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NQ - Q3 2016 NQ Mobile Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the NQ Mobile third quarter 2016 results conference call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question and answer session.

(Operator Instructions). I must advise you that this conference is being recorded today, Thursday, December 1, 2016. I would now like to hand the call over to your first speaker today, Ms. Dahlia Wei, Director of Investor Relations of NQ Mobile.

Thank you. Please go ahead.

Dahlia Wei - NQ Mobile Inc - Director of Investor Relations

Good evening and good morning in Asia. We welcome you to NQ Mobile's conference call to discuss the financial results for the third quarter of 2016.

On the call tonight is our Chairman, Dr. Vincent Shi; our CEO, Mr. Zemin Xu; our President, Mr. Justin Chen; our CFO, Mr. Roland Wu; and our Vice President of Capital Markets, Mr. Matt Mathison. We thank you for joining us.

Before we begin, here is our Safe Harbor disclaimer. Please note that the discussion today will contain certain forward-looking statements made under the Safe Harbor provision of the US Private Securities Litigation Reform Act of 1995.

These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from our current expectations. NQ Mobile does not assume any obligation to update any forward-looking statements except as required under applicable law. Also, please note that some of the information to be discussed includes non-GAAP financial measures as defined in Regulation G. The most direct comparable US GAAP financial measures and the information reconciling those non-GAAP financial measures to NQ Mobile's financial results prepared in accordance with US GAAP are included in our earnings release posted earlier today.

Finally, as a reminder, this conference call is being recorded. We are also offering investors a webcast of today's conference call, which can be found on the Investor Relations section of our website, at ir.nq.com. I will now turn the call over to Matt.

Matt Mathison - NQ Mobile Inc - VP Capital Markets

Thanks, Dahlia. We thank you all for joining us today. The call is going to go as follows.

Justin is going to first provide you with an update on the FL Mobile divestment, our chief executive officer, Mr. Zemin Xu, is going to make some remarks. I will then provide an update on our businesses and operating trends, and our CFO, Mr. Wu, will then review the financials and outlook.

We will then open the call up for Q&A. Justin, go ahead.

Justin Chen - NQ Mobile Inc - President

Thank you, Matt. Thank you everyone for joining us today.

I want to provide you with a summary on where we stand with our FL Mobile divestment in light of the several developments and announcements made over the past month.

As announced at the beginning of November, the company and all parties involved terminated the Shenzhen Prince transaction due to regulatory uncertainty and the changing capital markets situation in China. Following this termination, there were two other changes that we announced about a week ago. As previously disclosed, both the agreement with Dr. Shi and his 22% purchase and the agreement with the Xinjiang Yinghe, the affiliate of the management of FL Mobile on their 12% purchase had the option to request the reversal of this transaction under certain conditions, including not obtaining the necessary government approvals to close the FL Mobile divestment.

Accordingly and after the termination of the agreement with the Shenzhen Prince, the Company agreed to reverse the transaction with Xinjiang Yinghe completely and take back the 12% equity interest in FL Mobile and also partially reverse the transaction with Dr. Shi and take back 5.66% of the 22% total equity interest in FL Mobile from him.

Following this update and changes, let me clearly detail the current status of the FL Mobile divestment. The Company had sold 16.34% equity interest in FL Mobile to Dr. Shi for a total consideration of RMB653.6 million, which is proportionally adjusted total of the initial 22% stake for RMB880 million. The Company had received 50% of this consideration for a total of RMB326.8 million, with the remaining 50% due to us at the closing of the FL Mobile divestment.

Since the Company already had received RMB440 million which represented 50% of the initial RMB880 million total for 22%, the Company will return to Dr. Shi, RMB113.2 million to proportionately adjust the correct amount.

Both the Company and Dr. Shi have the right to request to reverse the transaction if certain closing conditions are not met.

The Company had sold 13.13% equity interest in FL Mobile to Jinxin Hengrui for a total consideration of RMB656.5 million. The Company has received RMB525.5 million. The Company had sold 3.53% equity interest in FL Mobile to Jinxin Haoyue for a total consideration of RMB176.5 million.

The Company has received RMB105.9 million. The Company had sold 3% equity interest in FL Mobile to Jinxin Huatong for a total consideration of RMB150 million. The Company has received RMB90 million.

And finally, the Company has sold 1% equity interest in FL Mobile to Tibet Zhuohua for a total consideration of RMB50 million. The Company has received RMB30 million.

In summary, the Company has sold 37% equity interest in FL Mobile for a total consideration of RMB1.687 billion and retained 63% currently. The Company has so far received RMB1.078 billion of the proceeds to date.

This is the most up to date information. The Company is moving ahead and focused on reaching a conclusive decision regarding the divestment. We look forward to providing you with this information shortly and are working to reach a conclusion as soon as possible.

Now, let me turn the call over to our CEO, Mr. Xu.

Zemin Xu - *NQ Mobile Inc - CEO*

Thank you, Justin. Hello, everyone, and thank you for joining us. I'm very pleased at our continued solid performance in our business during the third quarter.

While the FL Mobile divestment remains a major focus, we have continued to go about our day-to-day work. We look forward to finishing 2016 on a strong note and we will continue to share our progress with you. Thank you.

Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

Thanks, Zemin.

And thank you, Justin, for that clear summary of the entire FL Mobile divestment given the many recent updates. It is taking much longer than anyone could have anticipated and we have actually executed and delivered on a significant portion of the divestment so far, and received a significant amount of cash considerations so far. Having said that, I'm a big believer that things happen for a reason. And while the uncertainty and the regulatory environment and the changing capital market dynamics in China certainly created lengthy delays and ultimately lead to the change, we continue to move forward. In fact, one of the outcomes of this entire process is that it has been very visible by more and more investors.

We set out to unlock the value of the FL Mobile business for our shareholders, and we continue to be on that path. To monetize these businesses and then to in turn, use that significant cash to enhance shareholder value through buybacks and to be in a stronger financial position to invest in the future.

This is what we intended on doing and this is what we continue to do.

As Justin just mentioned, we are working to move as quickly and swiftly as we can to reach a conclusion on the FL Mobile divestments and we hope to be able to share this with you soon.

Now, stay tuned.

Over the past year, we have also executed on many of our other business objectives. We reached a new record level within our mobile value-added services or MVAS segment in the third quarter and we saw strong year-over-year growth again, led by a solid FL Mobile performance and a record performance by Showself.

Let me provide you with a more detailed discussion about our FL Mobile businesses. I would characterize the performance of our gaming business in the third quarter as solid. Many of our legacy titles continue to contribute in a stable manner. While our newly launched games performed in line with our expectations.

In addition, we highlighted the successful launch of the Legend of Three Kingdoms during our second quarter conference call. That game launched right at the end of the second quarter. This game performed well in the third quarter and we expect it to continue in the fourth quarter.

In addition, after FL Mobile consolidated the Hetu subsidiary, the overseas business continues to perform solidly and the geographic expansion is added to the overall business performance. Finally, we continue to see a strong pipeline of games going forward.

As for the advertising segment, the third quarter was in line with our expectations. This quarter saw a continuation of the solid trends from last quarter which included an expansion of our ad network business in overseas channels, the solid performance of our recently consolidated Launcher subsidiary, and the improvement of the monetization of some of our other applications with third party app referrals.

Let me now provide you with a more detailed discussion about our Showself businesses. The live mobile social video market in China is still a hot market and we are performing well in this market. In fact, we have well exceeded our expectations with the run-rate of this year already in the third quarter. We mentioned last quarter that we have launched several new applications within this segment including Lehai and Haixiu both of those new applications are performing well and we do continue to work at ways to expand user penetration activity and interest.

Revenues from this segment represented over 172% year-over-year growth and more than half of the MVAS segment. Monthly active users was 8.4 million representing over 71% year-over-year growth. As we mentioned last quarter, as we add new platforms and technology it is important to note that we continually shift our marketing focus and new user acquisition priorities. We are continuing to focus on not only generating new users, but also drawing the engagement of our paying users and ARPU which we are so far, pleased with.

This is a competitive space and we are focused on ensuring that we focused on growth but we remain disciplined about the cost of that growth. We were certainly ahead of our own expectations so far this year, and look forward to a strong finish in the fourth quarter.

Let me now elaborate and discuss our Showself desktop and Showself lock screen businesses. As a reminder, this is our collective group of applications that are personalized, interactive and programmable mobile desktop applications including dynamic wallpapers and lock screens.

The traffic from this set of applications was impacted during the third quarter which was the primary reason for the overall MAU decline for the overall company. The overall MAU decline for the Group was primarily the result of a decline in vLife users. There is no material financial impact from this MAU decline as the reduction came primarily from our vLife user base and does not impact the overall revenues much from a percentage wise basis. But I want to provide you with some additional color as to what happened.

During the third quarter, there were some regulatory related changes that several large handset makers enacted. These changes required an over the air upgrade that impacted our user counts as the vLife screens and desktops were not included in this OTA push. This impact may gradually recover in the fourth quarter and we do not see any material impact to our overall financial performance as a result of this. At the end of the third quarter of 2016, we had more than 65 million MAUs and 40 million DAUs. We have not included the Launcher MAUs into these figures but I will start providing you with the separate figures now.

At the end of the third quarter of 2016, Launcher had 8 million MAUs which is up from 6.7 million last quarter. There is no comparable year-over-year figure until we get to the first quarter of 2017.

As a reminder, Launcher is doing well with this monetization. We will continue to work on finding ways to monetize the Showself desktop and lock screen traffic, but for now, Launcher will contribute more of this segment's revenues.

Our Showself Music Radar business does continue to grow its traffic as well. At the end of the third quarter, our music radar application or Doreso applications have more than 19 million MAUs and we did see a bump in our unique daily search groups to 18 million now from 14.9 million a year ago.

Now, lastly, before I turn the call over to our CFO, I wish to mention our Link Motion business. We invested in Link Motion in the middle of 2015 last year and began consolidating the business at that time. We have been a mobile focused company from the very inception. In the previous decade plus, the technology innovation and advancement within the mobile landscape has been centered on the smartphone. We believe that the automotive and smart car markets will play a more and more important role in the mobile innovation and mobile advancement in the future decade.

We are positioning ourselves for this and we believe we have the technology and innovation that will enable us to hopefully, capture some of this very large trend.

We will share with you some exciting developments from our Link Motion business in the coming several quarters as they materialize.

With that, I wish to turn the call over to our CFO, Mr. Wu, who will walk you through our financial performance.



Roland Wu - *NQ Mobile Inc - CFO*

Thank you, Matt. Now, may I turn our attention to the financials. I wish to walk through some of the highlights and provide you with additional details behind the results. It's important to mention that I will be using figures excluding the NationSky business for all the numbers in the comparable period in order to better compare the nature of the business as we have previously done.

I also wish to highlight the depreciation of the RMB, the majority of our business is in China, and denominating in RMB. However, we report in US dollars. Given the significant depreciation in the RMB, our reported figures translated into US dollar is under-representing the underlying performance, especially in our topline figures.

For example, the foreign exchange rate used to translate our financials in the year ago period was RMB6.26, and in the previous quarter, was RMB6.53. The foreign exchange rate used to translate our financials in this quarter is RMB6.66, or equivalent of 6.4% translation impact from the year ago period and 2% impact from last quarter.

Whereas the RMB was depreciated even further up to now. I mentioned this just as a helpful reference point for you to consider the underlying financial performance relative to the reported figures in US dollars.

Now, let us start with the discussion of our revenues in the third quarter of 2016. We generated \$91.1 million in net revenues for the third quarter of 2016, which was an increase of 8.8% compared with last quarter, revenues from our MVAS segment reached a record level in the third quarter and increased 13% QoQ, this was due to strong performance of the FL Mobile and Showself business. FL Mobile's domestic business remains healthy and their international business is being supported by Hetu, a subsidiary.

The Showself business performed great and reached a record level and constitute more than half of our total MVAS segment in the third quarter. Our advertising revenues increased 4.2% QoQ, it was in line with our expectations here following a strong second quarter.

Revenues derived from our Enterprise mobility businesses increased 37% when compared with the last quarter, mainly because the second half of the year is always a seasonal stronger period for this business.

As a result, we also purchased additional hardware inventory in preparation for a stronger order at the end of the year timeframe which was the main reason for the higher prepaid line item on our balance sheet.

Next, let us spend a few minutes discussing our gross margin and walk you through some of the key elements within our cost of sales. Our gross margin in this quarter was 72.9% compared to 33.8% last quarter. Also our gross profit decreased 26.3% QoQ, the decrease in gross margin was mostly from two factors. First, the much higher percentage of our mobile gaming business in this quarter was booked on a gross basis. Because of the mix of inclusive titles versus a net basis last quarter. Second, there was higher performance of our enterprise hardware business compared to last quarter.

Let me now walk you through our operating expenses. In the third quarter, total operating expenses was \$24.2 million, an increase of 13.7% from last quarter. This increase was mainly due to higher general administrative expenses which came from higher compensation costs and the provision for doubtful accounts. As a percentage of revenues, our operating cost was normal and only slightly increased to 26.5% of revenues from 25.4% compared with last quarter.

Total share-based compensation expenses were \$3.4 million in the third quarter. The increase was mainly due to restricted shares to management of a subsidiary.

In this quarter, net loss was \$2.8 million, compared with a net loss of \$2.4 million a year ago and net income of \$5.3 million just last quarter. The difference between net income and net income attributable to NQ was affected by the treatment of the portion of FL Mobile that was transferred pursuant to the related share purchase agreement as non-controlling interest in this quarter. GAAP net loss attributable to NQ Mobile was \$9 million in this quarter, or \$0.09 per ADS, with \$6.2 million impact from that NCI line item I just mentioned.



Finally, let me conclude my review of the financial performance for the third quarter of 2016 by highlighting a few other things.

First, our balance sheet. We end this quarter with \$330.3 million of cash and cash equivalents, term deposits and restricted cash. Net cash used in operation for this quarter was \$11.3 million, which was primarily the result of two factors. The timing of our receivables which increased at the end of the quarter and was up at the end of the quarter and increased in various tax paid. Total cash used in investments, outside of the proceeds from the FL Mobile divestment, was \$11.3 million, including the final payment to Xinjiang and additional to Launcher and a new investee related to our broadcast video business.

And finally, to our guidance and outlook. In line of the magnitude of the currency depreciation and the subsequent headwind in our translated results, the RMB foreign currency translation rates impact our forecasts made at the beginning of the year. We would now expect the variance in our full year net revenue performance to be outside of the percentage of the ongoing currency depreciation changes. Thank you.

Matt Mathison - NQ Mobile Inc - VP Capital Markets

Thanks, Roland. This concludes our prepared remarks for the presentation. Operator, will you please open up the lines for our Q&A?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question today comes from the line of Jun Zhang from Rosenblatt Securities. Jun, please go ahead.

Jun Zhang - Rosenblatt Securities - Analyst

Good morning. Thanks for taking my questions. I have a couple of questions.

So the first one, could you talk a little bit about the RMB depreciation impact on the revenue and what's your expectation going forwards, because it seems that RMB is going to continue to appreciate in the next -- over the next couple of quarters? So, what's your takeaway that how is that going to affect revenue growth for the next couple of quarters? Thanks.

Matt Mathison - NQ Mobile Inc - VP Capital Markets

Yes, Jun, thanks for the question. Again, as Roland just went over, remember, the vast majority of our financials are generated in RMB, and so it really doesn't impact the actual numbers. However, we do report our numbers in dollar terms, and so the rate by which we translate those RMB financials obviously is impacted as the depreciation has obviously materialized over the course of this year dramatically. And I think most people expect that to continue.

Up to this point we have not reported the precise cost and currency impact as of yet, but I do think it's worth mentioning. As Roland just said, again, if you look at our financial guidance and you look at the RMB rate that was used at the beginning of the year to put that guidance forward, you're seeing 7%, 8%, maybe even 9% difference in depreciation in the currency rate that will be used at the end of this year, which is significant. But as Roland just said, any variance to our full year reported US dollar term revenues will not be greater than that variance. I think a good number that you could use is maybe 4% or 5%.

So this is mostly a top line impact just on the reported basis, but it's just something to be helpful of. We're obviously mindful of that and we wanted to address it on the call today.

Are you still there, Jun?



Jun Zhang - *Rosenblatt Securities - Analyst*

Yes, I'm here. Yes, thanks. So my second question is that, could you give us more color on the gross margin and operating margin for the Q3? It seems that it's coming down sequentially from Q2. Is that -- anything changed in the Q3 that affect gross margin?

Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

Yes, this is a great question, I think it's an important one to address. There's really two primary factors, and one of them is the largest factor to the gross margin performance in the third quarter. In our FL Mobile business, remember we book revenues on a gross basis if the gaming title is an exclusive title to FL Mobile. Okay? So what that means is we book revenues gross, and then as a cost of sale, have to back out the portion that's due to the app store and the portion that's due to the game developer. It's different if it's a non-exclusive title. Those revenues for non-exclusive titles are booked net of the game developer portion.

And so the fluctuation in the gross margin was largely tied to the performance of our exclusive titles. In fact, in the third quarter, almost 90% of our total gaming revenues came from exclusive titles -- not quite, but almost 90%. To give you some sort of comparison, that figure was closer to 60% in the second quarter. So that impact alone drove the gross margin performance of the FL Mobile business down. And again, we've talked about this revenue mix fluctuation in the past. The gaming revenue -- or excuse me, the gaming gross margin business fluctuates because of that accounting treatment from the 30s to the mid-60s. Right? In Q2 it was in the mid-50s, in Q3 it was in the low 30s. That was really the bulk of the reason why gross margins declined and why the cost of sales obviously went up.

The second reason had a smaller impact but had to do with the enterprise business. Obviously, we had a slightly stronger and higher percentage of our overall business coming from the enterprise side. Just keep in mind, while we're not focused on hardware sales and the Trustek business generally, the second half of the year is always a seasonally stronger period for that enterprise business. And so as that business performed a little bit better in Q3, that also had an impact on gross margins.

Jun Zhang - *Rosenblatt Securities - Analyst*

Okay, thanks. Also, about DSO, seems to be increasing a little bit. Is that due to the enterprise business or is that due to other business growth?

Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

Well, actually, DSOs didn't really go up that much overall for the Group. If you're talking about the accounts receivable figure which went up by a little more than \$20 million, that came from the two fastest-growing business units Showself and FL Mobile, and again timing of receivables at the end of the quarter and things like that. So that was the impact there.

Jun Zhang - *Rosenblatt Securities - Analyst*

Okay. And also come back to the FL Mobile divestment. So, what -- I know you're probably not able to disclose a lot of information, but could you talk a little bit about what's the directional for FL Mobile, is the management -- does the management team still stick with the selling FL Mobile to the other parties, or what's kind of the directional change is going to be for FL Mobile?

Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

Sure. Let me -- yes. Let me just reiterate what Justin said. We are obviously still going down the path to divest the entire FL Mobile business. That hasn't changed. Just to reiterate what we said, we obviously can't provide too much specifics while we're in the middle of that, but we continue to work on divesting the business and we're working as hard as we can to reach a conclusion as soon as possible.



Jun Zhang - *Rosenblatt Securities - Analyst*

Thanks. Also, I think when you announced the Zhongzhi, the investment in the convertible bonds, I think a lot of questions about why you need the Zhongzhi investment and also what's the purpose of the Zhongzhi investment. It seems that it's kind of the Chinese-based funds that investing in the US-listed company, things like convertible bonds. Could you give us more color on the Zhongzhi investment and what's the background and logic of that investment? Thanks.

Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

Let me just say this. We're very excited about having them as a partner. We view the investment as truly a great and important institutional sponsorship for us. Obviously there were benefits in terms of getting that investment in US dollars and clearing up the old CB, things like that. But we view this as a great new partnership and a new institutional sponsor.

As you know, we invited the Chairwoman to the Board. She now is a Board member. So we view this really much more than just as an investment. This is a new partnership, so.

Jun Zhang - *Rosenblatt Securities - Analyst*

Okay. My last question -- yes, go ahead.

Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

Go ahead with your last question.

Jun Zhang - *Rosenblatt Securities - Analyst*

Yes, sure. So my last question is the cash and buyback. So, by the end of Q3, what the cash -- what part of the cash includes, is that already include the Zhongzhi investment, and then what the cash outflow coming from? Also, what's the -- when the window opens for the corporate buyback. Thanks.

Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

So your question is about cash. The new investment closed in the fourth quarter, so that was not included in the balance sheet statements that were reported for Q3. None of that was. That will show up in our Q4 results.

In terms of the cash outflows, if you're talking about the cash flow from operations, is that what you're referring to?

Jun Zhang - *Rosenblatt Securities - Analyst*

Yes.



Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

Sure. So the \$11.3 million, again more than \$11.3 million came from the change in receivables, which was obviously offset some by the change in payables. But both of those things together accounted for the difference in our cash flows from operations. Without the timing of those receivable changes, cash flows from operations would have been positive.

And again, the other part of that also had to do with the taxable accounts across the balance sheet, which had a negative impact to cash flow from operations of a few million dollars as well. So, change in receivables and the taxable accounts more than accounted for that \$11.3 million in cash outflow from operations.

The last question, can you remind what the last part was? Oh buyback --

Jun Zhang - *Rosenblatt Securities - Analyst*

Yes, buyback window and commitment on the buyback.

Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

So again, let me just reiterate what I said in the prepared remarks on the buyback commitment. Remember, as a company, we set out on the path to divest FL Mobile to raise the cash and then to use the cash for two reasons, buyback was one of them. We remain committed to that. As we've said for quite some time now, we are not going to announce a buyback authorization until there is an opportunity to actually execute it. And I'm not going to get into the practice of discussing specifically when that is or when the window might open. But suffice to say, as we continue to move forward to reaching that conclusion on the FL Mobile divestment, you'll just have to stay tuned.

Jun Zhang - *Rosenblatt Securities - Analyst*

Okay, thanks. That's all my questions. Thanks a lot.

Operator

(Operator Instructions).

Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

Okay. Operator, is there any more questions?

Operator

No. That concludes today's question-and-answer session now. I would now like to hand the conference back to Mr. Mathison for closing remarks.

Matt Mathison - *NQ Mobile Inc - VP Capital Markets*

Great. Thank you all for joining us. We look forward to sharing updates with you in the future. Have a great day.



Operator

Ladies and gentlemen, that concludes our conference for today. We thank you all for your participation. You may now disconnect.

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