

21-Dec-2021

Neogen Corp. (NEOG)

Q2 2022 Earnings Call

CORPORATE PARTICIPANTS

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

Steven James Quinlan

Chief Financial Officer & Vice President, Neogen Corp.

OTHER PARTICIPANTS

Christine Rains

Analyst, William Blair & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the Neogen Fiscal Year 2022 Second Quarter Earnings Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to John Adent, CEO. Please go ahead.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

Good morning, and welcome to our regular quarterly conference call for investors and analysts. Today, we will be reporting on the second quarter of our 2022 fiscal year, which ended on November 30. As usual, some of the statements made here today could be termed as forward-looking statements. These statements are subject to certain risks and uncertainties, and our actual results may differ from those that we discuss today. The risks associated with our business are covered in part in the company's Form 10-K, as filed with the Securities and Exchange Commission.

In addition to those of you who are joining us by live telephone conference, I also want to welcome those of you joining us online. Additionally, I want to give a warm welcome back to those of you who may have joined us for our announcement regarding our agreement to combine 3M's Food Safety business into our existing operations. Following our prepared comments this morning, we will address questions from participants who have joined this live conference.

I'm joined again this morning by Steve Quinlan, our Chief Financial Officer, who will provide some additional details on our results for the quarter. As noted in our press release this morning, we've seen the business continue to rebound from the impacts of the COVID-19 pandemic, and we are pleased to report yet another strong quarter with 13% revenue growth across our worldwide business compared to the prior year's second quarter.

We also reported double-digit growth for both our Food and Animal Safety business units, as well as our fourth straight quarter of double-digit organic growth across both units. This continues our track record of over 22 years of compounded annual revenue growth rate of approximately 15%. As mentioned, we also had other news last week. On December 14, we announced that we had reached an agreement to combine 3M's Food Safety business with our existing operations. This is a major milestone for Neogen as we pursue our goal of protecting the world's food supply and providing our global customer base with the best-in-class food and animal safety solutions.

As the world increasingly focuses on sustainability in food safety and supply chain solutions, we believe this is the perfect time to combine to create a global innovator in food security. The combined company will have an enhanced geographic footprint, innovative product offerings, digitization capabilities and financial flexibility to capitalize on robust growth trends and sustainability, food safety and supply chain integrity. Together, we will be well-positioned to accelerate growth and drive significant additional value for customers, employees, and shareholders.

Combined, we have a total of 70 years of industry defining innovation in food safety and helping our customers protect the world's food supply. Our newly bolstered team of approximately 200 scientists and engineers will be able to provide new and innovative solutions to these customers, helping to change the food security landscape moving forward. Together, we will possess the digital capabilities to lead the growth and digitization of the food and animal safety industry. The complementary product offerings, combined with Neogen's data-driven analytics approach, will create a compelling solution as customers seek innovative partners to increase efficiency and enhance food safety protocols.

Following the close of the transaction, which we expect will occur by the end of the third calendar quarter of 2022, our enhanced product range will mean that we will have an expanded offering in food safety, particularly in indicator testing and pathogen detection areas which complement Neogen's existing microbiology lines. Neogen will be able to offer 3M's Food Safety customers our genomic services, which deliver innovative DNA testing. This expanded product range, along with Neogen's Animal Safety business, increases the solutions with which we can help customers protect the world's food supply from behind the farm gate all the way to the dinner plate.

I believe that the cultures of Neogen's and 3M Food Safety, our collective dedication to work that protects the world's food supply and our shared values of serving our customers and creating environments in which our employees can thrive, are what makes this transaction a great fit for both organizations.

I want to state again how excited I am to welcome the 3M Food Safety employees to the Neogen team upon closing, and thank our team here at Neogen for their hard work and dedication over the years. Without them, this would not have been possible.

We've also had several other notable acquisitions during the quarter, including companion animal health company, CAPInnoVet, Inc. in September; UK-based manufacturer and supplier of animal hygiene and industrial cleaning products, Delf (UK) Ltd on December 1; and companion animal genetic testing company, Genetic Veterinary Services (sic) [Sciences] (05:26), Inc. on December 9. These acquisitions each demonstrate our commitment to diversifying our portfolio and finding businesses that synergistically pair with our Food and Animal Safety segments, offering our customers around the world new products and solutions that help protect people, animals and food. More on that later.

This quarter represents a massive step forward for Neogen, our employees, our shareholders and our customers and we're looking forward to seeing how these additions strengthen our business in the third quarter and the rest of the fiscal year.

Now, I'll turn it over to Steve for some insight into the numbers for the quarter. Steve?

Steven James Quinlan

Chief Financial Officer & Vice President, Neogen Corp.

Thanks, John. Let me first start by saying how excited I also am about our planned merger with 3M's Food Safety business. I'm looking forward to 3M's Food Safety team joining the Neogen family, and I'm optimistic this combination will accelerate growth for products from both businesses. Now, this will clearly be a transformative deal for the company, and we incur significant costs in the quarter to get there.

I'll go into the details in a few minutes, but I need to point out that these costs will continue throughout the remainder of our fiscal year, as there still a lot of work to be done to finalize the combination and also to continue the preparation for the integration of the businesses. And let me get into some of the details on our second quarter financials. Sales for the second quarter were \$130.5 million, a 13.5% increase over the prior year. Revenues for our Food Safety segment increased 17% to \$67.1 million, while revenues in our Animal Safety segment were \$63.4 million, a 10% increase.

Our Food Safety revenues were positively impacted by the December 2020 acquisition of Megazyme, our Ireland-based producer of food quality and nutritional analysis products. On an organic basis, sales for the Food Safety segment increased 11% and for the fourth consecutive quarter, both the Food and Animal Safety segments have reported double-digit organic growth. On a constant currency basis, revenues were approximately \$1 million higher in the current quarter than the same period last year, primarily from the British pound strengthening against the US dollar.

In our current fiscal year, we've seen a lot of our customers benefit from improved economic conditions or a return to pre-COVID activity levels, but on the other hand, we've also been experiencing supply chain issues that are negatively impacting our ability to get product to customers and increasing our costs. Our operations team is working hard to find alternate suppliers and faster and more reliable shipping methods, and are also looking for creative ways to attract and retain labor.

That being said, I have some strong numbers to report. On the Food Safety side, natural toxin sales rose 10% from strength with domestic pet food manufacturers and also on increased testing due to regional deoxynivalenol or DON outbreaks in France and Germany. This is especially impressive considering sales of our aflatoxin test kits were down significantly in Brazil as an extended drought there has greatly reduced the corn crop and associated testing.

Sales of Neogen Culture Media products increased 11% in the second quarter compared to the prior year. This was primarily driven by strength in the UK as our new workflow called One Broth, One Plate has been adopted by many commercial labs. Our Soleris rapid microbial testing product line increased 22% in the second quarter on strong sales of our Soleris NG instrument, which continues to gain market acceptance more than a year after its launch.

AccuPoint NG, another newly launched reader used in environmental sanitation testing, also had a strong quarter, with sales up 19%. And our innovative Listeria Right Now test system continued its growth with a 36% increase

over the prior year. Allergen test kits increased 6% in the quarter. Growth in this line was constrained by supply issues, and I expect this situation to improve in the third quarter.

Sales of our dairy drug residue test kits declined 23%. As I have mentioned on previous calls, we ended our agreement with our European distributor and have experienced ongoing competitive pressure against this product line. Like most businesses recently, we've been impacted by rising costs, labor shortages and ongoing supply chain issues. While the number is not material, we did have to push some sales from the second quarter into the third due to our inability to obtain raw materials or build adequate volumes of inventory.

Moving on to the Animal Safety segment, our veterinary instrument line, which includes needles and syringes, once again had a strong quarter, with 30% growth, resulting in large part from recently won private label business. Our line of animal care products increased 18% on strength in the equine and companion animal markets. This category also includes the relaunched ThyroKare supplement line and sales of parasiticide products recently obtained in the CAPInnoVet acquisition.

In the second quarter, insect control products increased 46% on strength in the StandGuard product line. Our sales team has done a great job of steadily increasing our market share since this line was acquired in July of 2020. Rodent control product sales were down 14% in the second quarter due to a difficult comparison to the prior year in which we had very strong sales due to rodent outbreaks in the US. Sales in this line were also negatively impacted by supply constraints.

Genomic services reported through the Animal Safety segment increased 7%. Growth was primarily from our Australia operation as improved economic and weather conditions there led to increasing sampling for beef and sheep. Revenues at our Lincoln lab were flat as growth in dairy and beef cattle and poultry markets were offset by lower volumes in companion animal. The result of difficult comparisons due to strong growth in the second quarter of the prior year. On a worldwide basis, genomics revenues increased 8% with nice growth in our Scotland, Brazil, China, and Canada labs.

Overall, the company had strong growth in the quarter, with US revenues increasing over 9% and international operations up 20%. Excluding the Megazyme acquisition, international sales were up 14%. Our UK operations rose 20% in the second quarter from strength in culture media sales related to our new One Broth, One Plate workflow and natural toxin sales from the DON outbreaks I previously mentioned.

Our Quat-Chem operation also continue to have strong disinfectant sales into Asia, driven by the African swine fever outbreak and the Middle East on new business earned. Sales in Brazil decreased 5% primarily from the lower aflatoxin sales I previously mentioned, somewhat offset by increases in other food safety diagnostic kits and genomics. Revenues in China increased 28% with Megazyme sales, gains in natural toxins, and several Soleris equipment placements.

Gross margins in the second quarter were 46.4% compared to 46.3% in the prior year second quarter. As I've mentioned previously, we've experienced higher freight, labor and material costs in the current fiscal year. While we did receive some benefit from product mix, I'm proud that the team has been able to maintain overall gross margins while dealing with adverse operating conditions. We have taken some price increases as necessary to help cover our cost increases and our operations team has been focused on reducing costs where possible.

Sales and marketing expense for the quarter was \$21.2 million, an increase of 20% over the prior year. Now, this increase is the result of higher compensation costs due to increased head count and performance, shipping expenses, which rose due to volume and higher rate, and also higher spend on travel, tradeshow and other

customer-facing activities. The increased travel expense was planned as prior year activity was minimal due to COVID restrictions.

General and administrative costs were \$22.6 million compared to \$12.2 million in the second quarter of the prior year. As we mentioned in the press release, we incurred \$9.3 million in professional fees this quarter associated with due diligence, consulting and legal services related to the 3M deal. Excluding these deal costs, G&A expense increased 9% in the quarter due to higher salaries and bonus accruals resulting from improved operating performance and additional senior management hires, legal and amortization expenses from the Megazyme and CAPInnoVet acquisitions, and a rise in depreciation expense related to IT investments.

Research and development expense was \$4.3 million, a 7% increase over the prior year. The increase is primarily the result of personnel absorbed in the Megazyme acquisition and outside services for development spending on new products.

Operating income for the second quarter after excluding the \$9.3 million [ph] and (15:20) 3M deal cost was \$21.8 million or 16.7% of sales, an increase of 13% compared to \$19.3 million or 16.7% of sales in the prior year quarter. Other income for the quarter was \$459,000. Included in this, interest income of \$224,000 is down from \$560,000 from the prior year due to lower yields on our marketable securities balances.

Our effective tax rate in the second quarter was 16.2% compared to an effective rate of 17.8% in the prior year. The lower tax rate is primarily due to lower pre-tax income resulting from the 3M cost. Our tax benefit from option exercises in the quarter was \$859,000, compared to \$1,060,000 in last year's second quarter. Of note, on the balance sheet, inventory levels have risen \$6.4 million or 6% since year-end, approximately \$1 million of that increase is the result of our recent acquisitions.

Supply chain issues have forced us to review our safety stock levels and increase balances in several areas to ensure adequate balances of key raw materials and minimize back orders to our customers. I expect higher levels of inventory to continue for the remainder of this fiscal year. We've generated \$41.1 million in cash from operations during the first half of the year and invested \$27 million of that in acquisitions.

To wrap up, we had a solid quarter and are optimistic for the remainder of the fiscal year. Much credit and thanks goes to our 2,000 employees worldwide who continue to deliver these results. We will continue to drive that operating performance while working on the integration planning for the 3M combination.

I'll now return it to John for his closing comments.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

Thanks, Steve. While our big news is definitely taking the spotlight for the quarter, I do want to emphasize on how strong of a quarter this was for our existing business and the momentum that it presents as we look to our third quarter. We're happy to continue to see the business rebounding from the lows of the COVID-19 pandemic as customers continue to gain confidence within the marketplace. As we have for the last two years, we will continue to remain vigilant monitoring the ongoing pandemic and the Omicron variant. Our number one priority continues to be keeping our employees and customers around the world safe and healthy. I want to further touch on the series of acquisitions that I mentioned earlier.

I mentioned this briefly in the first quarter call, but on September 20, we announced our acquisition of CAPInnoVet, a companion animal health company that provides high quality and high value pet medications,

specifically parasiticides to the veterinary market. These products will blend naturally into our Animal Safety segment, and we're pleased with the progress that we have made in integrating the company with Neogen's operations. On December 1, we announced our acquisition of Delf UK, a manufacturer and supplier of animal hygiene and industrial cleaning products.

We see this as an opportunity for us to expand our offerings of performance dairy chemicals and believe the industrial cleaning products will complement our Quat-Chem disinfectant and cleaner offerings helping to enhance our biosecurity portfolio. And finally, on December 9, we announced our acquisition of Genetic Veterinary Sciences, a companion animal genetic testing company. This acquisition will enhance and diversify our portfolio of genomic tests, allowing us to better serve the growing companion animal market. The acquisition of GVS, along with the acquisition of CAPInnoVet, is part of our strategy to grow our companion animal offerings. We've seen the incredible worldwide growth of this market over the past two years, and we want to expand and grow with it.

This is a big focus of ours as we move forward, and these two new businesses are helping us move in the right direction. It's been a very strong and exciting quarter for us as a company, and I'm extremely happy with our entire Neogen team's continued hard work and dedication to our mission, as well as how they have responded as we've announced big changes. Our R&D pipeline remains strong and we're looking forward to introducing some new products very soon. We have a lot of momentum carrying us into the third quarter, and we're excited to see how the business continues to grow over the remainder of the fiscal year and into the future.

Now, I'll open up the floor for any questions you have for Steve and I.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Christine Rains from William Blair. Please go ahead.

Christine Rains

Analyst, William Blair & Co. LLC

Q

Hi. Good morning. Thanks for the opportunity. My first question is that I was hoping you could talk about how 3M product lineup differs from Neogen and also perhaps how if there's any geographic differences or customer differences. And then my second question is also on 3M. If you could just kind of walk through the integration plan there and speak about how you're equipped to handle such a large transaction? Thanks.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

A

Thanks, Christine. How much time do you have to go over these? So on product offering, it's really complementary. The flagship of that line is the Petrifilm business, which is the indicator testing business. We have nothing in that space. The pathogen lines are fully complementary. They're both within pathogen. But as you know, pathogen is such a big market, they don't compete and do the same things. And then our microbiology line is something that 3M doesn't offer. Our analytics blockchain is something they don't offer. We both have an allergen line, but that's [ph] our (21:44) acquisition they did quite recently, so it's really relatively small. And then lastly is the ATP line, and we both have that business. It's a big market. It's a lot of business. And there's a number of competitors in that market. So those are how the lines – the lineups kind of work.

From a customer basis, same thing, really excited about the complimentary look. It's interesting, because it's a lot of different businesses worldwide. Both of our businesses represent a little over 40% of our total sales, but we're strong in different markets, which we're excited about. So you think about some of the growth areas and opportunities. 3M is really strong in the Japanese market and we do very little Neogen in the Japanese market. We're really strong in the Australian market. They don't do very much in the Australian market. So we really see big opportunities to expand sales by utilizing best channels in both markets, and we see that kind of across kind of the whole globe. So that's been exciting for us.

[indiscernible] (22:52) and the last on the integration, we know how important this is. We've got a really strong team. We've got some really strong team built and put together. We've already started on the integration plan Phase 1, which is now to close. We've got that lined out. We know who's responsible for what. We've got the team members on each. We've got the goals and objectives. We've really started pushing that already even before the start of the calendar – start of the new calendar year. And we know that it's extremely important to do that right. And then once we finish Phase 1, we move right into Phase 2 on integration and working through fully bringing those facilities and people onboard into the Neogen team.

Steve, anything do you want to add to that?

Steven James Quinlan

Chief Financial Officer & Vice President, Neogen Corp.

A

No, I think you covered it, John. I think it's important to know that as we move forward with the integration plan, we'll be keeping you up to date on calls that we have to let you know progress we're making on that.

Operator: Okay. [Operator Instructions] Our next question will come from [ph] David Westenberg from Piper Sandler (24:04). Please go ahead.

Q

Hi. Thanks for taking the question, and I didn't get on the integration call or the 3M call. So congrats on that, [ph] and so having (24:15) got to tell you that.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

A

Yeah. Thanks, [ph] David (24:18).

Q

And I want to stick with the previous question about the complementarity of 3M and your existing business. Now in the past, and maybe I'm thinking of Jim Herbert's Neogen business, but I thought of international this long-term cash flow negative war, I would say margin dilutive kind of venture. I don't know if that's still the case. Can you confirm that's still the case? And do you think that the 3M combination maybe changes that P&L equation to something where it's not a – it has – it won't be a dilutive thing going international because you will have that scale that you finally need?

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

A

Yeah. Sure, [ph] David (25:06). That's a good question. I think it's dilutive only at the beginning, right? So if you think about where we go and invest greenfield like what we did in India and China and in some of the others. China was [ph] dilutive (25:18) for a while. China is making money for us. So it really depends on how long we've been in that market. The international with the 3M business is established markets just like our established international market.

So our sales to international markets, I like the profitability – I mean, we saw really good growth in profitability for our Australian business, our UK business, our Brazilian business. Mexico has done extremely well. Southern Cone came out of the gate really strong, so it really is where we are kind of on that growth trajectory. And because those are established business and a lot of them have already direct sales teams, that's only going to accelerate that growth. So I think it's when we go in and say, okay, we're going to greenfield or it is dilutive, but that's only because it takes us time to establish the sales team, build everything up and drive revenues forward.

Q

Got you. All right. Thank you very much. And not trying to attack here, I just think that you guys are doing a ton with this 3M acquisition. I mean, you're going to double the revenue. So can you give us kind of a little bit of reassurance that you're expanding in the companion animal I don't necessarily, or – you've already have been in companion. I apologize.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

Yeah.

A

Q

You're moving more into companion animal while doubling your revenue in the Food Safety side. What kind of – what can you kind of tell to investors that maybe you're not biting off more than you can chew with doubling your efforts in the companion animal while simultaneously integrating doubling your Food Safety?

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

Yeah. Sure, [ph] David (26:59). I mean, if you look, we've really done a nice job, I think, of strengthening our team over the last four or five years to continue to get ready for growth, right? So if you look at the leadership group, the strength of the individuals, we've brought in, the people we've promoted from internally, we're really excited about the strength of the team. We also have the ability because the businesses are managed and run kind of by different leadership groups that while yes, corporate and Food Safety is going to do an extremely heavy lift on the integration with 3M.

The Animal Safety business is going to be relatively unscathed by this, right, because it's just the corporate resources. Perhaps, they're going to have to do a little bit more on their own because of corporate resources are going to be pushed to work in the 3M. So for them to grow and expand in the Animal Safety, we feel really comfortable and confident about and there's a couple of reasons to that that give me excitement. You look at what we did with the StandGuard product from Elanco, right? That was a product that was languishing within their portfolio. We took it and doubled the business, right?

A

We think and we know that. We know we can do that with the product offerings that are coming out of CAPInnoVet. And I really like our acquisition also of our Genetic Veterinary Sciences in the West, in Washington. Not only is it a new product offering that focuses within that same space on genomics companion animal genomics, which we really like, but it's a really strong team. And we're adding not only the products, but this great infrastructure of the lab and the team members out there. They're going to allow us to leverage them to grow the platform even more. So it's – we're picking up and in a lot of these cases, not just product, but also strong team members that are going to help us grow.

Q

All right. Got you. Thank you very much.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

You're welcome.

A

Q

And then I guess just the final – final question on consolidation trends with your customers. Obviously, Food Safety, or not Food, I would say food producers have seen a pretty decent amount of consolidation over the years, but now you are dealing with supply chain issues. Do you think that maybe you're seeing a slow or you could be seeing a slowdown in consolidation amongst your food – food production customers? And could that be a beneficial net-net for pricing over the longer-term? And I'll just hop off.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

Yeah. Yeah, that's a tough one. It's hard to slow down kind of that momentum on consolidation because of the efficiencies you gain. I think you could see that from depending on the new administration on how they want to position that consolidation [ph] roadwork (29:49) or the consolidation blueprint. But while it is a probably a benefit on pricing, we do very well with our pricing for large customers because we're able to supply a much broader offering and solutions package than any of our competitors, right? So when we work with a customer, we were, let's say if there is we have a [ph] yogurt (30:15) customer, we work with, we don't just start at the plant, we're working with that customer. They're using our genetic services to choose the right animals on the dairy farms they own.

A

They are then using our dairy chemicals, our cleaners to clean the animal and the equipment before milking. They're using our disinfectants to clean the line and the tanks. The customer is also using our mycotoxin testing to make sure that the feed they're feeding that animals to help this quality feed. Then by the time when the milk gets to the plant, they're using our, their antibiotic test to make sure there's no antibiotic residues, then they're using our Soleris system to make sure that there's no yeast and mold on the finished product. They're using our Allergen test to make sure there's no foodborne allergens or any pathogens in the product. And then lastly, they use our new Megazyme offering on product quality to make sure that what's in, what's on the package is in the product.

So we've got this tremendous amount of products that touch so far along the pipeline that I think as they get bigger, we're more valuable. So to me, there could be competitive pricing pressures, but we're more valuable and we can deal with one company over six or seven to do the exact same thing.

Q

Got you. Thank you very much, and congrats on the acquisition and a nice quarter.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

Thank you.

A

Steven James Quinlan

Chief Financial Officer & Vice President, Neogen Corp.

Thank you, [ph] David (31:39).

A

Operator: This concludes our question-and-answer session. I'd like to turn the conference back over to John Adent for any closing remarks.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

Thanks, Scott. Well, I appreciate everyone getting on the call and your continued support of the Neogen and Steve and I talked about, we're really excited about the merger with 3M and the business of bringing this forward and the solutions and product offerings we're going to be able to offer to our customers and really the value we think – we know we can create for employees, shareholders and customers.

So with that, I'd like to wish all of you and your families a very safe and happy holiday season, and thank you again for joining us.

Operator: The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.

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