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NEXON Co., Ltd. (3659.JP)

Q2 2014 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to NEXON's Second Quarter Fiscal-Year 2014 Financial Results Q&A Conference Call. Today's call is being recorded.

At this time, I would like to turn the call over to your moderator, Shumpei Kumagai, Head of Investor Relations. Please go ahead, sir.

Shumpei Kumagai

Head-Investor Relations, NEXON Co., Ltd.

Hello, everyone, and welcome. With me today are Owen Mahoney, President and CEO of NEXON; and Shiro Uemura, CFO. Owen will make some opening remarks before moving on to the results for the quarter. After that, both Owen and Uemura-san will answer any questions that you all may have live on the call.

Before we get started, I'd like to remind you that although this is a stand-alone call, it will be helpful to have our quarterly presentation materials on hand as reference. Our financial results for the second quarter of fiscal year 2014, as well as our quarterly presentation, are available on our Investor Relations website.

Today's call will contain forward-looking statements, including statements about our results of operations and financial condition, such as revenues attributable to our key titles; growth prospects, including with respect to online games industry, our ability to compete effectively, adapt to technologies, and address new technical challenges; our use of intellectual property and other statements that are not historical facts. These statements represent our predictions and expectations of the future events, which we believe are reasonable or based on reasonable assumptions.

However, numerous risks and uncertainties could cause actual results to differ materially from those expressed or implied in the forward-looking statements. Information on some of these risks and uncertainties can be found in our earnings release. We assume no obligation to revise or update any forward-looking statements. A replay of this Q&A session will be available on the website following this call.

Also, please note that Net income refers to the net income attributable to owners of the parent as stated in NEXON's consolidated financial results. Furthermore, and this conference call is intended to generally provide investors and analysts with financial and operational information about NEXON, not to solicit or recommend any sale or purchase of stock or other securities of NEXON.

Please note we might be using Japanese/English interpretation during this Q&A session. I'd now like to turn the call over to Owen.

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

Thank you, Shumpei, and thank you all for joining us today. Shiro Uemura will review the quarter's performance in more detail in a few minutes. But first, I'd like to offer my perspective on our first half results and some of the initiatives the new management team has put in place, since I assumed the role of CEO in March.

First, the highlights of our performance in the first half of 2014. First half revenues were ¥84.4 billion, up 4% year-over-year. Operating income was ¥31.1 billion, a 9% decrease year-over-year, with a 37% operating margin. Net income was ¥20.2 billion, down 24% year-over-year. Last quarter, I told you our key operational word was FOCUS. Focus our resources only on the items that are likely to substantially grow our business and cut off [ph] area/efforts (03:20) that don't. Our teams have been applying that focus around three areas: Products, People, and Partners. I'd like to take a minute to talk to you about what we have done so far in each of these areas.

First is Products. Our goal is to create the best online games in the industry. In order to do that, we have pared down our development pipeline to focus only on the games that we feel really matter. This means, only games that we feel are truly fun and truly differentiated. In our existing games, we are focusing on retention and player longevity over near-term monetization. As we've said in the past, we believe making games and gameplay enjoyable and sustainable for non-paying players is vital to the long-term success of a game. And the right approach is to build a robust, dependable revenue base.

Second is People. In order to build and grow the best games in the industry, you need the best people in the industry. NEXON today has some of the best online game developers and operators in the world. I believe that in our business, the way to attract and retain such high-caliber people, is to have a clear mission and clear objectives. In this way, we are very clear: developing only the highest quality online games is how we build substantial revenues over time. Development community in our major markets appears to be responding to this, as they see us make the hard choices that get us to the best online games.

Third is Partners. Over the course of the last 18 months, especially the last 4 months, we have assembled a truly world-class lineup of partnerships, which we think will result in products that amaze our customers. We are extremely selective about who we partner with, so we are especially proud of what these mean for our future.

Now, I'd like to talk about some of the early results of our efforts with this new focus. Legion of Heroes was originally launched in Korea, where it quickly rose in the rankings to consistently place around the top 10 of Google Play Top Grossing apps. We have also announced the launch of this game in China, and will be bringing it to the U.S. and Japan soon.

You can see from the screenshots in our presentation materials and from the trailer available on YouTube, that Legion of Heroes doesn't look like any other mobile game. When we were developing it, the common belief around the industry was that only casual game content could work on mobile. We chose to break with convention and develop the game that we ourselves really wanted to play, an immersive, visually stunning 3DMMORPG.

Results so far show that we were right, and that players will stay with a great immersive game, including on the mobile platform. The DAU trend is very stable, showing excellent user retention, a marked contrast to mobile game and casual games, where DAUs can spike, but typically drop back down quickly. We believe that Legion of Heroes' retention is a result of the quality of the title, and the demand for this type of engaging content on mobile.

Another example is FIFA Online 3, which we are servicing in Korea through our partnership with EA. This game was launched in January 2013, and received special updates for the World Cup. It went on to set the all-time MCCU record in Korea, with 850,000 concurrent players in July. And while you might expect a lot of interest in this game around the World Cup, its metrics have held up extremely well, even since the end of the tournament.

In addition to FIFA Online 3 for PC, FIFA Online 3M for mobile, launched very successfully, contributing to our strong performance in Korea during the quarter. Because this is through a partnership, we can't disclose all of its KPIs, but the publicly available Google Play Top Grossing ranking in South Korea from App Annie for FIFA Online 3M, speaks to the incredibly consistent and strong revenue generation from this title.

Turning now to partnerships. Over the last 12 to 18 months, as you may have read in the news, we have announced deals at the pace of roughly one per month. These agreements include publishing contracts, minority investments or a combination of both. None of them have been full acquisitions.

What you may not know is that, every one of these companies is run by a well-known and a highly regarded creative head in the West. They may be less acknowledged in Asia than they are in the West, but this is truly a gold-plated list of developers. And I'm very proud of our company for having forged these relationships.

Over the next six months, you will start to see the fruits of this deal-making. John Schappert was a creative leader at EA, Microsoft and Zynga, and responsible for some of the industry's biggest franchises. Brian Reynolds at SecretNewCo was responsible for Civilization II and the Rise of Nations. Cliff Bleszinski was previously at Epic and responsible for the Gears of War franchise, and before that, Unreal Tournament. And Robert Bowling was formally Creative Strategist for the Call of Duty franchise.

Why did these leaders choose NEXON? First and foremost, they know that we have an unparalleled free-to-play experience. As the pioneer of the business model, we offer deep insights to partners who are looking to make the transition of free-to-play from other business models. Our expertise in maintaining game bounds is an important element in building and growing games that keep players coming back for months and years on end.

Second, we are truly an international company. We operate and have experience in all of the key markets of the world, with the localized knowledge about how free-to-play works in each one.

Third, we have worked hard to earn the reputation of being a great partner. This type of reputation is sadly unusual in the games business.

Our approach with these deals has to combine what we are good at, which is online and free-to-play, with what they are good at, which is making hit games with broad appeal. By doing so, we believe we will build fantastic online games in Western markets. And we will also be able to take many of those games to markets in Asia. In working so closely with these partners, including making equity investments in their companies, we get to know them much better, which gives us a range of benefits, including paving the way for potential M&A in the future.

Now, I've been talking to you about our intense focus, and how we have pared things down so we can concentrate on those projects that get us really excited. Despite that much sharper focus on quality games, our pipeline of new games is large and very strong, especially on mobile, over the next year.

Titles that I would like to call to your attention are MapleStory 2, which we plan to launch around Q4. This title is a new take on one of our most beloved franchises.

Next is Three Sword Heroes, a Chinese action RPG for mobile that we have published in Korea on July 8. Last but not least is Durango, a new genre of survival game, where you have to allocate your limited resources while fending off other players and dinosaurs.

Importantly, after 18 months of intense deal-making, we'll start to see the results: several new games from Western developers in the second half of 2014 and throughout 2015. We expect to make additional partnership announcements in the coming months.

So to summarize what we are today, when you say no to a lot of things, you end up with only things that you really care about. I think our pipeline represents just that. We think that the only way to have a big and financially successful games company and create value for shareholders is to make great online games. And the only way to make great games is by treating games as an art form, and demanding that we only make art that we are proud of. Some of these games will not be financially successful, but what I can promise you is that we are dedicated in making wildly creative and differentiated games.

The companies that have focus on creating quality products tend to be those that achieve long-term success. That's in fact how NEXON got its start, and how we grew for so many years. We believe this focus on creating really great games is the best way for us to grow and drive shareholder value.

With that, I would now like to turn it over to Shiro Uemura, to run you through the Q2 financials.

Shiro Uemura

Chief Financial Officer, NEXON Co., Ltd.

Thank you, Owen. Our second quarter revenues exceeded the high end of our outlook, on both on as-reported, and on constant currency basis. Revenues were ¥36.9 billion, [ph] largely up 1% (12:03) on an as-reported basis, and down 8% on a constant currency basis. The revenue outperformance against the high-end of our outlook was primarily driven by exceptionally strong results from Korea.

Operating income was ¥10.0 billion, down 26% year-over-year, primarily due to an increase in royalty payments, and the HR costs, and changes in the revenue mix.

Net income was ¥4.1 billion, down 64% year-over-year. The decrease was due primarily to foreign exchange loss.

Mobile revenues were ¥8.4 billion, which exceeded the high end of our outlook, with a strong performance of Legion of Heroes and the FIFA Online 3M. Our native games revenues was ¥3.2 billion, and nearly doubled quarter-over-quarter.

Turning to our performance metrics. Total MAUs for the quarter was 51.9 million, a decrease of 7% quarter-over-quarter. This sequential decrease is largely due to seasonality from China and Korea, at the second quarter, historically, it sees lower MAU. Despite this seasonal decrease, Dungeon&Fighter MAUs in China were flattish quarter-over-quarter. A good sign, showing stability.

Our pay rates remain stable, flattish from a year ago to 10.2%, but down 0.8 percentage points from 11.0% in Q1.

Our ARPPU was ¥2,781, up 28% versus a year ago. Our constant currency ARPPU was ¥2,658, up 22% versus a year ago. ARPPU increased, both on as-reported and constant currency basis, with successful content updates.

To summarize, while we are watching it closely, it appears our MAU count is trending steadily in first half 2014, compared to second half last year, while the other KPIs have been advancing as our core user base remains very engaged.

Continuing the regional highlights, our revenues from the China business were ¥13.5 billion, down 13% year-over-year on an as-reported basis, and down 22% on a constant currency basis. The large scale tier 1 update Grand Genesis for Dungeon&Fighter, was launched on June 17. As I mentioned earlier, Dungeon&Fighter MAUs were steady quarter-over-quarter, despite the historical seasonality of the second quarter, stabilizing from downward trend, experienced in the second half of last year. After our partner's efforts to curb users engaging in illicit activities.

Revenues from Korea business were ¥13.4 billion, up 56% year-over-year or 38% on a constant currency basis. This strong performance in Korea was driven by FIFA Online 3, Legion of Heroes and other existing PC titles.

FIFA Online 3 for PC and FIFA Online 3M for mobile, both had an excellent quarter, preceded by the FIFA World Cup. FIFA Online 3M exceeded 3 million downloads on June 17, three months after its initial launch on the Never App Store in March, and on Google Play at the end of May. User metrics remained strong after the World Cup, with FIFA Online 3 setting a new all-time record for PC online gaming in Korea, with 850,000 MCCU. For reference, the previous record was 620,000 set by MapleStory in 2011.

Legion of Heroes continues to remain a hit, with over 2 million downloads. It is consistently trending around the top 10 of Google Play's Top Grossing apps, and has monthly revenue close to ¥300 million. As Owen mentioned, this title's strong user metrics are evidence of how immersive the games on mobile differ compared to casual games. Also, both Legion of Heroes and the FIFA Online 3M have been the only non-Kakao titles in the top 10 of the Google Play Top Grossing ranking. We believe that this points to the quality and differentiation of these titles.

Our existing PC titles also demonstrated strong performance, particularly Dungeon&Fighter, Sudden Attack and the MapleStory.

Revenues from our Japan business was ¥7.7 billion, a 19% decrease versus a year ago. Both PC online and mobile revenues decreased year-over-year. Despite the well-known saturation of the mobile browser market, revenue from our mobile business in Japan only decreased 2% quarter-over-quarter. This tells us that our quality-first approach is working on live game operations of browser games.

During the quarter, we had an effective mass promotion campaign for Skylock, which nearly doubled its revenues month-over-month in June. Going forward, we will continue to focus our efforts on developing the high-quality, immersive native app games.

Revenues in North America were ¥1.1 billion, a 22% decrease versus a year ago, or 25% on a constant currency basis. Our revenues in Europe and other regions were ¥1.1 billion, a 33% decrease versus a year ago or 39% from a constant currency basis.

We have been concentrating our efforts on improving the user experience for our existing titles in the U.S., to further differentiate our titles in the market. As you know, our focus in the West has been on partnerships, with the titles now coming in the second half.

For the third quarter of 2014, we expect consolidated revenues in the range of ¥40.0 billion to ¥42.8 billion, representing the 0% to 7% increase year-over-year on an as-reported basis. We expect mobile revenues in the range of ¥8.2 billion to ¥9.0 billion, representing a year-over-year increase of 19% to 30% on as-reported basis. We expect operating income to be in the range of ¥10.7 billion to ¥13.0 billion, a decrease of 34% to 20% versus a year ago. We expect net income to be in the range of ¥7.3 billion to ¥9.1 billion, a decrease of 9% to an increase of 12% versus a year ago.

In China for the third of quarter, we expect year-over-year mid- to high-single digit decrease on an as reported basis. Dungeon&Fighter will receive additional high-quality content updates which started in July and we'll continue it through September. We also announced the launch of Legion of Heroes in the Chinese market, published by ChuKong. The game was featured at the ChinaJoy exhibition, and we are excited to bring this hit content to the whole new market of gamers.

In Korea for the third quarter, we anticipate year-over-year double-digit increase on an as-reported basis. We expect the FIFA Online 3 user base to maintain its momentum following the World Cup, in the subsequent in-game events. We also recently held a media conference in Korea, announcing high-quality mobile titles slated for release in the second half of the year. These titles will drive our revenue, and are the result of the rigorous quality review of the development pipeline that Owen discussed, focusing our resources only on those titles that we really believe in.

In Japan, we expect year-over-year high-teens to double-digit decrease on an as-reported basis. For mobile, we plan to launch more than three native games during the second half of the year from gloops. Additionally, Nexon Japan will publish a native app game title from Korea in the second half.

For North America, Europe and Others, we expect to see year-over-year single-digit to mid-teens decrease on an as-reported basis. However, new titles for our strategic partners, SecretNewCo and TURBO will start to come to the market around the end of the year. Additionally, Legion of Heroes concluded a very successful closed beta test in U.S., and it's ready for launch. In addition, Counter-Strike Nexon: Zombies will be launched on STEAM, targeting markets in North America, Europe and Russia.

In the third quarter, we expect our operating margin in the range of 27% to 30%. Factors impacting operating margin year-over-year includes the increasing royalty costs associated with third-party IP, such as FIFA Online 3 and the FIFA Online 3M. HR costs related to head count increases, as well as the grant of stock options, and revenue mix due to an increased contribution from Korea, which has lower margins than China.

In addition, marketing costs will increase year-over-year associated with new title releases in Korea, North America and Europe. During the last quarter's earnings call, we announced plans for ¥10 billion share buybacks. During the quarter, we continued our share repurchase program, and as of August 14, 2014, we had acquired 10.6 million shares for ¥10 billion. As previously announced, the share repurchase program concluded today, on August 14, 2014. This buyback reflects our capital allocation approach of maintaining the strong strategic flexibility, while also returning cash to shareholders, and also reflects our confidence in the future for Nexon.

With that, we'd be happy to take your questions.

Shumpei Kumagai

Head-Investor Relations, NEXON Co., Ltd.

This concludes the prepared remarks portion of today's call. Next, we will like to open up the lines to live Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. Today's question-and-answer session will be conducted live on the phone. [Operator Instructions] We will now pause for a moment to assemble the roster. Our first question comes from Mr. Luigi Limentani from Point72. Please go ahead, sir.

Q

Yes. Hi, guys. Good evening. Just one question from me. Can you confirm please that D&F MAUs are still holding in July and August, but you said it's on decline after the update? Thank you.

A

[Foreign Language] (25:00-25:34)

A

Thank you very much for your question. I would like to provide the answer. As you know, for Q1 and Q2, MAUs of Dungeon&Fighter have trended in a very stable manner. And in the recent months, we are still seeing the stability of MAU. And in the coming months, we will put our effort to provide high-quality content update, as well as live development, so that we will be able to further advance the MAUs of Dungeon&Fighter.

Operator: The next questioner. The next question comes from Mr. Han-Joon Kim from Deutsche Bank. Please go ahead.

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Q

Thank you very much. Let me ask a few questions, if I may. The first one being, if I look at your numbers, I get the impression that Counter-Strike Online may have been bit weak. Still along the line, what Owen mentioned about streamlining products that you don't think are worthwhile. So, are you considering CSO to continue to decline or was it sort of more of a one-off?

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

A

This is Owen. Thanks for your question. I mean, what I'd say about CSO in China is that, it hasn't been as strong as it previously has or has been in the past, as for cutting it off or doing anything like that. No, we're not thinking that at all. As a matter of fact, we've got a good content update plan that we're excited about. [ph] It's where (27:33) we continue to be very much supportive of that product in that region. And of course, Valve, who's our partner for that game, continues to be a wonderful partner and it's a very strong partnership there, not just for

Counter-Strike Online in China and other regions like Japan and Korea, but also for Dota 2, which we introduced a few quarters ago in Korea, and hope to build from here.

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Q

All right, great. Thanks. Just a follow-up question, if I may. We had a very significant tier 1 update for D&F in China, and I recognize the fact that we have fairly stable MAUs, but I'm just wondering, why we might not have seen a more significant improvement? I think, we saw a pretty good improvement in Korea, but I'm just wondering why we're not seeing one in China?

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

A

Well, just going back a few quarters, just if you recall a year ago, the reason why we had the primary driver for the decline that we had in MAUs coming in Dungeon&Fighter in China was really because we were – we, and really our partner with us in China, in case for that game, it's Tencent, felt that it was very important to eliminate the bots and the hackers from that game. And by doing so, we're going to focus on the core of users much more effectively and make the game more fun for them.

The more bots and hackers you have in a game, the less fun it is for actual real, live players. So, the problem, of course, is that it has a material impact on the MAU count, and because Dungeon&Fighter is such a large game in China, and China is the largest country in terms of total MAUs or total game players, it has an oversized impact on our overall MAU count, our worldwide MAU count. Having said all that, what we really wanted to see as we said before, was sort of a stabilization of the MAUs and the KPIs there. And we feel, as Uemura-san said, we feel like we're seeing that. So, we're going to watch it quarter-by-quarter and month-by-month. But where it goes from here will depend on all sorts of different factors, but the key thing is that we feel that the game is on a stable path.

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Q

Okay. And then, this is along that, do you think we should hinge any hopes on a pickup towards the end of September or heading into the golden week in October?

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

A

In terms of what? In terms of MAUs?

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Q

Yeah, in terms of MAU and/or monetization.

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

A

We make a point of not making predictions about our KPIs going forward. Our forward outlook for revenues is a function of several different – or scenarios around different combinations of KPIs that we think are in the range of realistic. But we don't really disclose how we come up with that, because there's so many factors at work on the MAU count alone. So, if you allow us to continue with that approach, we're going to watch how it goes from here in terms of MAU going forward.

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Q

That's okay . Okay . That's great. Just one last question from me. The labor cost had seem to gone up a bit, I just wanted to see if there's any one-off or I presume, maybe a little bit of bonus in there, but I just wanted to check if we should be assuming the current [ph] level as – treat this level as of the normalized rate or one just level?
(31:12-31:16) Thank you.

Owen Mahoney

President, Chief Executive Officer & Director, NEXON Co., Ltd.

A

Yeah. I'll take that. Just to be direct about this, there's a couple of things going on. One is we introduced the stock option program, and so there's some stock options expensing associated with that. Also, with new products that we are introducing, we, of course, have to ramp up the live operations, people and folks supporting games that we launch, so those are the key factors.

Han-Joon Kim

Analyst, Deutsche Securities Korea Co.

Q

Great. Thank you.

Operator: [Operator Instructions] This concludes the Q&A session. Mr. Kumagai, at this time, I would like to turn the conference back over to you for any additional or closing remarks.

Shumpei Kumagai

Head-Investor Relations, NEXON Co., Ltd.

Thank you. If there are no further questions, I would like to take this opportunity to thank you for your participation in this call. Please feel free to contact the NEXON IR team. E-mail address is investors@nexon.co.jp, should you have any further questions or comments about the second quarter results or regarding NEXON in general. We appreciate your interest in NEXON, and look forward to meeting with you, whether it is here in Tokyo or any corner of the world.

Operator: Thank you. That concludes today's conference. Thank you for your participation. You may now disconnect.

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