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NEXON Co., Ltd. (3659.JP)

Q3 2014 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to Nexon's 2014 Third Quarter Earnings Conference Call. Today's call is being recorded.

At this time, I'd like to turn the call over to Mr. Shumpei Kumagai, Head of Investor Relations. Please go ahead, sir.

Shumpei Kumagai
Head-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 condition, such as revenues attributable to our key titles; growth prospects, including with respect to the 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 the forward-looking statements. Information on some of these risks and uncertainties can be found in our earnings related 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 the Q&A session.

A recording of this conference call will be available in our Investor Relations website www.ir.nexon.co.jp/en/ following this call. Unauthorized recording of this conference is call not permitted.

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

Owen Mahoney

Representative Director, President, Chief Executive Officer

Thank you, Shumpei, and thank you all for joining us today. As you know, following the executive changes we announced in March, we laid out several new initiatives to put a laser like focus on improving game quality including live development as well as new titles. We strongly believe that improving game quality by making our games more fun to play and highly differentiated from other games in the market is what drives player adoption, and in turn drives profitability and long-term growth for Nexon.

As we reported our third quarter results today, I'm pleased to say that we are making excellent progress. I'd like to give you some highlights of our strategic momentum.

First, we've had great traction in Korea. As Uemura-san will describe in more detail shortly, Korea delivered another quarter of strong results in Q3. I'm most pleased about the strong focus and execution by the team there, which is translating into solid financial performance.

An example is in the mobile business in Korea. A year ago we had an insignificant presence in the mobile market. In just one year, we moved from very low rankings to the point where we are consistently delivering games that rank high on the Korean top grossing mobile game ranking. As a company, we ranked second in December (sic) [September] on App Annie in both downloads and revenue.

And consistent with our overall strategy and approach, these strong results in mobile are not coming from short-lived casual games, but from immersive games that provide deep and rich experiences, games that people play and enjoy for months and even years.

Second, I want to call out our progress in China. As you're all well aware, we saw a significant decrease in MAUs from Dungeon&Fighter beginning around the second half of last year. We're happy to report now that in Q3 2014, Dungeon&Fighter posted a slight quarter-over-quarter increase in MAUs. It's too early to say if this is the beginning of a new trend, but it is the third quarter in a row in which MAUs for D&F in China have been stable. I'm very pleased with the progress that China team has made to stabilize D&F this year.

And third is the pipeline of new games. Our pipeline both in Asia and the West continues to grow through our own development activities and through partnerships. We're very excited about both the quality and the quantity of our pipeline with the upcoming titles such as MapleStory 2, Sudden Attack2, Ghost in the Shell online for PC and Durango and DomiNations for mobile, all of which we are planning on launching in 2015. We believe this is our strongest pipeline of titles in several years, as we continue to focus on improving quality and delivering more fun and the unique game experiences.

As most of you know, G-STAR, the largest game exhibition in South Korea will be held next week in Busan. We'll have a lot to announce in the show, and as we move into 2015, about our pipeline for both PC and mobile.

So we're very pleased with the progress and the execution against the plan we've laid out. Having said that, we also continue to aggressively address some challenges we've had. In particular, I'd like to make you aware of two

upcoming items. Uemura-san will talk about them both in a little more detail. First is the possibility that we will be taking an impairment charge of gloops' goodwill. gloops has been putting great effort into preparing new native games for launch. At the same time, it's financial performance has suffered as gloops has made a transition from browser to native and as the market has continued to evolve.

As a result, subject to the performance of new launches in the next few months, we want to let you know that there is a possibility that we may have to take an impairment on gloops' goodwill in Q4. Related to that, if we end up taking an impairment on gloops' goodwill, there is a possibility that retained earnings in Nexon Japan corporate entity could be reduced to the point where we may not be in a position to pay the ¥5 per share dividend at year-end. Uemura-san will provide more detail about this in a moment. We'll update you on these two matters as soon as we can.

Nonetheless, I would like emphasize that as the results of this quarter indicate, our underlying business remains strong, our ability to generate cash remains strong and our desire to return value to our shareholders remains unchanged.

With that, now I would like to turn the call over to Uemura-san to take you through third quarter results and fourth quarter outlook.

Shiro Uemura
Chief Financial Officer

Thanks, Owen. Now, let's move on to the Q3 results. Revenues were ¥45.6 billion up 14% on an as-reported basis, and up 3% on constant currency basis. Operating income was ¥15.1 billion, down 7% year-over-year.

Operating margin was 33%. Our third quarter revenues and operating income both exceeded the high end of our outlook. The revenue outperformance was primarily driven by exceptional strong results from Korea, in late August and into September.

The operating income outperformance was the result of three main factors. The first was again the strong result from Korea. The second was less spending on marketing, which resulted from the delay in some new title launches, including gloops new native games. The third was lower than expected HR costs due to a smaller increase in head count than we had planned for.

Net income was ¥13.6 billion, up 69% year-over-year. The increase in net income was due primarily to the foreign exchange gains from the weaker yen in foreign currency-denominated cash, deposits, and accounts receivable.

Overall revenues have continued to maintain high growth rates. Third quarter mobile revenues were ¥9.7 billion, which exceeded the high end of our outlook. We were up 41% year-over-year. Native games have greatly contributed to the growth of our mobile revenues. Native games revenues were ¥4.8 billion, up 50% quarter-over-quarter, and up 472% year-over-year. Major titles with particularly significant contributions on native games serviced in Korea. Including FIFA Online 3M, Legion of Heroes, Legion of Heroes for Kakao, and Three Sword Heroes. With the strong performance of native games in Korea, in particular, native revenues accounted for about half of our third quarter mobile revenues.

Turning to our selected performance metrics for PC online games. Total MAUs for the third quarter were 52.7 million, a decrease of 16% year-over-year, and the increase of 2% quarter-over-quarter. The year-over-year MAU decrease was primarily due to the significant drop from Dungeon&Fighter in China relative to Q3 and Q4 last year. But as Owen mentioned, we did see a flat sequential rate increase in China Dungeon&Fighter MAUs, which

is encouraging. The slight quarter-over-quarter increase in our overall MAUs was primarily due to strong seasonality in Korea driven by the summer vacation season. In addition, we benefited from a continued tailwind from the FIFA World Cup in Brazil. Our pay rate remained stable, down 0.7 percentage points from a year ago to 9.7%, and down 0.5 percentage points from 10.2% in Q2.

Our ARPPU was ¥3,476 up 42% versus a year ago. Our constant currency ARPPU was ¥3,270, up 34% versus a year ago. The ARPPU increase was primarily driven by trends we are seeing in Dungeon&Fighter in China. As you likely recall, Dungeon&Fighter MAU declined in second half of 2013, and the user base shifted to a core group of users. Core players typically spend more on in-game purchases, and as such we are seeing ARPPU increase. As most of you know, we're very conscious of avoiding over-monetization and are highly focused on driving user engagement and the longevity.

Continuing with third quarter regional highlights, our revenues from the China business were ¥15.7 billion, down 2% year-over-year on an as-reported basis, and down 13% on a constant currency basis. Dungeon&Fighter finished close to the high-end of our outlook. We launched two large scale Tier 1 updates for Dungeon&Fighter in China during the third quarter. Specifically the July update geared towards the summer vacation and the September update launched before the holiday season [ph] celebrating the funding of PRC (12:05).

Again, third quarter Dungeon&Fighter MAUs slightly increased quarter-over-quarter, marking the third quarter in a row that they have remained stable.

Revenues from the Korean business were ¥20.0 billion, up 64% year-over-year on as-reported basis and up 45% on a constant currency basis. This strong performance in Korea was primarily driven by three factors. First, both FIFA Online 3 and FIFA Online 3 M showed strong performance in the third quarter largely due to increased profit resulting from the World Cup held from June to July. In addition, there is a holiday season in Korea in September called Chuseok, which has pushed FIFA Online 3 to its highest ever monthly sales in September. FIFA Online 3 M also now consistently ranked among Google Play Top 10 Grossing in Korea.

The second factor in Korea was our existing PC online games, titles such as Mabinogi Heroes, MapleStory and Dungeon&Fighter showed strong performance in the third quarter. Mabinogi Heroes in particular had a new character updated in July named Arisha who became very popular. Although, five years have passed since the launch of Mabinogi Heroes, the title recorded a highest ever monthly sales in August.

The third factor was mobile games. During the quarter, we began servicing Legion of Heroes on KakaoTalk on July 29. The game was originally serviced directly to Google Play. The version serviced to KakaoTalk alone exceeded 1 million downloads in three weeks. Direct service to Google Play and service to KakaoTalk combined have exceeded 4 million cumulative downloads to date. In addition, Three Sword Heroes was launched on July 8. It has exceeded 1 million cumulative downloads to date. It consistently ranks near Google Play's top 30 of the top grossing ranking.

Revenues from our Japan business was ¥7.2 billion, a 17% decrease versus a year ago. Mobile revenues were ¥5.6 billion, a 14% decrease versus a year ago. While native game revenues increased quarter-over-quarter, this was offset by continued decline of browser game revenue quarter-over-quarter. And overall mobile revenues were down 7% quarter-over-quarter. PC online revenues was ¥1.7 billion, down 27% year-over-year and down 2% quarter-over-quarter.

Revenues in North America were ¥1.4 billion, a 4% increase versus a year ago on an as-reported basis and a 1% decrease on a constant currency basis. We have been concentrating our efforts on improving the user experience for our existing titles in North America to further differentiate them in the market. These efforts have resulted in a

turnaround for titles such as Mabinogi and Vindictus in North America. Our North American revenues went from negative to positive growth on a constant currency basis in both August and September.

Our revenues in Europe and other regions were ¥1.3 billion, a 21% decrease versus a year ago on an as-reported basis, and 28% decrease on a constant currency basis. For the fourth quarter of 2014, we expect revenues in the range of ¥39.1 billion to ¥42.1 billion representing a 14% to 22% increase year-over-year on an as-reported basis.

We expect mobile revenues in the range of ¥8.7 billion to ¥9.9 billion, representing a year-over-year increase of 30% to 48% on an as-reported basis, and a quarter-over-quarter decrease of 10% to increase of 3%. We expect operating income to be in the range of ¥8.5 billion to ¥10.9 billion. We expect operating margin in the range of 22% to 26%. We expect net income to be in the range of ¥6.4 billion to ¥8.1 billion.

In China for fourth quarter revenues, we expect a year-over-year low teens to 20-plus percentage increase on an as-reported basis. Dungeon & Fighter is scheduled to receive a tier 1 update called the Kunoichi update.

In Korea, we anticipate year-over-year 30-plus percentage to 50-plus percentage increase on an as-reported basis for fourth quarter revenue. Several native games for mobile devices are scheduled to launch in Q4 in Korea. This include a first-person shooter game, Sudden Attack M, a strategy game, Super Fantasy War, and an action RPG Pocket MapleStory.

Native games for mobile devices that are already directly serviced on Google Play are also scheduled to launch on KakaoTalk, including Perfect Line-up for Kakao among others. As you know, we have focused our efforts on enhancing our pipeline with a commitment to game quality, entertainment and creativity. And we are looking forward to announcing multiple high quality PC online and mobile titles at G-STAR.

In Japan for fourth quarter revenues, we expect a year-over-year 20-plus percentage to high teens percentage decrease on an as-reported basis. [ph] Smartphone (18;33) native games for mobile devices are set to launch in Japan during the fourth quarter and into 2015.

On October 9, at LINE Conference Tokyo 2014, LINE announced that line Legion of Heroes, the service of Legion of Heroes for Japan is scheduled to launch. On October 29, Nexon Japan began servicing Soul Slash SAGA, a native game for mobile devices. The title has already exceeded 200,000 downloads. On October 15, gloops laid out its strategy for the smartphone market and announced that six new native games including Skylock are scheduled to launch. Skylock was launched on October 28, and its TV commercial will start from November 14. In addition gloops is preparing to launch titles such as Toys Drive and Summon Soul Battle including pre-registration on some titles.

In North America for fourth quarter revenues, we expect to see a year-over-year 20-plus percentage to 30-plus percentage increase on an as-reported basis. In Europe and other regions for fourth quarter revenues, we expect to see a year-over-year single-digit percentage decrease on an as-reported basis.

In the fourth quarter, Legion of Heroes was launched in English speaking regions including North America. In the fourth quarter, we expect our operating margin in the range of 22% to 26%. You may recall that we recognize ¥9.5 billion as impairment loss for goodwill on subsidiaries and intangible assets in the fourth quarter of 2013. As a result, our fourth quarter 2013 operating income was ¥327 million. Adding back the impairment loss which is a one-time cost, the fourth quarter of 2013 adjusted operating income was ¥9.8 billion. The high end of our operating income outlook for the fourth quarter 2014 is ¥10.9 billion representing a year-over-year increase of ¥1.1 billion from the fourth quarter 2013 adjusted operating income.

While we expect our operating income to grow year-over-year, we also expect a year-over-year increase in operating expenses driven by three factors. First, we expect an increase in variable costs as result of our forecasted revenue growth, namely royalty costs associated with third-party licensed games, particularly FIFA Online 3 and FIFA Online 3 M and platform fees related to mobile games. Second, we are forecasting an increase in HR costs related to salary increase and grant of stock options. And third, we expect an increase in marketing costs related to new title releases in Japan and the U.S.

Lastly, I'll try to provide a little more detail regarding two items that Owen touched upon earlier. First, the impairment of the gloops' goodwill. The mobile game market in Japan has changed significantly as gloops became a wholly owned subsidiary of Nexon in October 2012. In particular, the rapid growth of native games and the declining of browser games have got more rapid decline than we had initially expected.

As I just mentioned, on October 15, gloops announced that it would release six new native games. Preparation for those launches are currently underway. To the extent these launches are successful, we may not need to take an impairment. But based on our experience with prior launches in Japan, we felt it was prudent to alert our investors to the possibility of our impairment. It's premature to provide you with detailed estimates for the financial impact in the event of an impairment loss is recorded.

For reference, gloops' goodwill was about ¥31 billion as of September 30, 2014. And if we do take an impairment charge, a part of this amount will be subject to impairment loss. In addition, we acquired gloops for total of ¥36.5 billion in 2012. In the event, we record an impairment loss, we would have to recognize it, not only in the Nexon group's consolidated accounting but also in the Nexon Japan corporate entities accounting.

Our source of funding the dividend is the retained earnings of the Nexon Japan corporate entity. Therefore if an impairment loss is recorded, it may impact the retained earnings of the Nexon Japan corporate entity and thus presented the possibility that we cancel the ¥5 billion dividend currencies scheduled for year -end 2014. We will inform our investors in a timely manner in the event the year-end dividend is cancelled due to our recognition of gloop's impairment loss.

As Owen mentioned in his opening remarks, the underlying business and its cash flow generating capabilities remain strong, as does our desire to return value to our shareholders.

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

Shumpei Kumagai

Head-Investor Relations

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 come from Mr. Han-Joon Kim from Deutsche Bank. Please go ahead.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Great. Thank you very much for the call. If I may, can I just ask three questions and first one being, I've noticed in your presentation that you have ¥103.92 as your Japanese yen to the dollar as currency assumption for 4Q. I think the yen has depreciated quite more in recent days. I just wanted to get a sense as to why that is the basis of your currency?

Shumpei Kumagai

Head-Investor Relations

A

Okay. We got a question, please wait a moment. Okay, so we will answer in Japanese and we'll translate it into English.

Shiro Uemura

Chief Financial Officer

A

[Foreign Language] (27:10-27:33)

Thank you very much for your question. In terms of your question, I do understand that if we came to FX rate, as far as our Q4 exchange rate to a dollar is concerned we use our figure for July to September, that being the case to \$1 we assume ¥103.92.

Shumpei Kumagai

Head-Investor Relations

A

Does that answer your question?

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Sorry. Did you say that it was based on the historical rate for 3Q, so you just basically – and that's the practice that you used to factor it into 4Q. So if that's the case, if the currencies stays at the current level that it does, then does that cause upside risk to your numbers?

Shiro Uemura

Chief Financial Officer

A

[Foreign Language] (28:35-28:48)

Yes you are right. We are using the average exchange rate that was registered during the month of July to September, therefore depending on how the exchange rate fluctuates vis-à-vis dollar, it is indeed too that there might be some changes.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Understood. Thank you. If I may move on to my second question, could you help us identify the timing of your launch for Legion of Heroes online in Japan?

Shiro Uemura

Chief Financial Officer

A

[Foreign Language](29:29-00:29:47)

As mentioned in the presentation regarding Legion of Heroes, we will be launching it [ph] by LINE (29:56) here in Japan. But regarding the actual date of the launch, we haven't specified, but today, we hope that we will be able to launch it sometime in the early part of next year.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Okay. And my last question just pertains to your recent increase in stake acquisition in NCSOFT. While it is a small stake, I mean you guys did have to go to the Fair Trade Commission to get the approval for it. So there seemed a lot of work for a fairly small portion of the company to add. And just let us know what kind of process – thought process went into that? And that will be very much appreciated.

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

This is Owen. Our thought process was that we continue to be very much fans of the development teams at NCSOFT. And we're fans of the IP venture they have. We have not been able to affect the kind of strategic deal that we had hoped for, but we've also observed the price movement in the stock has been disappointing, and we felt that it was opportunistic at the time. We had already been bumping up against the threshold that which would require us a filing, so we knew we might have to do eventually if we wanted to increase our share. So that was what was going on there.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

So if I just maybe add a question to that. I'm sure the company has a lot of priorities on its cash usage. I guess, how should we be thinking about the priority that you placed on NCSOFT vis-à-vis perhaps some interest in other mobile studios, smaller mobile studios or it may be some U.S. studios to invest into and so forth?

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

Well, I guess, what I'd say in answer to your question is they're independent and they're certainly not – those types of opportunities are not mutually exclusive. There are a lot of small and independent mobile studios around the world for us to look at. And including in the U.S., we of course are, as you know, very value oriented, and we're also very clear about what our objectives are relative to the types of games that we want to build.

A vast majority of the kinds of game companies that we look at around the world, don't make the kinds of games that we believe in. And we have a very specific strategy about the types of games that we want to build and bring to market. We think that that strategy is certainly this quarter been proven out or the beginnings of that are being

begun to be proven out in games such as Legion of Heroes and Soul Slash SAGA in Japan, and FIFA Online in Korea, and now Pocket MapleStory in Korea.

So the large number of companies that you see don't make the kinds of games that we like to make for mobile, and we think again that our strategy will be proven out over time. And we certainly don't think that our NCSOFT investment is mutually exclusive with those.

Han-Joon Kim

Deutsche Securities Korea Co.

Q

Understood. Thank you very much.

Owen Mahoney

Representative Director, President, Chief Executive Officer

A

Thank you.

Operator: Our next question comes from [ph] Mr. Luigi Limentani from Point 7 2 (33:26). Please go ahead.

Q

Yes. Hi, guys. Good evening. And a quick question on Q4. The growth you're expecting from your Korean operation, in terms of platform, is it fair to expect the same breakdown as we saw for Q3, that is, if we look at the incremental rate of sales, for at least 60% came out of PC and 40% of mobile, do you expect the same breakdown for Q4?

Shiro Uemura

Chief Financial Officer

A

[Foreign Language] (34:17-35:00)

Thank you very much for your questions. I do understand that your question pertains to the Q4 growth in Korea regarding PC as well as mobile. And you want to know, which of the two will be the driving force to register growth in Korea. And my answer will be, both will be driving the growth in Korea. In terms of PC, it is growing even year-over-year, and regarding mobile, Nexon's mobile games did not have much presence last year. About this year, we are growing, and we do believe that that momentum will continue in Q4 as well.

Q

Thanks. And one more question. Again looking at Korean mobile in Q3, can you give us any color as to whether on a Q-on-Q basis the incremental revenue you had, what kind of percentage came from your own titles, Legion of Heroes in particular and what percentage came from licensed games? Thank you.

Shiro Uemura

Chief Financial Officer

A

[Foreign Language] (36:13-36:53)

Regarding mobile revenue, it grew from Q2 and the driving force of this growth can be contributed to two major titles, one being Legion of Heroes and another one being FIFA Online 3 M. And especially in terms of FIFA Online

3 M because of the World Cup, it acted as the tailwind, which further fostered the growth of FIFA Online 3 M. And as far as the Legion of Heroes is concerned, initially, we had direct publishing only, but we added KakaoTalk as well. Therefore, the addition of yet another platform actually drove the further growth of mobile.

Shumpei Kumagai
Head-Investor Relations

A

Hope, this answers your question.

Q

Thank you.

Operator: [Operator Instructions]

Shumpei Kumagai
Head-Investor Relations

Thank you. So if there are no further questions, I'd like to take this opportunity to thank you for your participation in this call. Before, our wrapping up this call, I just would like to make one amendment to the earlier statement. So earlier, we mentioned that in Korea, we became a number two download and grossing company in December, but actually it was in September. So I'd like to amend that statement.

So 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 you later 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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