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NEXON Co., Ltd. (3659.JP)

Q3 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to NEXON's 2016 Third Quarter Earnings Conference Call. Today's call is being recorded. At this time, I would like to turn the call over to Maiko Ara, Head of Global Investor Relations. Please go ahead, ma'am.

Maiko Ara

Head of Global Investor Relations, Nexon Co. Ltd.

Hello, everyone, and welcome. Thank you for joining us today. With me are Owen Mahoney, President and CEO of NEXON, and Shiro Uemura, CFO. Today's call will contain forward-looking statements, including statements about our results of operation and financial condition, such as revenues attributable to our key titles, growth prospects, including with respect to the online game industry, our ability to compete effectively, adapt to new technologies, and address new technical challenges, our use of intellectual property and other statements that are not historical facts.

These statements represent our predictions, projections and expectations about 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 related IR documents. We assume no obligation to update or alter any forward-looking statements.

Please note net income refers to net income attributable to owner of the parent as stated in NEXON's consolidated financial results. Furthermore, this conference call is intended to 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 may be using Japanese-English interpretation during the Q&A session. A recording of this conference call will be available on our Investor Relations website, www.ir.nexon.co.jp/en/ following this call. Unauthorized recording of this conference call is not permitted.

I'd now like to turn the call over to Owen.

Owen Mahoney

Representative Director, President and Chief Executive Officer, NEXON Co., Ltd.

Thanks, Ara-san, and thank you all for joining us today.

Before Uemura-san reviews our third quarter results and fourth quarter outlook, I'd like to share a few highlights of the third quarter, our pipeline, our recent investments and the bigger picture of what's happening in the business today.

First on the quarter, we delivered a great quarter with revenues ahead of our expectations. This was primarily driven by solid performances in Korea and China, especially in September. In Korea, both MapleStory and Dungeon&Fighter outperformed our expectations. Both titles had successful Tier 1 content updates and events, and MapleStory in particular, did exceptionally well during the quarter.

In China, we introduced the National Day update for Dungeon&Fighter on September 27, which got off to a very strong start. As we mentioned last quarter, the timing of this year's National Day update was later than last year's third quarter on September 22. And so, we expected the financial impact from this update in Q3 to be limited. But the early momentum of the update was really strong and its first few days performance exceeded our expectations.

In Japan, we launched two new titles in late September. A new PC online game, Tree of Savior and a new mobile game, HIDE AND FIRE. Although the impact on our consolidated Q3 financials from these titles was limited, both of them had good starts and helped to offset the declining browser game revenues there.

We also announced the Japan service of Ghost in the Shell S.A.C. ONLINE, an existing PC online game that we developed internally, based on our popular Japanese sci-fi anime, which is scheduled for commercial launch in late November. We are also going to bring more mobile games to Japan, including HIT and Dungeon&Fighter 3D mobile in 2016 and onwards.

As we move to the fourth quarter in Korea, we're seeing good early performance of our new mobile games launched in October, including Sangokushi Sousouden Online and MapleStoryM in Korea.

In October, we also completed the closed beta test for one of our highly-anticipated mobile games Dungeon & Fighter: Spirit, which is the official service name for what we've been referring to as Dungeon & Fighter 3D mobile.

At the upcoming G-STAR show in Korea, we're presenting a huge number of games, including 28 mobile titles and seven PC online titles that we will be launching in upcoming months. As most of you know, G-STAR is the largest game exhibition in Korea and it will run from November 17 through the 20th. We're extremely excited to show these titles, some of which are highly-anticipated inside the company, including Dungeon & Fighter: Spirit, Project Dynasty Warriors, DARK AVENGER 3, LawBreakers and Moonlight Blade.

Shifting gears now, I want to talk about our initiative of strategic investment in emerging markets. By way of background about a year ago, we established a subsidiary in Taiwan, following that, last month, we formerly entered the Thai market through the acquisition of a 49% equity stake in the leading Thai game publisher, iDCC.

We will acquire the remaining 51% stake upon Thai government approval. For those of you who don't know them, iDCC is a Thai game publisher with a successful portfolio of mobile games. We collaborated with them on mobile games including HIT and found them to be a great company providing strong regional operational support for that game.

This investment will enable us to provide enhanced user support in marketing activities for our mobile games in the region and accelerates our expansion in the rapidly growing Thai mobile game market, which is expected to grow over 20% year-over-year 2017 with the mobile sector expected to grow up to approximately 60% of the market or USD 2.2 billion.

Thailand currently represents over 20% of the South East Asian game market. The final message I'd like to leave you with is that this is a very exciting time for NEXON. As you know, last quarter we were in the midst of a tough period, taking challenges with some of our key titles in Korea.

Today, we're at the beginning of a large wave of new games launching in Korea, in and around the world. In Japan, that wave of games is resulting in some early successes such as Tree of Savior on PC and HIDE AND FIRE on mobile with more to come.

Meantime, China remains a huge and very stable market for NEXON. This wave of launches is a result of two and a half years of labor in game development, publishing and live operations preparation and deal-making.

And this points to a core strength of our business model. We have a robust and very consistent base of revenues from our significant IP base. Our new games give us layers of optionality into new revenue streams that we are looking to make as large and consistent as our existing games.

While not all of these new games will be a hit, we've had some strong early wins and we believe more will come throughout 2017. Around new world, the entertainment business is changing. As millions of consumers shift to spending their leisure time online and on mobile devices. NEXON is in an excellent position to capitalize on this trend in Asia and throughout the globe.

With that, I'll turn it over to Uemura-san to run through the third quarter results and fourth quarter outlook.

Shiro Uemura

Representative Director and Chief Financial Officer, NEXON Co., Ltd.

Thanks, Owen. First, I would like to explain a disclosure policy change we have implemented this quarter which affects our Q3 results and Q4 outlook. Since our IPO, we have disclosed constant currency revenue in addition to as-reported revenue in order to help you all understand our business without the impact of change in foreign exchange rates. Using the local functional currency for respective NEXON Group entities' locations, the constant currency basis amounts were calculated using the average FX rate for the comparable fiscal quarter in the prior year and applied to the current fiscal quarter. However, given the significant movement in the Chinese yuan, we no longer believe it is the most accurate presentation for constant currency results for China. This is because our constant currency revenue recognition mechanism in China is complex.

This quarter is a good example of why we needed to make this change. Our old constant currency methodology shows China down in Q3 year-over-year when in fact, it was up. We are making this change in order to be more accurate and to more fully reflect that complexity.

Specifically, Neople, the Korean entity that developed Dungeon&Fighter for China, records its revenues in South Korean won. The constant currency figures we have previously reported showed what Neople revenues would have been had the KRW/JPY exchange rate not changed from last year's same fiscal quarter.

As most of you know, in China, we license Dungeon&Fighter IP to Tencent. In exchange, we receive part of Tencent's Chinese yuan revenues as royalty and we receive these revenues in U.S. dollar. As a result, our as-reported revenues for Dungeon&Fighter in China are affected by both the Chinese Yuan versus U.S. dollar and the U.S. dollar versus Korean won FX rate.

While we have previously chosen not to introduce this added level of our complexity to our constant currency calculations, we now believe this presentation gives a more accurate view of the actual performance of the business in local market without any impact of all currency fluctuations and therefore, have made this policy change.

Going forward, we will use this network to calculate constant currency in China. For this quarter, for the sake of consistency and the comparability, we have provided both the previous constant currency calculations, namely Old constant currency and our constant currency calculations namely, New constant currency. Please be aware, all constant currency numbers referred in this presentation are based on the New constant currency basis.

Now, let's move on to the Q3 results. Revenues were ¥44.3 billion, down 11% year-over-year on an as-reported basis and up 4% year-over-year on a constant currency basis. Operating income was ¥16.3 billion and net income was ¥7.6 billion.

Third quarter revenues exceeded our outlook, primarily due to the strong performance of our PC online game business in China and Korea. Operating income also exceeded our outlook, this was primarily due to the revenue outperformance, particularly in China with higher margin, as well as lower-than-planned costs including marketing costs.

Net income was below our outlook, mainly due to the FX loss on our U.S. dollar-denominated cash deposits and account receivables, due to the appreciation of the Korean won against the U.S. dollar and the Japanese yen appreciation against the U.S. dollar.

Turning to our performance by platform, third quarter PC online game revenues were ¥34.5 billion, down 13% year-over-year on an as-reported basis and up 4% year-over-year on a constant currency basis. Please refer to the Investor Presentation for our selected performance metrics for PC online games.

Mobile revenues were ¥9.8 billion, down 5% year-over-year on an as-reported basis and up 5% year-over-year on a constant currency basis. As a reminder, about 80% of our mobile revenues are from native games.

Continuing on with third quarter regional highlights. Revenues from the China business were ¥17.4 billion, down 14% year-over-year on an as-reported basis and up 7% year-over-year on a constant currency basis.

As Owen mentioned, we conducted large scale updates for Dungeon&Fighter in the third quarter: The Summer Update in July and the National Day update in September. Both of these were well received by users. The National Day update we introduced on September 27, had the theme of Tales of King Arthur and it had a particularly strong start, which led to the outperformance against our outlook.

Factors contributing to solid performance included strong item package sales, in time for the National Day update driven by the popularity of a new character, Demonic Lancer which we introduced in June.

MAUs for Dungeon&Fighter increased quarter-over-quarter, in line with typical seasonality in the third quarter. On the other hand the number of paying users slightly decreased quarter-over-quarter. This is due to the difficult comparison with the second quarter with high base of paying users driven by favorable effect from update including the 8th anniversary update.

On a year-over-year basis, MAUs decreased while paying users increased. The slight decrease in MAUs was primarily due to the timing issue of the National Day update, which we introduced later than last year third quarter. However, thanks to the increased base of used paying users, which grew significantly in the fourth quarter of last year and has stayed around that level, paying users were higher in this year's third quarter compared to last year.

The ARPPU for Dungeon&Fighter increased quarter-over-quarter, in line with typical seasonality and decreased slightly year-over-year. The year-over-year decrease was primarily due to more like users with lower ARPPUs who became paying users for the first time since the fourth quarter of last year.

Revenues from the Korean business were ¥18.3 billion, down 9% year-over-year on an as-reported basis and up 4% year-over-year on a constant currency basis. PC online game revenues were ¥13.8 billion, down 10% year-over-year on an as-reported basis and up 2% year-over-year on a constant currency basis. Mobile game revenues were ¥4.5 billion, down 5% year-over-year on an as-reported basis and up 9% year-over-year on a constant currency basis.

Revenues exceeded our outlook, primarily due to the strong performance of key PC online titles, MapleStory and Dungeon & Fighter.

MapleStory performed exceptionally well due to the successful large scale update we conducted in July, events held during the quarter and item pocket sales in time for the Korean Thanksgiving holiday.

Dungeon&Fighter also performed very well due to the successful summer update and the 11th anniversary update introduced in the quarter, as well as item pocket sales in time for the Korean Thanksgiving holiday.

We expected third quarter PC online revenues to decrease year-over-year even on a constant currency basis due to FIFA Online 3 and Sudden Attack. However, this was more than offset by the strong performance of MapleStory and Dungeon&Fighter. As a result, we had a little growth in PC online revenue on a constant currency basis.

As for new titles, we launched multiple mobile games during the third quarter including our internally-developed title, Master of Eternity and a publishing title, Chaos Chronicle.

Revenues from our Japan business were ¥ 3.7 billion, a 25% decrease versus a year ago. Mobile revenues were at ¥2.7 billion, a 29% decrease year-over-year and a 12% decrease quarter-over-quarter. Revenues decreased sequentially for both native games and browser games. PC online revenues were ¥1.1 billion, down 13% year-over-year and up 24% sequentially.

As for new title, we started the official service of the PC online game, Tree of Savior in late September. In mobile game, we started to launching new titles on a monthly basis, including HIDE AND FIRE, Fantasy War Tactics and

Chaos Chronicle. HIDE AND FIRE launched in late September is a third person shooter game, which is a unique genre in Japanese mobile game market.

Revenues in North America were ¥2.1 billion, a 5% increase versus a year ago on an as-reported basis and a 24% increase on a constant currency basis. The year-over-year revenue growth was primarily due to the good start of the PC online game, Riders of Icarus, which was released into an open beta test in late July, as well as the mobile game HIT which was launched in early July.

Our revenues in Europe and other regions were ¥2.7 billion, a 14% increase versus a year ago on an as-reported basis and a 32% increase on a constant currency basis. The main factor driving the year-over-year growth in revenues was the strong performance of the mobile games HIT, which was launched in early July, it performed very well in Asian countries such as Taiwan, Hong Kong, Macau, Thailand and Vietnam included in the other components of Europe and other regions.

Now turning to our Q4 2016 outlook. For the fourth quarter of 2016, we expect revenues in the range of ¥39.3 billion to ¥42.2 billion, representing a 14% to 8% decrease year-over-year on an as-reported basis.

On a constant currency basis, we expect revenues in the range of ¥45.6 billion to ¥48.9 billion representing a flat to 7% increase year-over-year. We expect operating income to be in the range of ¥8.2 billion to ¥10.3 billion. We expect net income to be in the range of ¥7.7 billion to ¥9.5 billion. For the fourth quarter, we expect the major currencies in our business, including the Korean won and the Chinese yuan to depreciate against Japanese yen by 12% and 19%, respectively year-over-year.

As you are all aware, depreciation of these currencies against the Japanese yen would have a negative impact on our revenues, operating income and net income. As a reminder, we expect every ¥1 move against the U.S. dollar would have an impact of ¥0.34 billion on our revenues and ¥0.1 billion on our operating income.

For simplicity, forex sensitivity is calculated based on the assumption, assumptions that Korean won and Chinese yuan move similarly against Japanese yen when there is an exchange rate movement in U.S. dollar and Japanese yen.

In China for the fourth quarter revenues, we expect a 20plus% to low teens percent decrease year-over-year on an as-reported basis and a low single-digit percent decrease to high single-digit percent increase year-over-year on a constant currency basis.

We have scheduled to introduce a Tier 1 update, winter update to our key PC online game, Dungeon&Fighter in December. As you know, the timing of National Day update for the Dungeon&Fighter in this year's third quarter was later than that in last year's third quarter.

Therefore, we expect the contribution from the update to be mostly in the fourth quarter. Our fourth quarter China outlook reflects the October performance of the game, including the contribution from the update, as well as the most recent trend of the game.

In Korea, for fourth quarter revenue, we expect a low teens percent to high single-digit percent decrease year-over-year on an as-reported basis and a low single-digit percent decrease to a high single-digit percent increase year-over-year on a constant currency basis.

As for PC online games, we expect some titles including Sudden Attack to decrease year-over-year. Meanwhile, we expect this to be more than offset by a year-over-year increase from titles including MapleStory and Dungeon&Fighter and expect Korea revenues to slightly increase on a constant currency basis. As for new mobile games, we launched Sangokushi Sousouden Online and MapleStoryM launched in October which are both off to a good start.

We also conducted the close beta test for Dungeon&Fighter: Spirit in October. While we expect contributions from some of these new mobile games, we expect fourth quarter mobile revenues to slightly decrease year-over-year even on a constant currency basis due to the difficult comparison with last year's fourth quarter when HIT was just launched and it performed exceptionally well.

In Japan, for fourth quarter revenues, we expect low single-digit percent decrease to high single-digit percent increase year-over-year on an as-reported basis. While we expect mobile browser game revenues to decrease year-over-year, we expect revenues to be roughly flat year-over-year driven by the full quarter contribution from mobile game, HIDE AND FIRE and the PC online game, Tree of Savior, both of which were launched in the third quarter.

On the mobile side, we are scheduled to launch a new action RPG DUNGEON STRIKER G in November. For PC online, Ghost in the Shell S.A.C. ONLINE, a FPS based on the popular anime IP, Ghost in the Shell S.A.C. was released into open beta test in early November. We're scheduled to start the commercial service of the game in late November.

In North America, for fourth quarter revenues, we expect a high teens to a high single-digit percent decrease year-over-year on an as-reported basis and a low single-digit percent decrease to a high single-digit percent increase year-over-year on a constant currency basis.

In Europe and other regions, for fourth quarter revenues, we expect a low single-digit percent decrease to high-single digit percent increase year-over-year on an as-reported basis and a low teens percent to 20 plus% increase on a constant currency basis.

In the fourth quarter, we expect our operating income to be in the range of ¥8.2 billion to ¥10.3 billion, showing a 21% decrease to flat year-over-year. We expect Q4 revenues to decrease year-over-year, due to significant depreciation from the Korean won and the Chinese won yuan against the Japanese yen.

Also, we expect year-over-year increase of HR costs driven by increased head count primarily in Korea.

On the other hand, we expect these to be offset by lower variable costs including royalty costs associated with third-party licensed games and decreased one-off impairment loss we recorded last year in the fourth quarter. We expect royalty costs to decrease year-over-year primarily due to the lower contribution from the publishing title HIT, which just launched in Korea last year in the fourth quarter, as well as lower royalty costs for DomiNations in relation to our acquisition of its developer Big Huge Games in the first quarter.

As a reminder, since we follow International Financial Reporting Standards, impairment loss is recorded as other expenses in the calculation of the consolidated income statement and thus, has an impact on operating income.

Lastly, the share buyback program of up to ¥5.0 billion, which we announced on September 5, was completed. We repurchased 3.2 million shares for ¥5 billion in approximately two-months period from September 8 to October 31.

We'd like to remind you that the cancellation of these shares has been resolved by the Board of Directors. The details of the share buyback program are also available on our IR website, in addition to Q3 investor presentation.

Having shared that context on our performance and our outlook, we'll be happy to take your questions.

Maiko Ara

Head of Global Investor Relations, Nexon Co. Ltd.

Thank you Uemura-san. Next, we would like to open up the lines to live Q&A.

QUESTION AND ANSWER SECTION

Operator: Today's question-and-answer session will be conducted live over the phone. [Operator Instructions] Our first question comes from Mr. Han-Joon Kim from Deutsche Bank. Please go ahead.

Han-Joon Kim

Analyst, Deutsche Bank AG (Hong Kong)

Q

Great. Thank you very much and congratulations on a blowout quarter. I just wanted to get a better sense of your 4Q guidance. So, from what I can read, I think we're looking at somewhere between ¥4 billion to ¥5 billion – sorry, ¥2 billion to ¥5 billion of quarter-over-quarter decline in the revenues.

But I think on the operating profit side, I think it was more like, if I'm reading this correctly, ¥3 billion to ¥6 billion. So, I think we basically see a bigger [ph] OP decline route (30:53) the revenue decline sequentially. So, can you just give us a context of the thought behind the 4Q guidance?

Maiko Ara

Head of Global Investor Relations, Nexon Co. Ltd.

A

Thank you very much for your question, Han-Joon. Please give us a moment while we translate.

Shiro Uemura

Representative Director and Chief Financial Officer, NEXON Co., Ltd.

A

[Foreign Language] (32:03-32:58)

Thank you very much for your question. I understand that your question pertains to the comparison of Q3 to Q4 and mainly, we will be impacted by the seasonality. As you know, generally speaking, Q3 is a very strong quarter, whereas Q4 is a weaker season and also, on top of that, we will or be seeing strong trends in publishing titles, as well as mobile titles.

Therefore, our royalty fee, as well as PG fee will most probably rise. And also, in the fourth quarter we have multiple new title launches. And therefore, that will push up our marketing fee. Therefore, Q-on-Q wise, we believe that there will be an increase in costs and that has been impacted in.

Han-Joon Kim

Analyst, Deutsche Bank AG (Hong Kong)

Q

Okay. Great. I guess as a follow-up to that [indiscernible] (34:01) if you guys have a guidance for actual marketing cost for 4Q?

Maiko Ara

Head of Global Investor Relations, Nexon Co. Ltd.

A

Thank you very much for your question. Please give us a moment for translation.

Shiro Uemura

Representative Director and Chief Financial Officer, NEXON Co., Ltd.

A

[Foreign Language] (34:41-34:58)

Regarding the marketing cost, it will be on par with the marketing cost of Q4 of the previous year. As you know, we will be launching multiple titles in Q4, so we will be investing in the marketing area.

Han-Joon Kim

Analyst, Deutsche Bank AG (Hong Kong)

Q

Understood. One last question if I may, I think we'd been communicating that we have about 35 titles that we're going to showcase at the G-STAR next week and 35 is quite a bet. So, if you could just help think about what is the timeframe of launch for these 35 titles or if releasing a sizable chunk of them over the next six months and over the next three months. Or is this really the full breadth of what we have with undetermined dates on some – just if you can help us frame the idea behind showcasing so many titles. I think that will be very much appreciated?

Owen Mahoney

Representative Director, President and Chief Executive Officer, NEXON Co., Ltd.

A

Hey Han-Joon, this is Owen. So, we have a lot of titles as you mentioned and that we are launching. I guess the way to think about it is, whenever you're showing titles at a major tradeshow, you want them to be nearing up to launch, and you feel that you can really talk about them publicly.

So, without giving specifics on each title on and when we expect them to launch, what we see is that there are window where we're seeing they come out and they're going to be in the market in the foreseeable future and we feel confident enough that we can show them to the outside world.

Having said that there are a lot and our publishing teams around the world that become very, very busy because our development teams that have been hard at work for last two and a half years. We are looking at this wave of new titles. And I would just emphasize that while we're talking about a lot of titles, our emphasis is really on providing quality titles. And that we're not per se interested in launching a lot of titles, what we're trying to do is make sure that they're good titles that last a long time and grow a long time.

So although, we're planning on having a very big G-STAR show this year, we don't want to leave the impression that we're all about the numbers. We're about the games. Each of the games themselves are important to us.

Han-Joon Kim

Analyst, Deutsche Bank AG (Hong Kong)

Q

Okay. Great. So I'll be there as well, so, I'm looking forward to that? Thank you.

Owen Mahoney

Representative Director, President and Chief Executive Officer, NEXON Co., Ltd.

A

Looking forward to seeing you there.

Han-Joon Kim

Analyst, Deutsche Bank AG (Hong Kong)

Q

Sure.

Operator: [Operator Instructions] This concludes the question-and-answer session. Ms. Ara, at this time, I'd like to turn the conference call back over to you for any additional or closing remarks.

Maiko Ara

Head of Global 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 at investors@nexon.co.jp should you have any further questions. We appreciate your interest in NEXON and look forward to meeting you whether it is here in Tokyo or in your 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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