seen do well, given that you've [doubled] the comps October today (inaudible) -- I mean is there anything that we see that would indicate that there might be pull forward? I know it's a short-term question, but that might affect the next 2 quarters after this.

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

When we talk about pull forward, typically, it's within -- it's between quarters. If spring breaks early, especially across the North, and people are able to get out and do the repairs they've been holding off because it's been cold and snowy, you'll see a shift between the quarters. But most of our repairs are [rebased]. I've driven a certain number of miles, I'm going to change my oil, I'll change my oil filter. Or I run the brake pad friction material down to the steel, I got to replace those brake pads. So that's not a major concern at this issue or at this time because we've gone through the regular selling season. Weather has been what weather is during the summer. And maybe it's bad for a day or 2, and it's rained. And I don't have -- I'm a DIYer, I don't have a garage, fixing the driveway, I put it off for 2, 3 days, but it's not going to be months.

Anna Carolina Jolly - G. Research, LLC - Research Analyst

Great. And then I also want to get to the next question. It seems like you've taken a significant share. This quarter, we've kind of already had these 5 -- thought that maybe 5 more years in the U.S. if you're building stores at the same rate. So can you kind of talk about your expansion into Mexico? Any further expansion you're expecting? And if you feel as if you kind of need that given how big you've gotten in the U.S.?

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

Well, how many parts stores we can have in the U.S. is yet to be determined. We continue to be surprised at how many stores we have in Texas and we keep opening them in Texas. So part of it is based on population demographics and competitive situations. When we look at Mexico, I think we've been pretty clear that we partnered with a great company that we felt like could grow an even a better business in Mexico with our help. And we spent this year working on initiatives, planning for the future, understanding the folks that we're working with down there better and understanding the market. So no big great report on that. We're going to build it the right way. And we -- I'm sure it will be -- we'll focus on the

same things we focus here at the states. Parts availability, which we've improved. The family ran the business exceptionally well, but a family-run business looks at capital differently than a publicly traded company does.

So we've improved parts availability. We feel like we're making good headway. We feel like the customers are valuing the same things: service; parts availability, which means do we have the right distribution, what's our distribution footprint going to look like long-term, and planning those items out.

We talked about expansion -- other expansion. We've publicly stated that we were -- even before we entered Mexico that we were interested in finding the right partners in Mexico and Canada. Primary driver there is the vehicle population is very similar, that -- which helps us with our ability to buy better. So we continue to look for the right partners. As far as having to grow, we want to operate great part stores. And we're not in the business and never been in the business of opening stores to open new stores. We want to run good stores that get good returns.

But ultimately, if you are to take market share, you got to have the locally available parts in this business. So either greenfield growth or acquisition are items that intrigue us, if we can get the deals done either opportunistically the right way or strategically the right way. And we look at crossing the border as strategic and looking for the right partner.

Anna Carolina Jolly - G. Research, LLC - Research Analyst

Great. And lastly, supply has been a discussion throughout the conference. What are you looking...

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

Did you have suppliers on here?

Anna Carolina Jolly - G. Research, LLC - Research Analyst

I sure did.

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

And they said no problem, right?

Anna Carolina Jolly - G. Research, LLC - Research Analyst

They said we're going to meet everything working 7 days a week. But if you could just talk about what you're seeing? I mean, this year -- this quarter, you hit a payable to inventory ratio of 116%. Just talk about kind of restocking your shelves of this crazy demand and what we're seeing there?

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

Well, we started this year with a very un-O'Reilly initiative, which was to grow our per store inventory faster than our comp store sales, which we never set out to do. Although from a competitive standpoint, we're not going to be out of inventory by anyone. And then sales have gone through the roof, and that initiative has kind of gone by the wayside as we work to just take care of every customer we can that's lined up at the counter and then calling on the phone. So we are below the inventory levels that we would like to be even without the -- some of the inventory initiatives that we had to get parts closer to the customer this year. And it's due to most of our suppliers are fine. Some of them had and hiccups, some still are having a little bit of a problem, and we got to source other parts. Some of it is just pushing that level of volume, both from our suppliers, the manufacturing and us pushing it out to the stores.

So our inventory is lower, sales are huge. So turns are higher. So our AP inventory's artificially high. At some point, that will come back down. It will take a while to come down. So we have long terms. That's how we have that percentage.

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

[Brian], did I interrupt you? Is that -- what that?

Unidentified Analyst

No, we're just bumping up on time. We've got word...

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

Sorry. So, Tom, Mark, we're running up against time. I was -- [that's Brian]. Thank you so much for being here. [Mario] is on the phone as well. And he thanks you. Our whole team thanks you for being here every year. Your insights are great. And hopefully, next year, we see you in Las Vegas.

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

Sounds great. Thank you.

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

Thank you very much for having us. I noticed there was some questions that didn't get answered. If anybody has anything, just feel free to reach out, and I'll be happy to answer your questions. So everyone, be safe. Thank you.

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

Thank you, guys.

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