

Kimball Electronics, Inc.

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Earnings Call

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Call Participants

EXECUTIVES

Andrew D. Regrut
Vice President of Investor Relations

Jana T. Croom
Chief Financial Officer

Richard D. Phillips
CEO & Director

ANALYSTS

Hendi Susanto
Gabelli Funds, LLC

Jaeson Schmidt
Lake Street Capital Markets, LLC, Research Division

Mac Furst
Singular Research

Anja Soderstrom
Stephan Guillaume
Sidoti & Company, LLC

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Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the Kimball Electronics Third Quarter Fiscal 2023 Earnings Conference Call. My name is Daisy, and I'll be facilitating your call today. [Operator Instructions]

At this time, I would like to turn the call over to your host, Andy Regrut, Vice President of Investor Relations, to begin. So Mr. Regrut, please go ahead.

Andrew D. Regrut
Vice President of Investor Relations

Thank you, and good morning, everyone. Welcome to our third quarter conference call. With me here today is Ric Phillips, our Chief Executive Officer; and Jana Croom, Chief Financial Officer.

We issued a press release yesterday afternoon with our results for the third quarter of fiscal 2023. To accompany today's call, a presentation has been posted to the Investor Relations page on our company website.

Before we get started, I'd like to remind you that we will be making forward-looking statements that involve risk and uncertainty and are subject to our Safe Harbor provisions as stated in our press release and SEC filings, and that actual results can differ materially from the forward-looking statements. All commentary today is focused on adjusted non-GAAP results. Reconciliations of GAAP to non-GAAP amounts are available in our press release.

This morning Ric will start the call with a few opening comments, Jana will review the financial results for the quarter and guidance for fiscal 2023, and Ric will complete our prepared remarks before taking your questions.

I'll now turn the call over to Ric.

Richard D. Phillips
CEO & Director

Thanks, Andy, and good morning, everyone. I am very pleased with my first quarter as CEO of Kimball Electronics and with the opportunity to share strong results for Q3. The last 90 days have been filled with team meetings, customer introductions, facility visits and investor activities. I can assure you after a fast-paced onboarding that I'm even more excited about the future for our company. We've been on a path of unprecedented growth and for the fifth consecutive quarter, revenue reached an all-time record high. Throughout this journey, operating margin has improved as we ramp up new and existing programs and leverage our facility expansions in Thailand and Mexico. We are forecasting a solid finish in the fourth quarter and are updating our outlook for the fiscal year, with sales expected at the high end and adjusted operating margin in the mid to low end of our guidance range.

Net sales in Q3 were $485 million, a 32% increase compared to the same period last year and 11% better than our previous best quarter, which was in Q2. While conditions in the global supply chain continue to improve, the recovery remains gradual with only modest increases in the availability of the component parts that are in short supply and needed for the products we produce. We estimate top line growth was constrained approximately 5% in Q3 by part shortages. Similar to the first 2 quarters of the fiscal year, all 3 vertical markets reported robust double-digit increases, and this quarter, all of them set record highs.

Net sales in the automotive vertical, our largest business, were $216 million. This represents a 34% increase compared to Q3 last year and 45% of total company sales. It is also an 8% sequential step-up from Q2. During the quarter, we have also been updating our strategic plan, which includes a review of our positioning and the growth opportunities within each of the vertical markets we support. The industry megatrends in the automotive vertical identified during this review, continue to present a meaningful tailwind for the company, even if consumer demand softens during a global economic slowdown.

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Electronic content that leverages advanced technologies and expanded operating systems is being added to cars and trucks at an increasing rate and could generate growth for our company at 4x the OEM's vehicle production rate over the planning period. Approximately 70% of our automotive business is in electronic power steering and the balance is in other applications such as innovative next-generation braking system in Reynosa, Mexico, for example.

Within steering, features such as autonomous driving, lane departure and self-parking are increasing in popularity, and the technology to support them resides in an ECU or electronic control unit in the steering column. The architecture to turn the wheels for electric motors, internal combustion engines or a hybrid of the 2 is roughly the same, meaning the applications we support are agnostic to the type of vehicles produced. Because the physical size of the ECU is fixed, adding functionality to it increases the complexity of the manufacturing process and it increases the value to our customers.

In addition, the automotive industry is highly regulated with stringent certifications, validation protocols and change management systems. So this business is sticky and often results in program life cycles that can span 8 to 10 years in length with single source awards. The combination of these insights give us confidence that our positioning within automotive will continue to generate meaningful growth for the company.

Turning now to the medical vertical market. Net sales in the third quarter were $134 million, a 30% increase compared to Q3 last year and 28% of total company sales. This was a record result and the fourth consecutive quarter with growth of 30% or more compared to the same period in the prior year. It was also a 7% step-up versus Q2. Similar to automotive, our strategic plan identified meaningful growth opportunities for medical, fueled by industry mega trends, including an aging population, increasing access and affordability to health care, decreasing medical device sizes with added electronic content, connected drug delivery systems and an overall trend by OEMs to outsource higher level assemblies. We are strategically positioned to support this growth in areas such as respiratory care, surgical systems, patient monitoring equipment, in vitro diagnostics, drug delivery and imaging systems, all with a focus on Class II and Class III devices and higher-level assembly production.

Net sales in the industrial vertical market totaled $127 million, a 29% increase over the third quarter last year, and 26% of total company sales. This was a record, topping our previous quarterly high by 21%. Industrial, which we refer to as "green & clean" supports products that promote energy, efficiency, safety, carbon neutrality and the better consumption of natural resources, including water, gas and electricity. We are well positioned within the value chain for most major brands of residential and commercial heating and cooling systems, smart metering, particularly in Europe, factory automation and a new emerging market for EV charging stations, ones that dramatically reduce the length of time required to recharge electric vehicles through a supercharging process. We see the mega trend in legislation and incentives supporting decarbonization as meaningful growth drivers, and we are strategically positioned to support products that reduce environmental impacts.

So in summary, a very good quarter with record-setting sales in all 3 vertical markets and good momentum as we look to close out fiscal 2023.

I'll now turn the call over to Jana to review the Q3 financials in more detail and outline the outlook for the fiscal year. Jana?

Jana T. Croom
Chief Financial Officer

Thanks, Ric, and good morning, everyone. As Ric highlighted, net sales in the third quarter were $484.7 million, a 32% increase over Q3 last year. Foreign exchange negatively impacted sales by 2% in the quarter. So at historical rates, this record result would have been even stronger. The gross margin rate in Q3 was 8.9%, a 30 basis point decline compared to the third quarter of fiscal 2022, with the decrease primarily driven by underabsorption at our facilities that have recently been expanded and softness in the semi-cap and handset space.

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Adjusted selling and administrative expenses in the third quarter were $17.4 million compared to $14.4 million in Q3 last year, with the increase resulting from added resources to support our top line growth, wage inflation and accounts receivable factoring fees. When measured as a percentage of sales, however, adjusted selling and administrative expenses were 3.6%, a 30 basis point improvement compared to Q3 last year.

Adjusted operating income for the third quarter was $25.6 million or 5.3% of net sales, which compares to last year's adjusted results of $19.6 million or 5.3% of net sales, so a flat OI margin rate year-over-year. On a sequential basis, however, Q3 represents a 120 basis point step-up versus second quarter as we continue to make strides in operational efficiencies at our newly expanded facilities.

Other income and expense was expense of $3.3 million in the third quarter versus expense of $2.1 million in Q3 of fiscal 2022, with the change resulting from higher interest expense this year and outcome from elevated debt levels and the current interest rate environment. The effective tax rate was 25% in the third quarter, which equaled last year's rate.

Net income in the third quarter of fiscal 2023 was $16.4 million or $0.65 per diluted share compared to net income in Q3 last year of $13.6 million or $0.54 per diluted share, representing a 20%-plus increase year-over-year.

Now turning to the balance sheet. Cash and cash equivalents at March 31, 2023, were $30.4 million. Cash flow generated by operating activities was $14 million, our first quarter of positive cash flow in some time. Cash conversion days were 92 days compared to 79 days in the third quarter of last year and 97 days in Q2. Please note that we've started to include customer advances in our CCD calculation. This modification is consistent with our peers and industry norms. Prior periods have been recast for the change.

We're starting to see relief in working capital needed to compensate for parts shortages. Our cash flow and CCD results continue to be adversely impacted, although there was sequential improvement in days versus last quarter. Inventory increases have been a significant driver and ended the quarter at $488.2 million, up $149.8 million from a year ago, but roughly flat compared to last quarter. As anticipated, inventory is leveling off in terms of absolute dollars and the improvement in CCD is an indication that supply chain challenges are easing.

Capital expenditures in the third quarter were $24.7 million, largely in support of completing the facility expansion in Poland, adding equipment in Mexico and capital needed for new product introductions across our entire footprint. Borrowings on our credit facility at March 31 were $289.4 million compared to $137.1 million at March 31, 2022, and $273 million at the end of Q2. Our short-term liquidity available represented as cash and cash equivalents plus the unused amount of our credit facility totaled $128.5 million at March 31, 2023. There were no shares repurchased in the third quarter of fiscal 2023. Since October 2015, under our Board-authorized share repurchase program, a total of $88.8 million has been returned to our shareowners by purchasing 5.8 million shares of our common stock. We have $11.2 million remaining on the repurchase program.

As Ric noted, we are updating our outlook for fiscal 2023, with net sales expected at the high end of our guidance range of USD1.7 billion to USD1.8 billion, which would represent a 30% increase year-over-year.

Adjusted operating income is expected to be at the mid to low point of our guidance range of 4.6% to 5.2% from net sales and capital expenditures are expected to be in the range of USD80 million to USD100 million. The impact to operating income margin is driven by a decrease primarily due to underabsorption at our facilities that have been recently expanded and softness in the semi-cap and handset space. Similar to other companies, we are seeing a temporary slowdown in that space driven by the macroeconomic environment.

Finally, as we look forward to our next earnings release, we will report Q4 results in mid-August, which is a couple of weeks later than our normal practice. This change will reduce the gap between our earnings release and the filing of the 10-K, while keeping the overall reporting time line consistent with industry averages. As per normal, we will issue a press release with the details approximately 2 weeks in advance of the exit.

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So with that, I'll now turn the call back over to Ric.

Richard D. Phillips
CEO & Director

Thanks, Jana. I hope you can sense that we are very pleased with the financial results for Q3 and the outlook for the fiscal year. We are also encouraged by the learnings from the strategic plan. With a heavy focus on growth within EMS, the road to $2 billion in annual revenue is within our sights. Our work validated that we are strategically positioned to reach that milestone with new program wins and increased capacity resulting from the recent facility expansions. We expect to celebrate the completion of the expansion in Poznan, Poland with a ribbon cutting ceremony over the summer and will begin to ramp up additional production in this space in fiscal 2024.

We are also proud of the many other achievements in the quarter, including the publishing of our ESG report for calendar year 2022. This report titled "Poised to make an Impact" highlights how our company remains committed to creating quality of life for our customers, our employees, the communities where we operate and our shareowners. Morningstar Sustainalytics, a leading ESG research ratings and data firm, rated us #1 among electronics manufacturers for ESG risk. I would like to thank our team for the excellent work on this disclosure and the overall report -- support that I have received from the great people at Kimball Electronics while transitioning into my new role.

I look forward to working together with our team to provide excellent service and growth for our customers to enhance our outstanding company culture, to serve our communities and to create short-and long-term value for the company and our shareholders.

Daisy, I would now like to open the lines for questions.

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Question and Answer

Operator

[Operator Instructions] Our first question today is from Jaeson Schmidt from Lake Street Capital.

Jaeson Schmidt
Lake Street Capital Markets, LLC, Research Division

Congrats on some really solid results. Just want to start with sort of your backlog. I know that's remained pretty robust over the past year here. But are you seeing any issues with decommits or cancellations within that number?

Jana T. Croom
Chief Financial Officer

Jason, it's Jana. So our backlog remains fairly robust, and we have not seen material decommits or cancellations. And remember, when the supply chain shortage started, we were seeing 52-week lead times for parts coming through. And that was NCNR, right, the non-cancelable and non-returnable, and so it's unlikely that you see material decommitts. And our forecast, going forward, we continue to monitor that though for the future state of NPIs and so far, so good.

Jaeson Schmidt
Lake Street Capital Markets, LLC, Research Division

Okay. No, that's great to hear. And just kind of sticking with backlog, is the mix within backlog pretty similar to the current revenue mix?

Jana T. Croom
Chief Financial Officer

In terms of the verticals, automotive, medical, industrial?

Jaeson Schmidt
Lake Street Capital Markets, LLC, Research Division

Yes.

Jana T. Croom
Chief Financial Officer

Yes, it's fairly consistent.

Jaeson Schmidt
Lake Street Capital Markets, LLC, Research Division

Okay. And then looking at the medical space, obviously, that space was impacted by [indiscernible] elective surgery, labor shortages, et cetera. But do you think you're back to a more normalized environment within that business?

Jana T. Croom
Chief Financial Officer

I still think there's more opportunity in medical. The last data point I saw there were like 1 million surgical procedures that had still been yet to perform a pent-up demand from the pandemic. But that has been consistent for a while. And so we keep thinking when are people going back to have all these knee replacements, hip replacements, et cetera, are done. And so I'm not sure when that's ultimately going to push through, but the data demonstrates that the demand is certainly there.

Jaeson Schmidt
Lake Street Capital Markets, LLC, Research Division

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And then just the last one for me, and I'll jump back in the queue. You highlighted EV charging stations within that industrial segment. I mean, just curious how you think -- how big of an opportunity you think that can be here in the near term and I guess, longer term as well?

Richard D. Phillips
CEO & Director

Jason, this is Ric. We're quite bullish on that. We've been in a number of discussions with customers. We're talking about some pretty large potential opportunities. It's fairly early stage on some of those conversations as it relates to the supercharging stations. But we think we're well positioned for those, and we anticipate that, that will be a good driver for us in industrial.

Jana T. Croom
Chief Financial Officer

And it's important to [know] Jason, it's in industrial, it's not in automotive.

Operator

Our next question today comes from Anja Soderstrom from Sidoti.

Stephan Guillaume

This is Stephan Guillaume on for Anja Soderstrom. My first question is on what part of semi-cap do you participate in and how much it contributes to revenue and when do you see a comeback?

Jana T. Croom
Chief Financial Officer

So we don't disclose how much it contributes to medical. What I can tell you is it's wrapped in our industrial vertical. It is within the automated test and measurement portion of our industrial vertical. And the softness that we're seeing is -- is in keeping with what so many other companies have said in terms of softness and the consumer commercial handset space. We expect it to come back in a reasonable period of time. But I think the softness is just related to the soft landing of the global recession. And so we're continuing to monitor it very carefully similar to other companies.

Stephan Guillaume

And how is the GES business doing?

Jana T. Croom
Chief Financial Officer

So we tend not to talk specifically about certain pieces of our business. We don't give specifics. But the business is doing well, but we are seeing softening.

Stephan Guillaume

I guess the last one for me is how much of the auto demand is catching up [inventory] versus real demand you think?

Jana T. Croom
Chief Financial Officer

Well, we had a fairly large program come online in Reynosa relative to next-generation breaking. We've also had some fairly significant business related to steering in that next-generation technology. So I -- if what you're asking is if we expect that the demand related to the automotive is going to roll over as we see a push-through of the backlog? I don't anticipate that. The demand in automotive is still very strong.

Richard D. Phillips
CEO & Director

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And Stefan, the other element of that, I completely agree with Jana's comments. The other element is that we are seeing increased electronic content going into the cars. So that's a nice tailwind for us because it's not directly and completely driven by the number of units. We're seeing increases on our side because there's more content going into each unit.

Jana T. Croom
Chief Financial Officer

So if you're trying to get a correlation between us and the OEMs in terms of volume, it's going to be hard to do because it is absolutely not a one to one.

Operator

Our next question today is from Hendi Susanto from Gabelli Funds.

Hendi Susanto
Gabelli Funds, LLC

My first question is about the facility expansion. So Kimball Electronics is expanding facilities in Mexico, Thailand and Poland. Following the completion, how long is -- how long may it take before ramping up towards high utilization rates? That's my first question. And then my follow-up is that can you remind us for each of those facilities, what segments they will address?

Jana T. Croom
Chief Financial Officer

Yes, that's a great question. So -- and I'll give you some additional color. Thailand came online in January of 2022. So it's been up for almost 18 months. Mexico came online in the summer of 2022. So it's not yet anniversaried a year. And Poland, we will cut the ribbon on this summer. All of our facilities produce all 3 of our verticals. And so we don't have a single facility that is a unique vertical in terms of composition. We expect the ramp-up in terms of absorption to take roughly 12 to 15 months for a facility depending on a variety of timing aspects related to new product introductions. But generally 4 to 5 quarters in, we would expect it to be at a rate and OI margin and keeping with the rest of the portfolio. Is that helpful?

Hendi Susanto
Gabelli Funds, LLC

Yes, so I think that also implies that, okay, while you are ramping, there is some like gross margin pressure and then once you have reached, let's say, the high utilization rate margin will be -- we'll see no more margin pressure from the ramp-up, is that fair?

Jana T. Croom
Chief Financial Officer

Correct. And so Mexico now being the flagship of Kimball with the most significant footprint in terms of total capacity and we provide that information in the K. And so it's just getting that facility where it needs to be in terms of operational efficiency and utilization. But again, we're not even 4 quarters in to Mexico. And so we anticipated it would take some time. History tells us that it would take some time, but we are pleased with the progress and where we know that the facility is going to be once it anniversaried that year.

Hendi Susanto
Gabelli Funds, LLC

Okay. Yes. And then, Jana, I also want to ask about pricing and negotiation in light of the current environment inflation. What is the latest snapshot of pricing and the pricing negotiation?

Jana T. Croom
Chief Financial Officer

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Yes. And so one of the things that we're looking at providing to everyone is information on non-manufactured revenue. So what I can tell you is in terms of pricing, we are making great strides with our customers in terms of non-standard material orders, freight costs, et cetera, things specifically related to supply chain and passing those costs on, although I know that you know there is no margin associated with that. Relative to things like wage inflation, operational efficiencies, there is always the expectation from our customers that we find ways to be more efficient and keep that cost in line. And so that really becomes a partnership between us and the customer to drive savings.

Hendi Susanto
Gabelli Funds, LLC

I see. And then Ric mentioned that electronic contents in cars and trucks can provide opportunity for 4x as much as I believe the unit growth, I don't know, I forgot what Ric is referring to exactly. Can you provide more colors in terms of that like 4x, whether that refers to, let's say, like your main products like steering wheels, electronic brakes. And then like what else -- essentially like what else can capture that like 4x unit growth?

Richard D. Phillips
CEO & Director

Sure. So what we're seeing, given the limited size that's possible for the electronic control units that more electronics are being added to that. So this would include things like lane departure, self-parking capability. We have to build into that ECU additional electronic content. And so those items become more sophisticated, more costly and add more value. And so we're -- in the past, some of those technologies would not have been included in the ECU adding them in allows us to increase the value that we're creating and giving to our customers within that same ECU.

Hendi Susanto
Gabelli Funds, LLC

Okay. So Ric, let's say, the electronic control units, let's say, in steering wheels will increase in content at the same time, let's say, it may not like the ASP -- okay, you will see like higher ASP for the 4x content growth, does it include, let's say, like product expansion into adjacencies? And then I think I'm wondering whether e-brake is part of that like 4x estimate?

Richard D. Phillips
CEO & Director

Yes, that would also be included. Again, we're seeing, particularly in EV, I would say, we're seeing the braking systems become absolutely more sophisticated in a similar way.

Hendi Susanto
Gabelli Funds, LLC

Okay. And then any potential --

Jana T. Croom
Chief Financial Officer

So for battery storage, one of the things is how do you take all of the inertia from braking and send that power back to the battery to prolong the life of the battery and the number of miles that you're able to go between charging. And so it's a really, really neat technology that we're seeing evolve. But again, you have the limited space on the car. And so you have to figure out in this limited space, how do we provide the capability and so increase technology, increase engineering and higher quality.

Hendi Susanto
Gabelli Funds, LLC

Yes. And then any insight into the time line or either it may be like early 2024 or like late 2024, any insight into the time line will be appreciated?

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Jana T. Croom
Chief Financial Officer

So we are experiencing that onset of technology now and we expect it to come through in the automotive vertical over the coming years, for sure.

Operator

[Operator Instructions] Our next question is from Mac Furst from Singular Research.

Mac Furst

This is Mac Furst, Singular Research. Congratulations on the quarter. And thank you for your hard work, very much appreciated.

Jana T. Croom
Chief Financial Officer

Our operations team does an amazing job.

Mac Furst

So I have 2 questions. Let me start with question number one. So with the Federal Reserve and the ECB continuing to increase interest rates, which I think is a leading indicator. And regional banks, at least in the United States, continue to fail, which I also think is a leading indicator. How well, in your opinion, is Kimball positioned for a possible recession? Specifically, what changes would you institute in case of a recession?

Jana T. Croom
Chief Financial Officer

Mac, that's a great question. We actually just completed our strategic planning process that we do every year and part of the strategic planning process includes scenario analyses over outcomes that you never expect, but you have to be prepared for as part of risk management and just good financial hygiene. What I can tell you is, we feel really good about our forecast. However, having said that, we have solid protections in place in terms of ample liquidity and room on our balance sheet to make sure that we can service our customers and weather whatever storm may have.

Having said that, I actually think that we just got numbers that came out today, the jobs number is still very strong. And so we aren't anticipating some horrific economic doom and gloom downturn, rates are high, right? And so it was really great to see positive free cash flow coming out of Kimball, an indication of our improvement in CCD, which is going to improve our debt profile. We can continue to monitor it. And certainly, we have plans in place, but we feel confident that whatever may happen would be short-lived and we would be able to get through it just fine with our credit facility that we have in place.

Mac Furst

Question number two. So in quarters past, you spoke about global supply chain disruptions. You spoke about parts shortages. And today, you kind of said that the situation is easing. Can you provide a little bit more color on that, specifically what parts are still in very short supply, if any?

Jana T. Croom
Chief Financial Officer

So we don't talk specific parts. But what I can tell you is last quarter, we said that roughly 10% of sales we weren't able to produce because we were working through the parts shortage. This quarter, it was only 5% and we had an improvement in CCD and our inventory levels did not increase. It was roughly flat quarter-over-quarter. And so you should take that as a strong indication that as we indicated in Q2. And people have asked over the quarters. And if you go back to the transcript, what you'll hear is a consistent message for me, which was we expected that by the end of fiscal 2023, the parts shortage and supply chain challenges would be largely behind us, and we would see improvement in our cash conversion

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and inventory days, as we were working through the backlog. And this quarter bore that out in a really meaningful way.

Richard D. Phillips
CEO & Director

And Mac, maybe to add to that, one of the things that's directly related to your question that we track very closely internally is just on a monthly basis, how does -- what's the difference between the orders that we receive from a demand standpoint and what we ship out. And that's a very important metric for us. And we've seen it over the last 3 or 4 months, steadily improve. And as Jana said, it would -- we're on a trajectory to get back to normal levels over the next few months. So we're really encouraged by that, albeit it's still an issue, it's still a battle our supply chain folks fight every day to make sure that we have the parts that we need, but it is certainly easing.

Operator

[Operator Instructions] We have no further questions, so I'd like to hand back to the management team for any closing remarks.

Andrew D. Regrut
Vice President of Investor Relations

Thanks very much. That concludes our call today. Daisy, if you don't mind, please close the call with replay instructions.

Operator

Of course. Thank you. Thanks, everyone, for joining today's call. If you missed any portion of the call, or would like to listen to it again, a telephone replay will be made available shortly after the call has concluded on the IR page of the company's website. You may now disconnect your lines, and have a lovely day.

Jana T. Croom
Chief Financial Officer

Thank you.

Richard D. Phillips
CEO & Director
Thank you.

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