

13-Aug-2015

NEXON Co., Ltd. (3659.JP)

Q2 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to NEXON 2015 Second 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 Investor Relations. Please, go ahead, ma'am.

Maiko Ara

Head-Global Investor Relations

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 operations and financial conditions, such as revenues attributable to key titles; growth prospects, including with respect to online games 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 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 owners 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 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.

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

Owen Mahoney

Representative Director, President, Chief Executive Officer

Thank you, Ara-san, and thanks to all of you for joining us today. Uemura-san will review our second quarter results and outlook shortly. First of all, I'd like to offer my perspective on our first half results and the key themes heading into the second half. First, the highlights of our FY 2015 first half financial results; first half revenues were JPY94.6 billion, up 12% year-over-year. Operating income was JPY33.5 billion, up 8% year-over-year with a 35% operating margin. Net income was JPY31.5 billion, up 56% year-over-year. First half revenues, operating income and net income all grew year-over-year.

So you can see that we continued to deliver solid top line growth across our diversified portfolio of games and good leverage on the bottom line as we continue to focus on running the business efficiently. I think these results speak to the fact that we have the right strategy in place and are executing well against that strategy and that it's begun to provide us with the results we were looking to achieve.

If you remember, nothing else from our performance over the last six months, it should be that number one, our creative engine is firing on all cylinders and number two, that more partners than ever are coming to NEXON to leverage what we have. I'll talk about each in turn.

First, you are all likely aware that our primary focus as a management team has been on the game quality for both new games we launch and live games that are currently under service. Creating online games of high quality is easy in concept, but it's extremely hard in practice. So execution is the key. I am extremely proud of the work the creative teams and the game operation teams have done over the last six months and I believe the quality of the games we design and operate continues to rise steadily. Existing PC online games that we service showed strong performance across the world, primarily our key titles such as MapleStory, Dungeon&Fighter and Sudden Attack in key markets like Korea and China. The continued success of these games over many years gives NEXON a large and stable base of revenue, on top of which, we can build additional growth through our new games.

Our new game development teams have been doing a great job, and we're proud of both the games they have recently been launching as well as the upcoming games in the pipeline. As an example, our highly anticipated title, MapleStory2, launched on July 7 in Korea to broad customer and critical acclaim, and immediately took and held the number four position in Korea PC Café Rankings.

Today, NEXON titles account for half of the top ten in Korea's PC Café Rankings. We think that the early customer reviews bode well for the long-term success of MapleStory2 in Korea, and we think that MapleStory2 has very strong potential around the world. We have many more games in the pipeline, both on mobile and on PC. By focusing on creating games that we ourselves want to play, on games that make us proud, we secure successful future and we attract the kind of high quality talent that makes our game development even stronger.

The second area of focus for us has been our partnerships with leading game developers and IP owners around the world. NEXON is in a unique position to help our partners. We can provide huge reach and access to markets that are notoriously difficult to crack, and knowhow in technology on how to build up an online and free-to-play game over years. And we know how to monetize games in a way that actually grows the game's user base.

Repeatedly and at an increasing rate, we're seeing companies beat a path to our door to access what we have and what we know. This set of capabilities is very unique in our industry, and therefore, very valuable for NEXON, because it gives us access to some of the most valuable IP and developers in the world at terms that make business sense for NEXON. So this is a win-win for all parties and our partnering capability is adding significant value to our company.

On the mobile side, DomiNations, the first product to roll out from our strategic partnerships in the West started its service in the U.S., Europe and parts of Southeast Asia during Q2. DomiNations showed a strong start and contributed to significant year-over-year growth in the U.S. and Europe. Our Q2 North American revenues grew 2.5 times and revenues for Europe and Southeast Asia grew 1.9 times year-over-year, respectively.

On the PC side, Dirty Bomb was launched into Open Beta on June 2 and has been showing continued strong momentum since the launch. Most recently, we further strengthened our partnership with Electronic Arts, building on an already successful track record through the success of FIFA Online 3 and FIFA Online 3 Mobile.

In July, we announced our agreement with EA to publish Need for Speed Edge, the PC online version of Need for Speed, which we will service in Korea. Also in July, we announced a publishing agreement with EA and the developer, Respawn, to develop and publish a PC online version of the console title through the console hit, Titanfall. Details of the game are not yet revealed, but will be announced shortly. In addition to games that we have launched already in the first half of this year, we announced a series of deep relationships with world-class game developers and IP holders.

Earlier in the year, we announced a publishing agreement for Dungeon&Fighter Mobile in China with Tencent. As you're all aware, Tencent is one of our key business partners in China and currently services the PC version of Dungeon&Fighter there. We are of course thrilled to be working with them to deliver our mobile version of this major hit.

In March, we announced we will be working with SQUARE ENIX to co-develop a mobile version of FINAL FANTASY XI. And in January, we announced with Warner Bros. Group, that we entered into a licensing agreement to develop a mobile game, based on the LEGO IP.

We continue to be very selective in our partnerships; only working with companies that we think will meaningfully build our business around the world. There will be more such partnerships announced in the coming months and we look forward to updating you as they happen.

And the focus on great products and great partnerships has a significant and positive impact on our mobile business. Our view is that over the next few years, mobile devices and PCs will converge and with that convergence of platforms, so too will our games. So we've been building games that are more immersive and more differentiated than most of the mobile games available now, and our mobile business has been growing steadily.

In the first half, our native games business grew two times, year-over-year. A year ago, native games composed only 30% of our mobile revenues, whereas now 60% of our mobile games revenues comes from native games. This rapid growth is coming primarily from outside of Japan and in particular our Korean mobile business is very strong. Our games now account for 10% of the top 50 in the Korean Google Play Top Grossing. Two years ago, we had none that ranked in the top 50.

At the year end of 2014, I mentioned the unparalleled pipeline that would be hitting the market in FY 2015. We're on track for those launches with a series of highly anticipated titles about to hit the market across the globe including

both in-house and published titles. Those titles include BEASTS VS. BOTS by Shiver Entertainment, Legacy Quest by Socialspiel and Dungeon&Fighter Mobile.

With that, I'd now like to turn it over to Uemura-san to run you through the second quarter results and the third quarter outlook.

Shiro Uemura

Representative Director & Chief Financial Officer

Thanks, Owen. Now let's start with the Q2 results. Revenues were JPY42.7 billion, up 16% on an as-reported basis, and up 5% on a constant currency basis. Operating income was JPY11.3 billion, up 14% year-over-year on an as-reported basis. Net income was JPY13.0 billion, up about 3.2 times year-over-year.

Our second quarter revenues landed near the high end of our outlook. Our PC online game revenues exceeded the high end of our outlook. This was primarily driven by stronger than expected results from Dungeon&Fighter in China. Our mobile game revenues were near the low end of our outlook.

Operating income exceeded the high end of our outlook. This was primarily due to the strong performance by Dungeon&Fighter in China and lower than planned spending in some cost items. Net income exceeded the high end of our outlook. The outperformance was primarily due to higher than expected operating income in addition to lower than expected tax expenses, as well as foreign exchange gains from foreign currency denominated cash deposits and trade accounts receivables.

Turning to our performances by platform; our second quarter mobile revenues were JPY10.2 billion, up 20% year-over-year. Within mobile, native game revenues were JPY6.7 billion, about 2 times year-over-year. Revenues from native games account for about 2/3 of second quarter mobile revenues. Our second quarter PC online game revenues were JPY32.5 billion, up 14% year-over-year. Please refer to the Investor Presentation for our selected performance metrics for PC online games.

Continuing on with second quarter regional highlights; our revenues from China business were JPY16.0 billion, up 18% year-over-year on an as-reported basis and up 6% on a constant currency basis. We conducted two large-scale Tier 1 updates for Dungeon&Fighter in the second quarter. Specifically, we introduced our Labor Day Update on April 23 and 7th Anniversary Update on June 18. The 7th Anniversary Update was especially well received by users.

Second quarter MAUs for Dungeon&Fighter decreased quarter-over-quarter, meanwhile the number of paying users increased quarter-over-quarter. During the second quarter, we also launched a PC online game, Counter-Strike Online 2. The publisher for Counter-Strike Online 2 in China is Tiancity.

Revenues from the Korean business were JPY16.3 billion, up 21% year-over-year on an as-reported basis, and up 9% on a constant currency basis.

Our key PC online games, such as Dungeon&Fighter, Sudden Attack and MapleStory performed well and showed year-over-year growth. We also launched several new mobile game titles. For publishing title, we launched Top of Tanker, HeroxHero and Tian Long Ba Bu, and for in-house title we started servicing Mabinogi Duel.

Revenues for our Japan business were JPY5.5 billion, a 29% decrease versus a year ago. Mobile revenues were JPY4.1 billion, a 32% decrease year-over-year and a 9% decrease quarter-over-quarter. Our both native and

browser game revenues decreased quarter-over-quarter. The rate of decrease for browser games was less than that of native games.

In the second quarter, we launched LINE Cross Legion, the Japan service of Legion of Heroes, a popular mobile game in Korea. PC online revenues were JPY1.4 billion, down 19% year-over-year and up 1% sequentially.

Revenues in North America were JPY2.8 billion, a 149% increase versus a year ago on an as-reported basis, and a 109% increase on a constant currency basis. The launch of the mobile game, DomiNations, greatly contributed to Q2 revenue growth in North America. DomiNations began service on April 2 and achieved over 10 million cumulative downloads to date.

Our PC online game business also performed well with its key titles, such as MapleStory, Mabinogi, Vindictus and Dragon Nest, all showing a year-over-year growth. Our new PC online game is also off to a good start. Dirty Bomb was released into Open Beta on June 2 through Steam, a platform provided by Valve and has been well received by users.

Our revenues in Europe and other regions were JPY2.2 billion, an 88% increase versus a year ago on an as-reported basis and a 68% increase on a constant currency basis. As in North America, the revenue growth in Europe and other regions was also driven by mobile game, DomiNations.

Now, let me turn to our Q3 outlook. For the third quarter of 2015, we expect revenues in the range of JPY46.3 billion to JPY49.7 billion, representing a 2% to 9% increase year-over-year on an as-reported basis. We expect operating income to be in the range of JPY14.3 billion to JPY17.3 billion. We expect net income to be in the range of JPY12.9 billion to JPY15.3 billion.

In China, for third quarter revenues, we expect low teens to 20%-plus year-over-year increase on an as-reported basis.

Our key PC online game, Dungeon&Fighter, received a summer update on July 2. The National holiday update is also scheduled for the latter half of September. As for mobile games, we'll be launching new titles, including Pocket MapleStory during the quarter. In Korea, we anticipate high single digit percent year-over-year decrease to low single digit percent year-over-year increase on an as-reported basis for the third quarter revenue.

MapleStory2, a new internally developed PC online title was launched on July 7. MapleStory2 is showing strong performance soon after its launch and it is already among the top-ranking titles on PC Café Rankings. On the mobile side, we launched our internally developed title, Gwangaeto the Great, on July 9. In addition, the launch of DomiNations in Asia including Korea as well as service of new publishing titles such as CROSS SUMMONER, are also scheduled.

Despite these exciting launches in Korea, we are expecting revenue in the region to be flattish simply due to the difficult comparison to last year's third quarter. Having said that, both our PC online game and mobile game business are performing very well in Korea.

In Japan, we expect third quarter revenues to decrease 30%-plus year-over-year on an as-reported basis.

On mobile side, MapleStory Pocket was launched in August. In addition, DomiNations is also scheduled for launch.

In North America, we expect to see a year-over-year growth of over two times on an as-reported basis. In Europe and other regions, we expect to see a year-over-year 50%-plus increase on an as-reported basis. In North America, Europe and other regions, BEASTS VS. BOTS and Super Senso, which are new mobile games, developed by strategic partner studios are scheduled for launch.

In third quarter, we expect an operating margin in the range of 31% to 35% representing a slight decrease or increase year-over-year. As I've mentioned earlier, we expect a decrease in variable costs, including royalty costs associated with third-party IPs from the higher levels of last year's Q3, which was impacted by FIFA Online 3 and FIFA Online 3 M, and a decrease in amortization expense due to completion of amortization associated with Dungeon&Fighter IP in August. On the other hand, we expect an increase in HR costs mainly due to increased headcount and a significant increase in marketing costs due to our launches of multiple new PC and mobile titles.

Lastly, I'd like to give a quick update on the 2015 interim dividend. We are scheduled to pay out a dividend of JPY5 per share to shareholders registered on our shareholder register as of June 30.

Now, we'll be happy to take your questions.

Maiko Ara

Head-Global Investor Relations

Thank you, Uemura-san. Next, we will 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

Deutsche Securities Korea Co.

Hi, guys, thank you very much for the call. I just had maybe three or four questions if I may. First off, I just wanted to discuss guidance, I wasn't quite sure if we have some of your new games that haven't been released yet and whether that's included into the guidance, so things like DomiNations you've mentioned that it's coming out in August, just wondering if that's been made into the guidance numbers?

Q

Maiko Ara

Head-Global Investor Relations

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

A

Shiro Uemura

Representative Director & Chief Financial Officer

Hi, Han-Joon. [Foreign Language] (24:22 – 25:03).

A

Thank you very much. Uemura would like to answer your question. Regarding our Q3, we will be launching new titles and also there are new titles that have been released in Q2. And in a reasonable extent, we have factored in those numbers into our guidance. And regarding DomiNations, we looked at the recent trend and factored that into our Q3 forecast. And since the new titles haven't been launched yet, we're not able to read between the lines

and incorporate strong numbers pertaining to those new titles. Therefore, we took a reasonable step in incorporating them as well in our guidance.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Can you just elaborate on that a little bit. So, I agree I mean it's hard to predict what games might do. So what is the type of framework you do to make that into your guidance. Do they cast what's been achieved in recent market and try to ascribe that to here, I mean do you like the relative market size I mean when is that procedure you take, if you can just give us an insight as to how you come up with your guidance numbers?

Maiko Ara

Head-Global Investor Relations

A

Thank you very much. Please, give us a moment while we translate.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Sure.

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

Hey, Han-Joon, this is Owen. Thanks for your question. Probably, it might be faster if I just answer. The general answer to your question is that when we have a title that is coming up, we look at it; we basically have our local teams look at it. They've played a game a lot of course and then we factor in, of course, market size, how we think the game will resonate with the market and how similar games have done. What's different and a variety of different factors and then we make a forecast based off of that.

We don't apply a straight-up sort of formula-like approach to this. It's really based off of how we think the game will resonate in the market. Now, of course there is a lot of – there is a degree of a large number of unknowns before you launch a game. So really what we're doing is making an assessment of game quality and about resonance with the market.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Okay. That's fair. That's good. Thank you very much. So the follow-up question is so, 2Q in terms of marketing, we spent quite a bit, depending on DomiNations and 3Q if we had to think about where we have or want to be spending money, it's very clear we spent some money on MapleStory2 when we launched it, seems like we're doing some spending for DomiNations out in Asia as well. What are the stuffs we'd be expecting and how should we be thinking about the magnitude of marketing budget in 3Q relative to 2Q?

Maiko Ara

Head-Global Investor Relations

A

Thank you for your question. Please give us a moment while we translate.

Shiro Uemura

Representative Director & Chief Financial Officer

A

Regarding our marketing cost allocation in Q3, we will have multiple new titles. Therefore as a form of investment, we plan to have marketing costs for those new titles. And also regarding DomiNations, it is a very high quality good game and we would like to expand our user base. Therefore, even in Q3, we plan to spend the bulk from marketing costs for DomiNations as well.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Okay, understood. Next question is D&F Mobile. Can you just give us some update on where we are? Are we still looking at a year end potential release? Yes, if you could just walk us through whether there's going to be one or two closed B testing, how we think about the progress towards commercial launch and when that might be helpful?

Shiro Uemura

Representative Director & Chief Financial Officer

A

As already announced, Dungeon&Fighter Mobile will be published from Tencent in 2015. Therefore, right now, we are putting our throughput efforts in the development as well as necessary adjustments that must be made. Once we know something more concrete, we would like to disclose that on a timely basis.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Okay, great. My last just question is your Japan business. So unfortunately, I think, it's the part of the business that could probably use a little bit more work and strategizing. So if you could just walk us through how we're trying to get that done, I think that'll be good?

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

Yes, Han-Joon, it's Owen. So just by way of background, so first of all, yes, the Japan business has continued to disappoint us. We continue to think there's a large opportunity in Japan. And we are therefore working very hard as a management team to make sure that our Japan businesses is in much better shape than it has been recently.

We think about – if you look back over the last year and quarters, a new management team came aboard, we set out a very simple strategy that I think you're well familiar with because we talk about it every quarter, but it's a focus on quality of both new games and then live game development and operations. And in the areas in a world that we have followed that strategy – we've been able to execute against that strategy well, we've done very well.

Our business performance has shown that. Examples are Korea, where our business is significantly stronger than it was two years ago or 1.5 years ago. And another good example of that is North America, where our business had been on the decline. If you recall – oh, and North America has been coming up nicely. But if you recall a year ago, we had a similar frustrating several quarters in North America. And what we said at the time when asked was actually what we need to do is fix the engine, that is the blocking and tackling that the day-to-day work of live game operations and marketing. And those are easy things to say, but very hard to do in execution.

So the answer to your question is about 1,000 really small, but very, very important things about live game operations and that's across both our PC business and our mobile business. But we are confident in our ability to do that, because we've done it several times in the past as management team and we feel like we know what the issues are. So the answer to your question is nothing really heavily about strategy other than to follow closely the strategy that we set worldwide, it's all about execution.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Yes. Thanks Owen for that and kind response. If I just may be just press your buttons a little bit, I mean, I think Korea we've definitely invested a lot of resources to get that up and working quite well. I think, to your point about the U.S. and Europe I think, we've had some restructuring there, but those really grow recently mostly thanks to some of the strategic investments that have been made over the course of the year.

So it was probably a little less about capital – issuing capital infusion there. So if we look at Japan, I feel like we've had some attrition there, we are probably going to have some attrition in the head count there. So we are talking about really booking up on the development team to really get that working up and running well or you're talking more about type of process that we adopted in the Western markets and try to may be bring some of the titles and publish them into Japan?

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

Well, Han-Joon, I'm not sure I really understand the premises of your questions on neither talking about Korea and North America nor on Japan. In Korea and North America, both are existing games; games that have been in existence for several years. Those games have been doing in most cases quite nicely since the changes that we made and then we've been introducing new games on top of that.

So that's about both execute – that's in large part about execution. Again when you are talking about live game operations, we think about it's sort of like fixing the engine out of a car. You need to fix the engine before you drive it across the country and if you introduce new games into a group that is not prepared for those games, then you're not going to get very much success. And over that 20 years that we've been doing online and free-to-play games, we've learned how incredibly important execution is of live games. So we think that that's very important in Japan as well.

So, that is what we are focused on. It's a prerequisite and very critical to do and it's, frankly, it's about day-to-day execution. So we're making the required changes that put us in a much better position. And as I said, we're very confident in our ability to do that, because we've done it several times especially in the last year and a quarter.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Okay. So, I appreciate that. And maybe I should have rephrased, so I'm coming from the assumption that browser market is just going through a decay process and that most of group's revenues will continue to decay, but it seems like you're not from that view there is room for turnaround in the browser business?

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

Well, I think you're starting to put words in my mouth, Han-Joon. I think that the browser market has clearly been shrinking as an overall market, but it continues to be very large and we think that we have a great place in that market and our teams execute well there, that's one area of our business. Another area of business is in new game development, we're focusing certainly on that part. And then the third is effectively publishing all the games that we have coming from our worldwide studios as well as from our partners. So, each of those three are important to us, and we're focused on all three of those.

Han-Joon Kim

Deutsche Securities Korea Co.

Okay. Understood.

Q

Owen Mahoney

Representative Director, President, Chief Executive Officer

Hopefully that answers your question.

A

Han-Joon Kim

Deutsche Securities Korea Co.

Yes. It does. Thank you very much.

Q

Operator: [Operator Instructions]

Maiko Ara

Head-Global Investor Relations

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 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 with 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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