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NUAN - Q3 2017 Nuance Communications Inc Earnings Call

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OVERVIEW:

NUAN reported 3Q17 results. Co. expects 4Q17 non-GAAP revenue of \$442-472m. FY18 organic revenue growth is estimated to be 2-4%.



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CORPORATE PARTICIPANTS

Christine Marchuska

Daniel D. Tempesta *Nuance Communications, Inc. - Executive VP & CFO*

Paul A. Ricci *Nuance Communications, Inc. - Chairman of the Board & CEO*

CONFERENCE CALL PARTICIPANTS

David E. Hynes *Canaccord Genuity Limited, Research Division - Analyst*

J. Parker Lane

Jeffrey Lee Van Rhee *Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst*

Nandan Amladi *Deutsche Bank AG, Research Division - Research Analyst*

Saket Kalia *Barclays PLC, Research Division - Senior Analyst*

Sanjit Kumar Singh *Morgan Stanley, Research Division - VP*

Tavis Christian McCourt *Raymond James & Associates, Inc., Research Division - Research Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Nuance's Third Quarter Fiscal 2017 Conference Call. As a reminder, this conference is being recorded. With us today from Nuance are Chairman and CEO, Paul Ricci; CFO, Dan Tempesta; and Head of Investor Relations, Christine Marchuska.

I'd now like to turn the call over to Ms. Marchuska. Please go ahead.

Christine Marchuska

Thank you. Before we begin, I remind everyone our discussion this afternoon includes predictions, estimates, expectations and other forward-looking statements. These statements are subject to risks and uncertainties that could cause material differences in our actual results. Please refer to our SEC filings for a discussion of these risks.

All references to income statement results are non-GAAP, unless otherwise stated. And as noted in our press release, we issued a set of prepared remarks in advance of this call, which are available on our website. Those remarks are intended to serve in place of extended formal comments, and we will not repeat them here.

I will now turn the call over to Paul.

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

Good afternoon, everyone. I want to take a few minutes to discuss today's results and our expectations for the remainder of the year. Our fiscal 2017 has been a year of strong performance enabled by opportunities in our most attractive markets, focused investments in support of the business and productivity initiatives in our transformation program, which have enhanced our earnings and cash flows.

Our performance has been demonstrated by sustained bookings growth that has exceeded our expectations throughout FY '17 and underscores broad-based momentum in our businesses. Within Healthcare, we've capitalized on the adoption of our Dragon Medical cloud solutions and



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continue to see strong pipeline development. In Enterprise, we've seen strength from our omnichannel cloud offerings in voice biometric solutions. For Imaging, although we faced some challenges, we've seen recently strengthening of our pipeline and bookings. And in Mobile, we returned to organic revenue growth for the first time in almost 2 years due to the strength of our automotive business and expanded geographical footprint of our telecommunications and mobile operator business.

Our third quarter, in particular, was set to be an excellent quarter by nearly all measures prior to the onset of the June 27 global malware incident that disrupted our business operations as well as thousands of other companies globally. As noted, the incident had an effect on our third quarter, primarily in our Healthcare Transcription and Imaging businesses, although the impact was limited since it occurred just 4 days before the end of the quarter. Despite the incident, we delivered solid results in key financial metrics, including bookings, recurring revenues and cash flow from operations. On an as-reported basis, net new bookings were strong, up 21% year-over-year; recurring revenue was at 73%, up 200 basis points from a year ago; and cash flows were robust at \$132 million.

Furthermore, on a pro forma basis, had the incident not occurred, we would have generated organic revenue growth for the second consecutive quarter, a trend we have not seen for several years. Of note, our primary growth business lines: Dragon Medical cloud, omnichannel solutions, automotive and biometrics continue to fuel our performance with key bookings wins. As previously forecasted, Q3 would have marked the milestone in which Dragon Medical cloud growth outpaced the HIM transcription decline. We also note that, absent the incident, gross margins and operating margins would have improved further from a year ago.

Overall, we remain confident in our business fundamentals and the continuation of recent trends. Without the malware incident, Q4 and the fiscal year would have landed well within the previous revenue and EPS guidance ranges we provided. However, the effects of the incident in the fourth quarter will be extensive with an impact of approximately \$65 million to \$75 million in Healthcare and Imaging revenue, bringing our Q4 non-GAAP revenue guidance range to \$442 million and \$472 million.

To help you understand the core performance of the business, absent this impact, we estimate that Q4 revenue on a pro forma basis would have been between \$517 million and \$537 million had the incident not occurred. Our prepared remarks outline the company's revised guidance in detail.

As we exit the fiscal year, the remediation of our systems will be largely behind us. In Healthcare, we have steadily brought hospitals back online and as of today have met our goal of enabling functionality for substantially all our clients for our flagship transcription platform. Furthermore, we have made rapid progress in restoring our systems safely and with enhanced security. As we look ahead to fiscal 2018, we anticipate continued growth from our AI, cloud and virtual assistant offerings, sustained performance in our core domains and additional expansion in international markets.

Similarly, we expect a continuation of trends in our most promising lines of business, including strong growth for Dragon Medical cloud, which will accelerate as we increasingly transition transcription clients, ongoing competitive advantage in automotive led by our cognitive and voice capabilities within Dragon Drive, momentum for our Enterprise omnichannel and virtual assistant solutions, solid demand for our biometrics, one of our fastest growing product lines, and expansion in building volume of our mobile operator services.

Overall, our pipeline remains strong, and we are confident in delivering bookings growth in fiscal 2018. But we expect some remaining effects of the incident in the next fiscal year. We believe the incident will reduce FY '18 revenue by approximately \$65 million to \$75 million, primarily within our HIM transcription business and to a much lesser extent within our Imaging business.

In previous earnings calls, we have provided organic revenue growth guidance for FY '18 of between 2% to 4%. After adjusting for the impact from the incident on revenue and evaluating the other trends in our business, we reaffirm our estimate of organic revenue growth in the range of 2% to 4%. In addition, we previously provided guidance for FY '17 operating margins between 28% and 29% with an additional 50 basis point improvement for fiscal '18. Prior to the incident, we were on track to achieve our FY '17 target.

We expect that the reduced FY '18 HIM revenue will carry with it though a loss of \$25 million in FY '18 operating profit and that we expect some ongoing remediation expenses in FY '18 as well. While we will offset some of these effects through accelerated transformation initiatives, investors



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should preliminarily anticipate operating margins in FY '18 in the range of 27% to 28%. We'll provide more definitive guidance on FY '18 in November as part of our customary annual guidance briefing.

In closing, I'd like to return where I began. Fiscal 2017 has operationally been an excellent year for Nuance, led by growth opportunities and bookings at our most attractive markets, focused investments in the business and productivity initiatives that have enhanced earnings and cash flows. Despite the malware incident, these trends remain intact and will propel us ahead as we move forward into FY '18.

And with that, we're pleased to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Saket Kalia with Barclays.

Saket Kalia - *Barclays PLC, Research Division - Senior Analyst*

First question maybe for you, Dan. Can you just talk about how much of the dollar impact from the malware incidents -- of the malware incident in Q3 and Q4 are from customer credits? And when would those customer credits stop?

Daniel D. Tempesta - *Nuance Communications, Inc. - Executive VP & CFO*

So there is a fair amount of customer credits, although we haven't given that number. The majority of the number is related to the production, but I think you should think of it as maybe 70% of the number from production and credits and then 30% from other items.

Saket Kalia - *Barclays PLC, Research Division - Senior Analyst*

Okay. Got it. And then for my follow-up, again, for you, Dan. So thanks for kind of reiterating the fiscal '18 guide. Just mechanically, should we be adding back the \$90 million in fiscal '17 related to the incident and then growing '18 by that 2% to 4% and then reducing by \$65 million to \$75 million in fiscal '18 to get where you're sort of generally thinking about for revenue for next year? I know there was a little bit of math in there, but does that make sense in terms of the approach?

Daniel D. Tempesta - *Nuance Communications, Inc. - Executive VP & CFO*

I think the best approach would be, we had told you we were going to grow 2% to 4% on our run rate in '17, so I would start there. I would then reduce the balance by -- reduce the ending balance, so the ending plan by the \$70 million and then assume a 2% to 4% growth rate from there.

Operator

And next we will go to the line of Tavis McCourt.



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Tavis Christian McCourt - *Raymond James & Associates, Inc., Research Division - Research Analyst*

A couple more follow-ups on the impact, specifically within HIM transcription. So in the prepared remarks you indicate 2018 you'd expect to be impacted by \$65 million to \$75 million in transcription. So that's above and beyond the typical decline of, call it, \$30 million to \$40 million that you would normally expect in that business, correct?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman of the Board & CEO*

Well, I think what we said is \$65 million to \$75 million in total revenue impact in FY '18, of which the preponderance is in Healthcare but not quite all of it. And I think your question is, is that independent of the erosion factor?

Tavis Christian McCourt - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Correct. And does it -- and is that also taking to account some of that transitioned revenue I assume will end up with Dragon Medical from -- is that a net number?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman of the Board & CEO*

It is true that some of that revenue will transfer to Dragon Medical. We haven't estimated that number. And it is also true that that's an effect above and beyond the erosion.

Tavis Christian McCourt - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Got it. So I guess the -- although I can probably appreciate you want to be a little conservative at this point, you're baking in, in effect, some significant market share losses in transcription.

Paul A. Ricci - *Nuance Communications, Inc. - Chairman of the Board & CEO*

We're baking in the -- some market share losses and some transfer to front-end Dragon cloud solutions as well.

Tavis Christian McCourt - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Got it. And then on the Imaging business, although I guess slightly better if you pro forma it this quarter, kind of third consecutive week quarter. You did mention that perhaps the pipeline looks a little better. Do you expect that to get back to stability either in Q4 or 2018?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman of the Board & CEO*

We did expect -- first, we have seen a strengthening of the pipeline in the third quarter. And we were projecting a strong finish to bookings in the year. I think we'll still have a reasonable finish to bookings in the year for Imaging. It has been affected and the delays in bringing back the operational systems in Imaging have had an impact in Q4. We'll have some impact in Q1, but I do think the business will stabilize in FY '18, yes.

Tavis Christian McCourt - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Got you. And then final question, kind of a big picture thought with -- I guess, not completely behind us, at least the worst part of the impact of the malware behind us. Does it change your opinion on how you run the technology platforms throughout your businesses? Historically, I think



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it's been reasonably decentralized. Will you do more work to centralize technology platforms going forward? And is that kind of baked into the expense guidance, if so?

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

Well, I think what I can say -- I'm not sure about your comment about decentralization. We have some centralized platforms in the company, and we have some divisionalized platforms, and that's a function of the specific technologies. What is -- what is true is that we have implemented additional security measures to prevent this kind of attack in the future.

Operator

And next we'll go to the line of Jeff Van Rhee.

Jeffrey Lee Van Rhee - Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst

So a couple for me. First, I guess, Dan, with respect to margins for '18, just to be clear because there's a lot of adjustments to work through here, the 50 basis point improvement that you have referenced as the target for -- initial target for '18, ex the impact here is reiterated you were on track and nothing has changed outside of the impact of the malware?

Daniel D. Tempesta - Nuance Communications, Inc. - Executive VP & CFO

Well, we were tracking to our previous guidance. The modest 50 basis points that we've been talking about for the year. But in the call remarks and as Paul discussed, as you think about 2018 with the impact of the malware, you should plan the 27% to 28% operating margin. But absent the malware, yes, we were tracking fine.

Jeffrey Lee Van Rhee - Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst

Okay. That's what I'm looking for. And then with respect to the net new, help us understand the seasonality. You certainly put up some good quarters thus far through the year, how do you envision typical seasonality in the year and how might this year's Q4 vary from that?

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

Well, we've been, I think, consistent throughout the year of saying that although we were significantly outperforming our guidance range for bookings, that Q4 would be a difficult year-over-year comparison because of a very large bookings quarter in fiscal '16, and that remains our expectation. Having said that, the fourth quarter is typically a robust bookings quarter because of end-of-year incentives among -- within the sales organization and other factors, and we expect it to be a good quarter. And as you note in our formal comments, we raised somewhat -- we've narrowed the range and raised the midpoint of our guidance in net new bookings from last quarter.

Jeffrey Lee Van Rhee - Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst

Yes. So maybe I could just follow-up on that a little bit. As I look at '15, you had exceptional bookings in Q3 that made some compares difficult, Q4 difficulties in the September '16 year. So rather than year-over-year, I guess what I'm looking for is the sequentials through the year, in particular because of the incentives and other reasons. All else the same, you would typically look for a Q4 that would exceed a Q3?



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Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

Well, on average, over any number of years, that would be true. But I want to remind you of something else that we've always accentuated, and that is we have some very large bookings, 7 and 8 figure bookings that occur in our business. And it's very difficult to know what period they're going to occur in. We enjoyed a couple of really prominent bookings in Q3. And we can't know whether some of the bookings in our pipeline that drove that magnitude will close in Q4. And they would be significantly determined of whether we saw that uplift in seasonality in the fourth quarter. So we -- we've been, I think, consistent with investors that we want them to -- we encourage them to think of bookings on an annual basis and avoid the focusing on the lumpiness of quarter-to-quarter performance.

Jeffrey Lee Van Rhee - Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst

Okay. And I guess, last for me. Understanding the guidance for '18 is limited at this point. You narrowed the net new bookings to 8 to 10 for this year. Would you speak to '18 and things that would potentially be accelerants to that level of net new bookings, things that would potentially be decelerants to the ability to hit that range? Again, without -- I understand you're probably not going to be willing to us give us a narrow range, but give us some crude sense of is that a basic reasonable run rate for bookings growth? Or are there some obvious things that will accelerate it or decelerate it?

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

I really appreciate the question, but I -- we're not in a position today to provide any more specificity on the FY '18 bookings forecast. I will say though, in response to your question, that the -- we had an outstanding year in bookings performance this year. And so as we head into next year, the year-over-year comparisons will be more significant than they were -- more difficult than they were this year.

Operator

Next we'll go to the line of Nandan Amladi.

Nandan Amladi - Deutsche Bank AG, Research Division - Research Analyst

So on this malware attack, can you characterize any potential reputational damage to your business from which you might have lost some customers or any major change on the way competitors are reacting to it?

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

Well, from the first hours of the incident, we've had an extremely proactive program focused on our customers of getting them back online, getting our systems up and running and ensuring that we had the highest level of security protection that we could while we did that. I think we've been very transparent with our customers about the incident which, as you know, affected thousands of companies globally. And we've been very transparent with them about the security measures we have in place and the additional security measures that we're putting in place. I think that we have always enjoyed a great deal of trust from our customers. And I think we've managed to get through this with that trust intact based on our transparency and the steps we've taken.

Nandan Amladi - Deutsche Bank AG, Research Division - Research Analyst

And a quick follow-up on the financial model. Over the last 3 or 4 quarters you talked about maybe still doing a little bit of OpEx improvements, but generally speaking, sort of skewing more towards a shift of revenue growth kind of mindset, more of an investment mindset. Has this malware attack changed any of that thought process?



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Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

No. I don't believe it has. And I appreciate the question. You'll note in our prepared remarks, we referenced the fact that we were balancing margin expansion with the growth. We've been signaling that over the last year. We continue to do that. And we believe the fundamental opportunities in our market, our automotive, voice biometrics, Enterprise omnichannel, our Healthcare clinical documentation business, we believe the fundamental opportunities remain large. We believe we're well positioned to serve them. And we think it's important to continue to manage that balance between margin expansion and growth in order to -- growth investments in order to do that.

Operator

The next question comes from the line of Sanjit Singh.

Sanjit Kumar Singh - Morgan Stanley, Research Division - VP

I have a question on the net new bookings. As we think about the composition of net new bookings, it seems like it's being a little more weighted to Enterprise versus maybe automotive compared to prior years. And so my question is in terms of the conversion of bookings to revenue, when Enterprise accounts for a greater amount of the mix, does that imply a faster conversion to revenue versus a bookings that would be otherwise weighted more towards automotive?

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

Well, first, it is true that the Enterprise business is having an excellent bookings year, but the automotive business is also having an excellent bookings year. And I think that the commentary we provided may have suggested some shift in this quarter, some proportional shift in this quarter towards Enterprise. They did have a really outstanding set of bookings, and particularly in voice biometrics. But I don't think that the composition change this year would materially change our revenue recognition, the aggregate revenue recognition for the company.

Sanjit Kumar Singh - Morgan Stanley, Research Division - VP

Understood. And then in terms of just -- I'm sorry, I missed that.

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

I just said revenue realization, not revenue recognition.

Sanjit Kumar Singh - Morgan Stanley, Research Division - VP

Understood. And then on the Mobile segment, it did seem like there was a big uplift in margins. And I wanted to get an understanding of some of the factors that drove the uplift in margins and how sustainable we should think about that. Is it sort of the level of segment margins in Mobile that we should be continuing to expect going forward?

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

Yes. I think the Mobile business has benefited, first of all, from the expanding revenues, particularly in its automotive business and that has created operating leverage in the model. It's also benefited from productivity and transformation initiatives through the business over the last 18 months, and that's also benefited the margins. What is true for the entire business is true for the Mobile business, and that is that we have to balance margin



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expansion with growth. And in particular, the growth opportunities in the automotive business are key -- are considerable and so we are leaning more towards an investment posture there than margin expansion at the moment.

Sanjit Kumar Singh - *Morgan Stanley, Research Division - VP*

Got it. And one last one if I may and this goes back to the impact on fiscal '18 guidance from the malware incident. When we think about the \$65 million to \$75 million range, if we think about some of the factors that could cause you to underperform that range, what might those factors be? If fiscal year '18 were to play out and we saw a greater than expected impact, what would be some of the sources for that?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman of the Board & CEO*

For fiscal '18?

Sanjit Kumar Singh - *Morgan Stanley, Research Division - VP*

That's right.

Paul A. Ricci - *Nuance Communications, Inc. - Chairman of the Board & CEO*

Well, I think that's unlikely. But if it were to happen, it would be possibly because we suffered market share loss. I think we have a good sense about that at this point. And it might also be because there is a faster transition to alternative solutions and particularly, the Dragon cloud solution which is, of course, the long-term direction of that business.

Operator

Next we'll go to the line of David Hynes.

David E. Hynes - *Canaccord Genuity Limited, Research Division - Analyst*

Paul, just want to get some color on the record biometrics deal in the quarter. I guess I'm curious, was that part of a broader systems upgrade? How long had this deal been in the pipe? Just give us kind of some context of what needs to break right for these big biometrics deals to kind of push across the finish line?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman of the Board & CEO*

Well, the interest around voice biometrics in the financial services industry, in particular, has been quite keen. And we've seen a great deal of success over the last 18 to 24 months in focusing on that vertical as part of the overall solutions -- security solution that the financial services industry is trying to implement. I don't know precisely how long that sale cycle was. It's a complex sale so it was undoubtedly lengthy, but I don't know precisely.

David E. Hynes - *Canaccord Genuity Limited, Research Division - Analyst*

Yes. Okay. And then maybe one for Dan. Obviously, bookings growth has been really strong. On a trailing 12 month basis, I think, like 30%. My worry is that bookings without duration can at times be misleading. So help us think about what this net new growth might approximate to if we considered it on kind of an ACV basis.



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Daniel D. Tempesta - Nuance Communications, Inc. - Executive VP & CFO

We don't -- that's a challenging way to look at it. Because we have so many different business models, we really just don't equate it to that type of a metric. We have said historically that about 30% of the bookings convert within a 12-month period and then another 30% in the second. And it sort of ratchets itself up to around 90% within 5 years. And there's a tail at the end because of some of those long auto bookings. That's still a pretty good model to go by.

David E. Hynes - Canaccord Genuity Limited, Research Division - Analyst

Okay. It makes sense. And then one last quick one just as we think about kind of modeling out the impact of the malware incident. Is it fair to think that any Healthcare impact runs through the services and hosting line and any Imaging impact runs through the product and licensing line?

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

Yes. That's actually a very good way to think about it for the most part.

Operator

And our last question will come from the line of Tom Roderick.

J. Parker Lane

It's actually Parker Lane, in for Tom. You guys highlighted a clinical documentation win with a French-based organization during the quarter that was driven by a partner. I was wondering if you can comment on some of the best opportunities for growth in the International regions in Healthcare. What's your penetration rates look like there today and what do relative growth of International versus domestic for Healthcare?

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

I don't know the answer to the penetration question. I do know that the International business and Healthcare has enjoyed a good year. It's a much smaller business than our North American business, but it's been growing well this year. It's, as you know, not a single market. Our European market, in particular, which is where our growth -- our International business is focused has to be looked at country by country. And the U.K., Germany, in particular, are strong countries for us in that market.

Operator

And at this time, there's no further question in queue.

Paul A. Ricci - Nuance Communications, Inc. - Chairman of the Board & CEO

Okay, then. We thank you all for joining us. And we look forward to speaking with you again in November. Take care.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for your participation and for using AT&T Teleconference. You may now disconnect.



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