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PNR - Pentair plc at Electrical Products Group Conference

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Steve Tusa *JP Morgan - Analyst*

PRESENTATION

Julian Mitchell - *Credit Suisse - Analyst*

Okay. We'll get started with our second speaker, Mr. Randy Hogan, Chairman and CEO of Pentair. I guess this is maybe the last time you'll be at EPG.

Randall J. Hogan - *Pentair plc - Chairman and CEO*

I hope so.

Julian Mitchell - *Credit Suisse - Analyst*

It depends. I mean, if you close the spin-off of Electrical like you closed the sale of Valves & Controls, we'll probably see you here in 2018.

Randall J. Hogan - *Pentair plc - Chairman and CEO*

No, that was -- it closed well. It closed well. I have no regrets about that. So when I started -- well, it was maybe 18 years ago; I've been CEO now for 17 years -- and my most admired company then, as is now, is Danaher. And I thought Danaher spun off, then I should probably do that before I leave, too. So that's what I did. So that's a little glib, right? There's a little more to it than that.

But as we're exiting Valves & Controls and taking a look at streamlining the company and revisiting and renewing the strategy for the Water and Electrical businesses, which had opportunities curtailed because of the downturn in Valves & Controls, we really said we have one business that's focused on sustainability, one focused on protection. There wasn't much holding them together, and they're both of a size and a scale that they can be very attractive, successful businesses on their own. They're both large enough, and they both are top of market in terms of profitability. So that's what led us to the decision to announce that we're going to spin off Electrical.

So the structure of the deal is the -- it will be a spin-off of Electrical, which would create 2 public companies, both with



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prodigious cash flows; both with strong balance sheets. The structure, the name Pentair will stay with Water. And the whole structure, basically, that exists as Pentair today will stay with that. We anticipate that the Electrical business will have the same structure, so a Irish-English legal structure and the tax advantages that go with it. We don't think there's any tax leakage of this.

Now what we see is 2 businesses with distinctive growth opportunities to add to their high profitability already. And by focusing, having a laser focus on the specific opportunities and not sharing capital with the other side, which is sub-optimizing one or the other, they'll be able to add the one piece that they both need to add to get premium valuations, which is growth on top of the premium profitability they already have. And as I mentioned, we'll have a strong financial position.

So the -- a little more. I talked about the transaction structure, timing of approval. Next, we said next year, second quarter, and it wasn't my fault that the Valves & Controls took too long to close. That would have been our crack government that took a little longer to approve it. But there are some approvals that the government has to do, but they don't look like they're going to be difficult ones.

The capital structure, I mentioned. And John Stauch, my longtime CEO -- CFO partner, is going to be the CEO of Water. And Beth Wozniak, who joined us a couple of years ago from Honeywell, will be the CEO on the Electrical side. We expect maybe \$100 million to \$125 million of separation costs. And -- ouch, I don't know what I did. What is that? Am I too close to that? Oh, okay. Heck of an entry. I see it's you.

So the one reason why I'm confident that we can do this now is, over the last 17 years, we've applied these strategic principles of basically finding more attractive markets to be in and in businesses where we can control our own destiny. That has been the strategic raison d'etre for Pentair for 18 years, and it has led us to these 2 nice businesses, Water and Electrical.

And over time, we've also built better operating capability. There's still room to go. We can be better. But what we call the Pentair Integrated Management System has been embedded in both sides of the business, as is the culture. So as we look at separating the 2 companies, we feel the cultures are sound. They're well-staffed. There's people on both sides that know both how to think strategically and how to apply our operating principles. So we really think they're ready to go.

So let me talk about each in turn. The Water business, at \$2.8 billion, one of the largest single-focused businesses on water; and at 18% profitability, one of the highest profitability -- one of the most profitable businesses, with room to go, with more room to go in profitability.

With the exit of Valves & Controls, we're again skewed to North America, so we have a lot of opportunity outside. Now it hasn't been bad to be skewed in North America because North American markets have been growing better than the rest of the world by and large. And we have 2 things we're focused on in Water: water quality and availability, and food and beverage. And I'll talk about more in a little bit.

I talked about the leadership. We are a leader in filtration, and what we call Filtration & Process is \$1 billion, about split evenly between residential, commercial and -- residential and commercial and industrial. Flow Technologies, which is our pump business, not a leader by any stretch of the imagination in pump, nor have we been trying to be. We're trying to be good in the areas we compete and invest in the ones that we find most attractive. And then Aquatic & Environmental Systems, a business that I don't think is taken seriously enough, given the fundamentals that drive it, our position in it and the ability to innovate. It's been a huge driver and will continue to be a driver, and particularly as we now leverage that into a leadership position in aquaculture and hydroponics. It's a pretty interesting base to grow from. So we have industry-leading positions, we have strong brands, we've got strong teams and we have great opportunities.

So a little more about the opportunities. When we talk about water quality and availability, we're talking about reducing, recovering and reusing water in all -- anywhere they're used and to do that with less energy. So this is playing towards wanting to be good, but it's also helping people make money being good and sustainable. In the residential area, we're a leader in making components for home use. And this is a global business. In fact, the focus on water quality among the middle class is much more important outside Western Europe and the United States than it is in. But the importance is growing in both of those areas in the developed world as people realize how important it is to have safe, clean water. Pools and spas, you know about. But well and irrigation and being more precise in how we do irrigation is an area of growth and promise as well.



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In the commercial area, building solutions. Hospitality and food service is really a big focus of ours. We're a leader. We're the strategic partner for a lot of folks who are growing the food service area, but a lot of the hospitalities are looking -- hospitality hotels and institutions are looking at total water management, how do we do a better job of managing the resources we use and do it more cheaply. So that's our commercial focus.

In industrial, we have a number of nice niches. In the wastewater area, we're growing in biogas, the processing of biogas. We just bought another company, Union Engineering. We now have an array of technologies used in basically harvesting off gases and repurposing them either for use in industry or burning as fuel. And then a number of other niche applications in chemicals and refining where we put our filtration to use. So that's the water quality and availability side.

In the food and beverage processing side, we basically have a number of different things. One is we're a provider of precision spray and pump equipment for agriculture. In the aquaculture area, as I said, we've leveraged our pool business into a leading position, not just in the technology of aquaculture, but we're also helping incubate some of the urban farms that are being developed around the world. And then finally, in the beverage, dairy and beer solutions business, which can improve profitability and will improve profitability, but we have a really nice strategic position there. And so that's the food and beverage processing side.

Now the growth opportunity, as I've kind of touched on already, in residential water, we're investing to be closer to the customer to really understand the customers so we can drive innovation. What we have found is that the 2-tiered distribution that is largely used in Western Europe and the United States doesn't get us close enough to the customer. And therefore, a lot of the innovations we have get muted by the time they get to the customer. So we're reaching around the building, very much more of a pole strategy to talk to the customer at the end.

Commercial water, we already have really good relationships with the big hotel chains, with the big food service chains. And it's just again being their strategic partner as opposed to just the supplier.

Global filtration, we just want to make sure that we're Pentair inside, particularly our hollow fiber membranes and nanofiltration in hollow fiber membranes, which is coming. And then industrial fluid processing, again, niche applications that we have in water-oil separations, water-gas separations, a number of different, specific applications that use our filters.

And then in terms of enablers, we're investing a lot to improve the digital customer experience so we can actually talk to customers directly. A lot of investments in smart products. You're familiar with it if you're in the pool business, but really everything can be smart. You just want to be smart about how you do it so you don't waste the money. And then moving to solutions and services from components.

So let me talk about Electrical. Now by no means is the Electrical business among the largest. Water is among the largest of their peers. Electrical isn't, but it's more than viable, and it can actually thrive because at over \$2 billion, they have a leading position, the #2 in the world in metal and nonmetallic enclosures that are used. They're ubiquitous everywhere.

In Thermal Management in the Electrical side, we are the leader in the world. And then the fastening -- Electrical & Fastening solutions products, again, we have a number of competitors. If you take a look at the product lines that they have, we're among the same size. And altogether, in terms of the channel, we're a top 10 supplier to anybody who matters, which means that we have a seat at the table to talk about the channel and how the channel is changing and making sure that we have a good position to win.

Again, we're skewed North America, and we're about 60-40 between industrial efficiency and building protection. So we have strong brands. We have access to all the channels. We have opportunities to grow globally, and that really is on both the building protection side, and industrial process and efficiency.

On the building protection side, it's all about protecting sensitive equipment and electronic protection. Rail and building protection, a business that we are growing nicely. This was really improved with our -- our position there was really improved with ERICO. And then of course, fastening, grounding and bonding also something that was improved with ERICO. So, again, we have a right to play in a number of different industries that are investing.



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In the industrial process and efficiency, you're much more familiar with those, the equipment protection, industrial enclosures and the thermal management. So this area, which is a \$19 billion addressable market, is much bigger and more addressable because of the ERICO acquisition.

So similar structure here. Our opportunities are commercial building solutions. Data centers and networking, it's going to continue to grow. Cloud computing is driving that. We have a number of good customers that we work with there. Electrical protection systems, the more power that's used, the more sensitive electronics is used, there's more investment going into protecting the electrical system. And then infrastructure and industrial, we have a number of applications that just get pulled along as investments come up. We'll see how fast infrastructure comes. I've been waiting since 1977 to see North American infrastructure improved, when I got out of college, and they're still talking about it. So the real focus is industrial, because industrial will -- and it looks like we're at the front end of a cycle of investment for industrial.

So again, digital customer experience, smart products, solutions and services, same thing, you have to be focused on this to be relevant to your customers.

So next steps, we have to prepare the Form 10. You're all familiar with that. There's various closing conditions. The SEC will review the Form 10. Hopefully, they're faster than the FTC. We'll get receipt of tax opinions and rulings. We've already had enough comfort to have announced this, but we'll get the final. And then we need no shareholder vote, but we do have to take a final board vote. But obviously, we announced it, and the board was unanimously behind it, the spin. And so, as I mentioned, anticipate closing a year from now.

So in summary, I forgot to reaffirm our Q2 and full year outlook, but I know that will be the first question, so let me just get that out of the way. And the other thing I'd like to say is we have 2 great businesses. They are really fine businesses. And on their own, they are going to thrive. They both have great growth opportunities. They have -- with focus and scaled investments at a level that are meaningful for them, they can move the needle. And because of the strong balance sheet and because of the discipline that we've always had about deploying capital, we expect that they will continue to do the same thing. So we see it as a great opportunity to create value, and we are all excited about it.

So with that, I'll turn it over to questions.

QUESTIONS AND ANSWERS

Jeff Sprague - Vertical Research Partners - Analyst

Just thinking about the Electrical spin, is there anything in the structure of that business or historical M&A in that business that would create any problem for it to be an inversion vehicle of any sort, whether it be an RMT or other type of transaction?

Randall J. Hogan - Pentair plc - Chairman and CEO

The tax basis on that business is fairly low. And I don't know about the political environment to do inversions right now.

Jeff Sprague - Vertical Research Partners - Analyst

That's all of them? That's all?

Randall J. Hogan - Pentair plc - Chairman and CEO

Those 2 things?



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Jeff Sprague - Vertical Research Partners - Analyst

To get a low tax basis?

Randall J. Hogan - Pentair plc - Chairman and CEO

Well, I think -- I don't think Electrical's had peak profitability yet by a wide margin, by a wide margin. Enclosures has been a little disappointing for the last 18 months in terms of margins, and it's just getting growth back, and that's a machine. And then we're still dealing with the Thermal roll-off of the large projects. Now I'm actually pretty pleased with what I saw in the first quarter in terms of their margins, but they'll stabilize and get volumes back, too. So I think that business has a couple of really nice years ahead of it. Yes?

Martin A. Sankey - Neuberger Berman Group LLC - MD

Randy, this is Martin Sankey at Neuberger.

Randall J. Hogan - Pentair plc - Chairman and CEO

Martin, I know you.

Martin A. Sankey - Neuberger Berman Group LLC - MD

Okay. This is for the benefit of those listening in outside the room.

Randall J. Hogan - Pentair plc - Chairman and CEO

Martin is here, guys.

Martin A. Sankey - Neuberger Berman Group LLC - MD

Okay. Before the split -- the pending spin-off was announced, there was -- you kept saying stay tuned on what Pentair would do with the excess surplus cash remaining after paying down the debt associated with Tyco. What is the plan now for what to do with the cash? And is there any reason or barrier to buying back stock before the spin-off? So what's the thinking about the balance sheet?

Randall J. Hogan - Pentair plc - Chairman and CEO

Well, the thinking is pretty much the same. We're not going to rush headlong into buying back a bunch of stock, but we're not ruling out we might do something with the money. What we want to do is do what we said is we are refreshing the strategies of each business as independent businesses. We have lists of M&A on both sides where, frankly, job one right now is to do the separation, to finish the year strong. And that would preclude, I'd say, anything really remarkable in M&A, but bolt-ons certainly are of interest in it. As I always do, I never say never about M&A. But once we have the strategy, we want both businesses to have the opportunity and the degrees of freedom to drive those strategies to ground and win with them, which means that we want them to have the strong balance sheets we talked about, and we don't want to leave them in over-leveraged situations. But that's going to be a big part of the effort over the next 6 months or so of basically deciding what we're going to do with that. And we're not going to let the money burn a hole in our pocket, but we're not going to just jump to get a big hit in the stock price because the real value creation here is in effecting these spins and showing you that these businesses are going to sing.



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Nigel Coe - Morgan Stanley, Research Division - MD

Randy, it's Nigel. So you'll be -- you're going with the Electrical spin as Chairman. Is that a faction that you view to get more optionality or better growth or better margin opportunities there? So that's number one. Or was it a coin toss? And secondly, thinking about the cash flow characteristics of the 2 businesses, is there any difference in conversion ratios between the 2 businesses and, hence, levered opportunities?

Randall J. Hogan - Pentair plc - Chairman and CEO

Yes, I'll start with that. They both, we believe, are going to have very strong -- they're both be able to do over 100% conversion net income. They both will have the same tax structure. So they'll have the benefit of the, I'll just call it, the advantage structure. And they both have high profitability. So that's going to be on top of some balance sheet capacity. Their free cash flow will be very beneficial to the M&A strategy. They wouldn't let me be Chairman on both sides, and that's the answer there. No, I didn't flip a coin. 20 years ago, I started, when I came, I started in Electrical. As we built the company, a lot of the love went to the Water side. I believe in the Electrical business as much as I believe in the Water side. With Karl Frykman and John over in the Water side, I felt that I could be most helpful as Chairman on the Electrical side, and the board agreed.

Robert D. Barry - Susquehanna Financial Group, LLLP, Research Division - Senior Analyst

Randy, it's Rob Barry. A couple of things. You've been talking about refreshing the strategy. How soon can that occur? I mean, John and Beth both already know these businesses pretty well. Or do we really need to wait until the separation to get an update on the growth strategy?

Randall J. Hogan - Pentair plc - Chairman and CEO

No, we'll give you updates on the growth strategy. We're in our process now. We usually revisit that in September, so I'm sure we'll have a coming-out party with you and talk about the strategies. But one of the things, and it was disheartening that Valves & Controls hurt the company overall so badly, Water and Electrical did not get the attention either managerial or capital-wise that they deserved. And so I want to make sure that we don't rush to something as important as this, but we'll move tightly.

Robert D. Barry - Susquehanna Financial Group, LLLP, Research Division - Senior Analyst

And then just a follow-up. I mean, I appreciate the focus at a high level of -- or the logic of focus to improving the growth, but both of these are still going to be pretty diverse businesses. I mean, can you give an example of how the current structure has kind of held back the growth at Water or Electrical?

Randall J. Hogan - Pentair plc - Chairman and CEO

Well, we moved a lot of people out of Electrical in particular over to Valves & Controls to help improve the margins that we did. We improved margins 370 basis points. We kind of denuded them a little bit. So we rebuilt the capability, and there has been an internal focus on the operations and less investments on the marketing and growth side. So that's a specific example of that. And some of our Water business, too. So it was a risk we knew we were taking. And it worked really fine until the oil and gas industry dropped 60% on capital spending. It's tough when that happens -- actually, 45%. Yes?

Deane Dray - RBC Capital Markets - Analyst

Randy, a couple of questions. One on the logistics of the separation. And it's been suggested that you've already had a bit of a head start in going through the separation process, having carved out Valves & Controls and gone through all the subsidiaries and the regulators and so forth. So is there a suggestion that you might be able to separate sooner or just easier? And then a separate question, just curious why the Electrical business did not have an announced COO, similar to what Karl's role is in Water.

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Randall J. Hogan - *Pentair plc - Chairman and CEO*

I'll address that one first. The -- we have 3 SBUs in Electrical, and so they're some of our most seasoned leaders, and we just didn't see the need to have a COO. Karl has got 5 or 6. Some are coming along. Karl has deep customer contact. I mean, he is a customer guy, and he's a great partner. I mean, he and John work really well together. So it's a nice combination. Now on the first question, and we talked a little bit last night, basically, when we separated Valves & Controls, when we merged Tyco Flow Control and Pentair, we interwove a lot of things to get the structure right, and we had to unwind them to be able to sell Valves & Controls. In doing so, we cleaned up a lot of things, kept our advantage. And so it's fresh, right? We just -- we kind of went through it like a dry run. So we believe it won't be easy, but we have the road map. And if we can close it earlier, we'll let you know. But we're confident we can do it by the second quarter next year. Rob?

Rob McCarthy - *Stifel - Analyst*

So I guess the check is cleared, and you're happy with the price what Emerson paid. But could you talk kind of warts and all what opportunities they have there with respect to it? And then obviously, to the extent you can, can you comment? I know the disc ops for now are closed or about to close. So just talk about current business trends there.

Randall J. Hogan - *Pentair plc - Chairman and CEO*

Well, I reaffirm -- I'll start with that. I reaffirm the second quarter and the full year. That's all I'll say about it -- oh, Valves & Controls. Actually, I'd rather not comment about the specifics on Valves & Controls. It's in disc ops, and you'll forgive me if I haven't paid that much attention to it lately. The Valves & Controls, we talked for a long time about how we had a leading position in Valves & Controls. We only had 11% market share. It's an extraordinarily fragmented industry. It's an industry that has all kinds of pieces that needs to be consolidated. We looked at being a consolidator. And then as it turned -- as the oil and gas industry showed us that we're in a for a long adjustment period, we said, yes, the business should be consolidated, but we're not going to be the consolidator. Emerson was the right buyer. It's the best strategic fit. I think they have lots of synergies. I'll let them talk about that. The length of the close, how long it took the close was not great for the business, but people hung in there and stuck with it. And I think they have -- they certainly have synergies from a combination, but they also have channel synergies that could be pretty interesting. Yes. And I'll let them talk about the details. Way in the back?

Scott Graham - *BMO Capital Markets - Analyst*

Randy, when you had your conference call on the split, one of the things that you led with on the Electrical side was that there's more work to do on the cost side. Are you implying that the organic growth in that business might be a little slower for the next, say, year, 18 months.

Randall J. Hogan - *Pentair plc - Chairman and CEO*

No. Actually, they -- it was -- the growth, as you saw, we saw growth in the Enclosures business, which was the piece of it that I was disappointed with, in the first quarter for the first time in 9 quarters. Where they were late on the cost, that was a year ago. Everyone else took cost out. They didn't get it done, and that's what I was referring to. That's why the late was -- the cost was taken out once I put Beth in there, and it will read out.

Scott Graham - *BMO Capital Markets - Analyst*

And then a corollary to that question, your heat-tracing business has a large component that is commercial facing end market. Shouldn't we see that business start to improve a little bit faster than the later cycle end markets that they face?



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Randall J. Hogan - *Pentair plc - Chairman and CEO*

Yes. And actually, commercial -- correct me if I'm wrong, but commercial is solid. It's growing. It's hard to see because the oil sands was -- the oil sands is still a great business for the Thermal business because it's a very hostile environment, and it has good aftermarket, but that's all it's going to be, is aftermarket. So it's selling down to there. So as the sales come down, it's really hard -- it's hard to see the commercial going up, but it is going up.

Joe Ritchie - *Goldman Sachs - Analyst*

Randy, the -- maybe the flip side to Rob's question. Are there still pieces of the portfolio that still needs some cleaning up that you could potentially divest in the interim before the split? So like, what comes to mind for me is within the Flow Tech piece, it's been growing at a pretty slow rate over the last couple of years. I'm just curious whether there are any pieces that you guys would consider doing.

Randall J. Hogan - *Pentair plc - Chairman and CEO*

There could be. I think that will come out of the strategic review as well, where -- or areas that we really don't want to invest. And what we do is, if something falls to the bottom of the investment list, we then have a specific question of, "Are we the best owner?" And if we aren't the best owner, who is and can we get that capital out? We bought, in my 17 years, we bought a lot of sales, and we sold a lot. And so it is part of our discipline to do mergers and acquisitions and divestitures. So, but I -- that would be a likely place if there was some place.

Steve Tusa - *JP Morgan - Analyst*

Randy, Scott Davis from Barclays over here.

Randall J. Hogan - *Pentair plc - Chairman and CEO*

Hi Steve.

Steve Tusa - *JP Morgan - Analyst*

So just on the industrial channel, what you guys are seeing in the Enclosures business coming out of the second quarter? ISM is kind of fading a little bit, but you guys are obviously an interesting read into what's happening in automation and machine builders, et cetera. So maybe just a little bit more color on what you're seeing there. And then the second question would be, anything on the tax front that kind of precludes you? There's this like 2-year window from a tax-free spin perspective. Anything you believe precludes you from doing something more advanced with the Electrical business?

Randall J. Hogan - *Pentair plc - Chairman and CEO*

Yes. I don't like talking about quarter mid-quarter, but I was very happy with our exit rate on Enclosures from the first quarter. On the tax rate, we are focused on getting the spin done and getting out 2 years and showing what that Electrical business can look like. And I don't know, but I have to check whether that anti-inversion law -- I'm a little familiar with it because I'm on the Board of Medtronic, and it was done when Medtronic announced the Covidien. So I'm a little familiar with the rule, but I don't know whether it would apply to us. Nothing?

Julian Mitchell - *Credit Suisse - Analyst*

All right, we'll wrap it up.



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Randall J. Hogan - *Pentair plc - Chairman and CEO*

Yes, that's good. Thank you all.

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