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FAF - Q1 2015 First American Financial Corp Earnings Call

EVENT DATE/TIME: APRIL 23, 2015 / 3:00PM GMT



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PRESENTATION

Operator

Greetings and welcome to the First American Financial Corporation first-quarter 2015 earnings conference call. (Operator Instructions). A copy of today's press release is available on First America's website at www.firstam.com/investor.

Please note that the call is being recorded and will be available for replay from the Company's Investor website and for a short time after by dialing 877-660-6853 or 201-612-7145 and enter the conference ID number 13606835. We will now turn the call over to Craig Barberio, Director of Investor Relations, to make an introductory statement.

Craig Barberio - *First American Financial Corporation - Director of IR*

Good morning and thank you for joining us for our first-quarter 2015 earnings conference call. Joining us on today's call will be our Chief Executive Officer, Dennis Gilmore, and Mark Seaton, Executive Vice President and Chief Financial Officer.

At this time we would like to remind listeners that management's commentary and responses to your questions may contain forward-looking statements, such as those described on page 4 of today's news release, and other statements that do not relate strictly to historical or current fact.

The forward-looking statements speak only as of the date they are made and the Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made.

Risks and uncertainties exist that may cause the results to differ materially from those set forth in these forward-looking statements. Factors that could cause the anticipated results to differ from those described in the forward-looking statements are also described on pages 4 and 5 of today's news release.

Management's commentary contains, and responses to your questions may also contain, certain financial measures that are not presented in accordance with generally accepted accounting principles including personnel and other operating expense ratios, adjusted personnel costs, adjusted operating costs and success ratios.



The Company is presenting these non-financial measures because they provide the Company's management and investors with additional insight into the operational efficiency and performance of the Company relative to earlier periods and relative to the Company's competitors. The Company does not intend for these non-GAAP financial measures to be a substitute for any GAAP financial information.

In the news release that we filed today, which is available on our website, www.firstam.com, the non-GAAP financial measures disclosed in management's commentary are presented with and reconciled to the most comparable directly comparable GAAP financial measures. Investors should use these non-GAAP financial measures only in conjunction with the comparable GAAP financial measures. With that I will now turn the call over to Dennis Gilmore.

Dennis Gilmore - *First American Financial Corporation - CEO*

Good morning and thanks for joining the call. I will begin with a review of our first-quarter financial and operating results followed by a few comments regarding our outlook for 2015. Revenue in the first quarter was \$1.1 billion, up 10% from last year. The increase was driven by strength in our refinance and commercial businesses.

Our closed refinance orders were up 62% compared to last year, as a drop in mortgage rates in early January triggered a surge in order volumes. Our open refinance orders peaked at approximately 2,600 per day in the first two months of the year but have leveled out at approximately 2,000 per day in March and April.

Our commercial business showed continued strength in the first quarter with revenues up 28% compared to last year. A number of large deals closed in the quarter which helped drive the average revenue per order up 24%. We continue to see broad-based strength throughout our commercial business.

Revenues in our purchase business increased 9% compared to last year. Closed purchase orders were up 2% and the average fee per purchase transaction grew 7% during the quarter. Our title insurance pretax margin was 6.8% in the quarter compared with 4.6% last year. Not only have we benefited from improved market conditions but we continue to focus on expense management. Our success ratio was 57% in the first quarter, better than our current 60% target.

Headcount increased by less than 1% despite a 30% increase in open orders compared to the fourth quarter of 2014. We are being cautious with our hiring given the volatile nature of refinance orders, choosing to rely on overtime and temporary employees as our primary method of handling the increased order volume.

Overall our title insurance business performed well in what is typically a seasonally difficult quarter for the industry. Revenues in our Specialty Insurance segment were \$95 million, up 8% compared to last year. Pretax margin was 18% driven by lower personnel costs and favorable claims experience.

Earnings in this segment are typically counter seasonal to our title segment with improved earnings in the winter due to lower claim frequency in our Home Warranty business. In the first quarter Home Warranty posted all-time record earnings.

Turning to the outlook for 2015, we remain optimistic as April is off to a good start with purchase orders up 8% compared to last year driven by strong growth in new home sales. All indications point to an improving spring selling season relative to what we experienced in 2014. Our refinance volumes are stabilized and our overall pipeline remains robust.

As we discussed in our last call, we continue our focus on the new integrated mortgage disclosure rule that becomes effective August 1, 2015. This new disclosure rule requires the replacement of three existing disclosure forms that have been used by all industry participants for many years. We continue to spend significant time, resources and work very closely with the lending community to ensure that our systems and our workflow are ready for this significant change.



Given the magnitude of the change we do anticipate some temporary delays in closings on orders opened after August 1 as the mortgage industry adapts to the new disclosure requirement. However, we believe the implementation of the new rule will present a growth opportunity for First American as a settlement service provider who is prepared to deliver the highest quality work in this new environment.

In closing, I would like to invite the investment community to attend our Investor Day on May 20 in New York City. At this meeting you will hear from many of our executives as they discuss the Company's strategy and provide greater detail on the Company's operation. I would now like to turn the call over to Mark for a more detailed review of our financial results.

Mark Seaton - *First American Financial Corporation - EVP & CFO*

Thank you, Dennis. Total revenue in the first quarter was \$1.1 billion, up 10% compared to the first quarter of 2014. Net income was \$38 million or \$0.34 per diluted share compared with net income of \$22 million or \$0.20 per diluted share in the same quarter last year. The current quarter results include net realized investment losses of just under \$1 million or \$0.01 per diluted share.

In the Title Insurance and Services segment direct premium and escrow fees were up 23% compared with last year. This growth was driven by a 15% increase in a number of direct title orders closed and an 8% increase in the average revenue per order. The average revenue per order increased to \$1,865 driven by higher average fees for all major order types.

The average revenue per order increased 7% for purchase transactions, 8% for refinance transactions and 24% for commercial transactions. We continue to see a number of large commercial deals close which had a positive effect on our average revenue per order.

Agent premiums were up 1% while the agent split was 80.3% of agent premiums. Information and other revenues totaled \$146 million, up 6% compared with last year, driven by the impact of recent acquisitions offset by lower demand for the Company's default information products.

Personnel costs were \$331 million, up \$31 million or 10% from the prior year. This increase is primarily due to higher incentive-based compensation driven by the improvement in revenues and profitability as well as higher salary expense driven by recent acquisitions.

Other operating expenses were \$189 million, up \$19 million or 11% from last year. The increase is primarily due to higher production-related costs and temporary labor expenses given the increase in the order volumes. The ratio of personnel and other operating expenses to net operating revenue was 79.0%, an improvement from the 82.4% we posted in the first quarter of last year.

The provision for title policy losses and other claims was \$56 million or 6.5% of title premiums and escrow fees compared with a loss provision rate of 6.0% in the same quarter of the prior year. Pretax income for the Title Insurance and Services segment was \$70 million in the first quarter compared with \$43 million in the first quarter 2014. Pretax margin was 6.8% compared with 4.6% last year.

Turning to the specialty Insurance segment, total revenues were \$95 million, up 8% compared with last year, driven by higher premiums earned in both the Home Warranty and Property Casualty business lines. The loss ratio for the segment was 51%, a slight decrease from the 52% experienced last year. Pretax margin for the segment was 18.2% driven by record earnings in our Home Warranty business.

Net expenses in the corporate segment were \$28 million in the first quarter, up \$6 million relative to the prior year. \$4 million of this increase was driven by a one-time non-cash charge relating to our benefit plans which was reflected in our investment income line item. The effective tax rate for the quarter was 35.9%, in line with our normalized tax rate of 36%.

In terms of cash flow, cash used for operations was \$66 million versus \$105 million in the first quarter of last year. The change was primarily due to higher net income and improvements in working capital. Capital expenditures were \$32 million, up from \$21 million in the first quarter of last year due to increases in capitalized software and capitalized data.

Turning to capital management, debt on our balance sheet totaled \$586 million as of March 31. Our debt consisted of \$549 million of senior notes, \$34 million of trustee notes and \$3 million of other notes and obligations. Our debt to capital ratio as of March 31 was 18.3%. I would now like to turn the call back over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mark DeVries, Barclays.

Mark DeVries - Barclays Capital - Analyst

I know historically you have indicated that there is roughly a two-thirds pull through from home price depreciation to the ARPO. However, ARPO was -- for both direct residential and purchased and refi grew 7% to 8% year over year. Can you talk about what is driving the strong increase relative to HPA here?

Mark Seaton - First American Financial Corporation - EVP & CFO

Yes, Mark, thanks for the question, this is Mark. One of the things we are seeing is we're seeing the average revenue per order in some of the big states like California and Texas, that is really what is driving the purchase ARPO.

So when we look at California our average fee per file in California for purchase transactions was up about 7% or 8%, similar with Texas. So we are really seeing kind of more higher-priced homes being sold in some of the bigger states. And that is really what we are seeing this quarter.

Mark DeVries - Barclays Capital - Analyst

And then also, ARPO was really strong in commercial. I think Dennis alluded to a couple of chunkier transactions. Can you give us a sense of how much of that, maybe one or two big transactions, contributed to that 24% year-over-year growth there?

Dennis Gilmore - First American Financial Corporation - CEO

It is really two things. We had a big increase in an ARPO, up 24%, driven by a number of large transactions that we completed in the quarter. So clearly that drove it. But we also just saw an overall increase in the number of large transactions in general that also helped drive it up.

Mark DeVries - Barclays Capital - Analyst

Okay, that is helpful. And then finally, GE Capital is looking to sell a pretty large commercial real estate portfolio to Blackstone here as part of their spinoff plan. Do you have any sense on how large of an opportunity that could be for the commercial title business?

Dennis Gilmore - First American Financial Corporation - CEO

I really don't at this point.



Mark DeVries - *Barclays Capital - Analyst*

Okay, got it, thanks.

Operator

Eric Beardsley, Goldman Sachs.

Eric Beardsley - *Goldman Sachs - Analyst*

Just wanted to clarify when you were talking about purchase orders being up 8% in April was that open or closed?

Dennis Gilmore - *First American Financial Corporation - CEO*

That is open orders.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay. And where do you see the closed trend in April?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

So far on the closed side it is up about 6%. And we are talking April month to date versus April month to date last year, 6% on the close and 8% on the open.

Eric Beardsley - *Goldman Sachs - Analyst*

Got it. And on the refi side -- I guess when do you expect to see that start to tail off if we were to have rates staying here? Is that something that we'll see the benefit go through the end of the second quarter or is that going to end earlier sometime around May?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

Well, we do think that the refis on the closed side are going to start to tail off. In March we closed about 1,700 a day. April we are running roughly 1,500 a day and we think it will start to trickle down in May and June as well.

But on the open side though it seems like refis, at least for now, have leveled off. They peaked at about 2,600 and they have been pretty consistent at the 2,000 level in March and April. And so, we do think on the closed side they are going to tail off, but if opens continue to stay where they are we think we can have some good refinance business in the second quarter.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay, great. And just lastly, have you had any incremental OpEx related to the mortgage disclosure rules? You had mentioned using time and resources for those.

Mark Seaton - *First American Financial Corporation - EVP & CFO*

Yes, there absolutely has been OpEx. We spent a lot of time and effort training our people. We have had to spend capital upgrading our technology systems which wouldn't necessarily go into OpEx, but that is one reason why our capital expenditures are up significantly versus last year. So we've had to really spend a lot of money in training systems to get ready for these new disclosure rules coming out in August.

Eric Beardsley - *Goldman Sachs - Analyst*

Got it. Is there any benefit we see come the third quarter where any of those expenses come out?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

No, I think in terms of the training and the technology, I mean we feel like they're going to be there at least for the rest of the year. And then I think starting in 2015 we will start to see those specific costs start to wane.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay, is there any way to size those?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

We don't -- I wouldn't say it is material to the operations. It is probably material to CapEx number, but not for the overall expense base.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay, great. Thank you.

Operator

Bose George, KBW.

Bose George - *Keefe, Bruyette & Woods - Analyst*

Just a follow-up on the commercial question. In most years your commercial fee per file is lowest in the first quarter then it trends up. Now just with the strong first quarter do you think the trend could be different this year?

Dennis Gilmore - *First American Financial Corporation - CEO*

I actually think that [CVR] will probably drop a little bit going into the rest of the year. Again, we had number of very large deals close in the quarter. But as I said earlier, we just had a larger number of large deals moving through the first quarter. So it is kind of a combination of both. But again, I would suggest that they are probably going to drop down, the ARPO will start to drop in the second and third quarter.

Bose George - *Keefe, Bruyette & Woods - Analyst*

Okay. Thanks. And then actually just a question on the TitleVest acquisition that you guys did earlier this year. I mean just any way to sort of quantify the potential benefits of that?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes, it was part of our acquisition strategy. We want to continue to look for tuck-in acquisitions in our key states, New York being one of them. It gave us a nice little uptick in our direct footprint in New York. From a size perspective it is in the mid-20 range in revenue. So nice to us but not that material.

Bose George - *Keefe, Bruyette & Woods - Analyst*

Okay, great. And then just one more. Last quarter you guys said you had about \$125 million of excess capital, I guess some was used for TitleVest. Just curious any other plans for excess capital that you can highlight?

Dennis Gilmore - *First American Financial Corporation - CEO*

Again, no change there. We are continuing to look to invest in the business or do acquisitions if they fit our criteria. We have looked at a lot of transactions over the last couple quarters, they just haven't had the returns we want or there's been other issues with them, so we just haven't pulled the trigger, but we keep actively looking.

Bose George - *Keefe, Bruyette & Woods - Analyst*

Okay, great. Thank you.

Operator

John Campbell, Stephens.

Peyton Blair - *Stephens Inc. - Analyst*

Hey, guys, this is Peyton Blair sitting in for John Campbell. Can you guys give us your organic revenue growth on the title side?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

It was -- really it was about 10% on the title side this quarter. I mean we did a couple of acquisitions. The TitleVest deal that we just talked about really closed in March and there wasn't really anything meaningful there. We did a couple of acquisitions in March of last year. But the organic growth was about 10%.

Peyton Blair - *Stephens Inc. - Analyst*

Got you, thanks for that. And then also it looks like agent retention rate came in a little higher than this. It looks like that is up year over year. Can you talk about the drivers there, whether that is geographical or just maybe more of a push to take more agent share there?

Dennis Gilmore - *First American Financial Corporation - CEO*

This is Dennis. It is definitely not because of share, we are not reducing our retention for a share gain perspective. It is really geographic distribution right now. So it is really running right in line with what we expect it to be, right around that 80% number.

Peyton Blair - *Stephens Inc. - Analyst*

Got it. And then last if I can real quick. It looks like 50/50 or so direct agency split in the quarter and I think that was more like 45% in 1Q 2014. What is driving that direct market shift? Is that refi or commercial or is there something else there?

Dennis Gilmore - *First American Financial Corporation - CEO*

Yes, agent revenue came in a little light and that is really what we think driven by the sharp uptick in refinance. When we see a real quick uptick in refinance, the majority of that business typically goes to direct shops with big central service platforms like ours, our mortgage solutions group. So we think this is really what happens with the market and the type of revenue that is being generated quickly.

Peyton Blair - *Stephens Inc. - Analyst*

Thanks for the question.

Operator

Jason Deeleeuw, Piper Jaffray.

Jason Deeleeuw - *Piper Jaffray - Analyst*

Just looking at the April upfront orders that [what we do] is 8%. Could you break that at between purchase and refi?

Dennis Gilmore - *First American Financial Corporation - CEO*

Let me give the first answer and I will let Mark take the second part of it. The 8% is on our purchase only.

Jason Deeleeuw - *Piper Jaffray - Analyst*

Okay, okay. What about on the refi side?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

I'm sorry, can you repeat the question?

Jason Deeleeuw - *Piper Jaffray - Analyst*

Just looking at the -- okay, so sorry, it was 8% open purchase orders then, got it. Could you break out refi as well?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

Yes, refis were up 40% in April on the open side.



Jason Deeleeuw - Piper Jaffray - Analyst

Okay, great, thanks. And then what about your title provision? It looks like it is about 6.5%. Is that a good rate to think about going forward or could we see it go down a little?

Mark Seaton - First American Financial Corporation - EVP & CFO

Well, I think for the next couple of quarters we intend to book at 6.5%. So I think that is our intent at this time. I think over a longer period of time we would definitely expect to see that loss provision rate come down in the 5.5% range. But we are going to be cautious and for the next two or three quarters continue to book at 6.5%.

Our claims this quarter came below our expectation and they have done that for the last two or three quarters now, but we're just kind of booking at the conservative end of the range just given our experience in the past.

Jason Deeleeuw - Piper Jaffray - Analyst

Okay, got it. Great, thanks. Thanks. And then just looking at the margin, you guys came in very strong in the first quarter here. Do you guys still think the 10% pretax title margin is attainable for the full year or where are you guys trending right now?

Dennis Gilmore - First American Financial Corporation - CEO

I think it is. I think we are optimistic, we are off to a good start, we had a good first quarter. And if we continue to see the leverage growing on the revenue we will get the leverage on the business, that is our intent right now. So if the business continues the way it is and spring continues to develop positively like we think it will, we are optimistic that we can exceed our margin from last year.

Jason Deeleeuw - Piper Jaffray - Analyst

All right, great. Thanks for the question.

Operator

Ryan Byrnes, Janney Capital.

Ryan Byrnes - Janney Montgomery Scott - Analyst

Just had one question, I guess. On the \$3 million of corporate kind of investment income that was a negative, I am kind of assuming that was from the pension plan. Should we expect that to recur throughout the year or I think you guys maybe mentioned it was a one timer. But on the last call you said it may have been \$9 million for the year, just wanted to make sure I understand that.

Mark Seaton - First American Financial Corporation - EVP & CFO

They are two separate issues. The pension expenses that we book we wouldn't expect to change for the year. What I talked about in my script, it was a \$4 million one-time charge relating to -- we terminated an (inaudible) related to a company life insurance policy. So it was really one time, we don't expect it to repeat going forward.

Ryan Byrnes - *Janney Montgomery Scott - Analyst*

And then -- but the pension drag, should we see that continue through the -- I am just trying to figure out where that would be flowing through. Would that be through the investment income side or the personnel costs? Where would that be flowing through?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

The pension will go through personnel costs in the corporate segment.

Ryan Byrnes - *Janney Montgomery Scott - Analyst*

Got you. Great, thanks for the color, guys.

Operator

(Operator Instructions). Kevin Kaczmarek, Zelman & Associates.

Kevin Kaczmarek - *Zelman & Associates - Analyst*

Actually I had a question on the investment portfolio. It seems like there was a pretty big rise in it quarter over quarter, maybe \$0.5 billion. Is that just investments from the escrow deposits or is something else driving that?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

There is a few things driving it. One is, yes, we absolutely are getting more business and so we are investing in those escrow deposits. Another thing is we've started to use some outside managers for our portfolio, so we just had I would say an unusual amount of cash at the end of the year -- as of 12/31 that we have invested in Q1. So those are really the two primary reasons why cash is down and investments is up.

Kevin Kaczmarek - *Zelman & Associates - Analyst*

Okay, so I assume that is a good run rate for the investment balance going forward. And on the yield, should the yield on those new investments be similar to the rest of the portfolio? Or are you going to invest -- is that going to be treated as more like a cash amount where maybe it is invested at a much lower yield?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

I would say the yield on those investments are probably slightly higher. I mean right now our yield is running somewhere in 2.0 to 2.1. And I think it would be slightly higher than that, but not materially more than that. But it is not in cash though, they are in marketable securities.

Kevin Kaczmarek - *Zelman & Associates - Analyst*

Okay, great. Thanks. All of my other questions happen answered. So, thanks a lot.

Operator

Mark Hughes, SunTrust.



Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

The outlook for potential market share gain related to the new disclosure rules, could you talk a little bit about that? I think you had mentioned last call that you picked up maybe 120 basis points of share in 2014 and hope to repeat that. What do you think now?

Dennis Gilmore - *First American Financial Corporation - CEO*

Well, two separate issues. We are doing well in our market share initiatives. We did pick up about 100 basis points last year; about 160 basis points over the last two years. So we think that activity will continue. We are really hitting the objectives we have set out for the Company.

Separate issue is the new disclosure. We just think that there will be a lot of disruption in the market and we are working diligently to be as prepared as possible. And we think when the new disclosures come on line we will be ready for it. And we just think there may be a little disruption in the market which will allow us to pick up some share at that point also -- different than our long-term share gain strategy.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

How meaningful could that be?

Dennis Gilmore - *First American Financial Corporation - CEO*

It is literally impossible to make the call right now because we don't at this stage know the level of disruption. We will see when the new disclosures go into effect August 1.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

The paid title claims were a little higher this quarter year over year as I read it. How do you think that will look for the full year?

Mark Seaton - *First American Financial Corporation - EVP & CFO*

Paid title claims were unusually high this quarter. We had two large claims -- two of the largest claims we have ever paid in our history that hit in Q1. We had a \$20 million claim that we paid that was previously reserved for early last year. We had another \$15 million claim that we paid this quarter that was -- had been reserved for a couple of years.

And sometimes when we reserve for them it takes a while for us to actually pay them. And so, our paid claims were \$89 million and that was up 14% from last year. But if you take out these two -- literally two claims our paid claims were down 30% from last year.

So paid claims are lumpy, anything could happen in any one quarter. But over time we absolutely expect our paid claims are going to continue to fall and fall meaningfully from where they are right now.

Mark Hughes - *SunTrust Robinson Humphrey - Analyst*

Thank you.

Operator

Thank you. There are no additional questions at this time. This does conclude this morning's call. We would like to remind listeners that today's call will be available for replay on the Company's website or by dialing 877-660-6853 or 201-612-7415 and entering the conference ID number 13606835. The Company would like to thank you for your participation. This concludes today's conference call. You may now disconnect.

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