

Q2 2019 Earnings Call

Company Participants

- Milton Rangel, Head of Finance
- Nelson Queiroz, Chief Executive Officer
- Roberto Bernardes Monteiro, Chief Operations Officer
- Roberto Monteiro, CFO
- Unidentified Speaker

Other Participants

- Analyst
- Tiago Noel

Presentation

Operator

Good day, ladies and gentlemen. Welcome to the Conference Call to discuss Second Quarter 2019 Results of PetroRio. Thank you for standing by. At this time, all participants are in a listen-only mode.

Later, we will conduct a question-and-answer session for analysts and investors, when further instructions to participate will be provided. (Operator Instructions). This event, as always, is also being broadcast simultaneously over the internet via webcast, and maybe accessed through PetroRio's Investor Relations website, at ri.petroriosa.com.br, by clicking on the banner 2Q '19 Earnings Release. Before proceeding, let me mention that forward-looking statements that might be made during this conference call relative to the company's business perspectives, projections and operating and financial goals are based on the beliefs and assumptions of PetroRio management and on information currently available to the company.

Forward-looking statements are not a guarantee of success. They involve risks, uncertainties and assumptions as they are related to future events, and therefore, depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions and other operating factors could also affect the future results of PetroRio and could cause results to differ materially from those expressed in such forward-looking statements. I would now like to turn the conference over to Mr.Nelson Queiroz Tanure, CEO; Mr.Roberto Monteiro, CFO; and Mr.Milton Rangel, Head of Finance.

Mr.Tanure, please go ahead.

Nelson Queiroz

Good afternoon, everyone. This is Nelson. Welcome to PetroRio's conference call to discuss Q2 2019 results.

Thank you all for participating. I can see that there are a lot of PetroRio's employees on this call. I know many of you are shareholders. So folks, it's great to have you on-board.

It's always a matter of pride to me to see you're interested in following our earnings conference call, and honestly you're the ones creating all this value for the company. So it's only natural that you get interested and participate all of this value creation. So this is great. So speaking a little about our Q2 '19 results more conceptually.

PetroRio's second quarter was very good. Again, first quarter was better than the previous quarter in a long sequence of historical quarters, if you can call them that, with each quarter exceeding the previous record mark. And this quarter remains behind this was Frade Field. In the first quarter, we recorded just a little Frade reduction as we closed the deal at the end of March.

So just a few days were posted. But in the second quarter, we have the whole production and results of Frade. So this greatly explains such a significant result. And our expectation is that Frade Field and the results of the company will continue to improve as we implement our efficient management methodology; and Roberto can comment more on that later with at the end.

So the quarter was very good, as I've said. We had Frade Field to producing throughout the quarter. We also had a good performance at our Polvo Field. We had two objects in the quarter, so Polvo contributed really well.

It is a field that also has a very promising future. Another drilling campaign scheduled for the second half. In other words, we hope to very soon see once again showing all of its resilience. So this is the great focus for us in the second half of the year.

And Manati Field continues to operate very well. That field is like clockwork, and we're happy with its performance and production. There are some assets related to the demand for gas from which impacted its results. But the overall, it is a field that has been delivering good results.

It is somewhat curious. This field used to represent so much in terms of results and numbers for the company. Now its representing less and less because of our growth, although the field remains very important to us. So to conclude with the financial piece, we posted in record net revenue, which makes me very happy.

Revenue in this quarter accounts for more than half the revenue for the full year '18. So this is excellent news in terms of cash generation, EBITDA, free cash flow, while production posted very good numbers, all higher than any other number previously delivered so far,

and our cost was the very best ever. So most essentially, we had very good and positive numbers, which we believe will be long-lasting. Now, I would like to share with you a couple of other points, which make us very happy regarding the company's performance.

First, we recently received an award from -- and as Best Oil and Gas Company in the 2016 through 2018 period. So that makes us very happy, particularly for all of you who work at the company and who lived that period and who remember how hard it was and all the efforts and sacrifice we had to make to overcome the challenges and hurdles and to continue to grow the company. And frankly, even with the good results that we're delivering now, the results are the consequence. The cause is all the efforts, dedication and discipline, the blood and sweat that we put into this company.

So this award reflects the -- the good performance we had during that period and it is a 100% because of the effort of each and every one of you working day after day. So congratulations. We had positive numbers in the past and we've seen a lot of difficulties. We have bigger challenges ahead of us, but I'm sure that we will put even more effort in that we have everything we need to continue to overcome these challenges and make the company continue to grow with availability.

Another point that also makes me very proud and I would like to share with all of you is that our internship program once again attracted a significant number of students interested in joining the company. This year, we had more than 16,000 applicants for our internship. We selected 15 or 16. So it was a very competitive process.

And to you interns who might be on the call, for every one of you, there were another 1,000 who wanted to be in your place. So we expect a lot from you guys. Count on us to help you, but also what does make this company continue to grow. People are the drivers of PetroRio.

This is a virtuous cycle and this is one of the main reasons to continue growth of the company with people coming to join us. And a couple more points then I'll be done. I'll comment on the acquisition of approximately 18% working interest of Frade Field from Inpex. We wanted this deal to have been completed by now and we continue to expect this to happen soon.

We are all working very hard for this to happen sooner than later, and our expectation remains unchanged. Finally, and I touched on this, the company is getting ready for the drilling campaign at Polvo Field this year. So this is among our goals for the next quarter, to drill wells at Polvo. And we also announced previously the issuance of a Norwegian bond intended to raise around \$400 million.

So the company can be capitalized to have more fire power to be able to continue very active at trying to buy new assets, new fields for PetroRio and to maintain our solid financial health. Well, before I turn the floor to Roberto, I guess you all have heard that Blener Mayhew left the company. For many years, he was the company's CFO and IRO. So Blener, on behalf of the whole company, I'd like to thank you for your contribution to PetroRio.

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It was very much appreciated. We wish you good luck. And let me say a few words about Roberto. He already was our Chief Operations Officer, and now takes over as CFO.

Roberto has been with us for a long time, approximately since the birth of PetroRio. He was CFO in the past and he is very knowledgeable with the company's numbers. He has great ambitious plans to improve our financial department even more. So Roberto, you're not new to the company and I'm excited that you're taking on this new role.

I'd like now to welcome, he was one of the main people possible for our successful drilling campaign last year at Polvo. Frank Somar spent many weekends here and making sure that our drilling campaign would unfold well. So Frank Somar, welcome to your new role. You have with a challenge ahead of you, but we are confident that you're more than capable of delivering excellent results.

You'll be spending more weekends at work with your new team, given that we have a new drilling campaign coming up. So that's it. Everyone, thank you all for participating, and I'll now turn the floor to our new CFO, Roberto Monteiro. Thank you.

Roberto Monteiro {BIO 16616322 <GO>}

Thank you very much, Nelson. This will be my last call as the Head of Operation. So let's start on Slide 3, where we start presenting our operational highlights. I believe the main operational highlight in this quarter was Frade's transition.

Everyone -- everything unfolded really well. The operation is running well. I'd say the thing is very smooth, all synergies have been captured as planned. Actually some of them are a little ahead of schedule.

We maintained a high operating efficiency both at Frade and Polvo. Actually Frade's operating efficiency in this quarter was the highest that we posted at least in the last 12 months, for sure. So all is unfolding really well. The drilling campaign had also planned to start in September.

The drilling rig is 100% ready, all is 100% prepared. The only news here regarding the drilling campaign is Frade, we will see this later. We divided it into two phases, with the possibility of starting earlier. But we'll talk more about this in a moment.

Please go to Slide number four. I'd just like to draw your attention to the geographic location of our assets, particularly when we take into account Frade and Polvo, we see that they are located close together and it is this proximity that allows us to derive great operating synergies, particularly regarding land and sea logistics, air logistics and so on and so forth. So I guess this plot serves its purpose to give you an overview and to help you understand where the synergies are coming from and it is very much related to the proximity of the field. Well, moving on to Slide 5 please, we see our operating efficiency.

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We see Frade more than 99% operating efficiency, so the field is running very well, 100% under PetroRio's operatorship. And opened with a high operating efficiency, 97.6% in this quarter. We did have some BCF problems mainly related to VSD, which is not the part that is in the well, but the part that fits on the platform. This reduced a little our operating efficiency.

It's over, but nothing too striking, nothing problematic. Today, we are back to a higher operating efficiency with Frade. On the upper right hand corner of the slide, this was a part that is yet to be highlighted. Looking closely we can see great stability since March.

In March, we produced 19,200 barrels; in February, 19,100 barrels; in June, we have produced 18,978 barrels; in July, we also reopened one of the wells that were stopped at Frade. They were two wells idle, one because of fine solids and the other because of formation. The problem of this hydrate well and reopened it. In the month of July, we had produced some 20,000 barrels or a little under 20,000 barrels.

So I'd say that our Frade operation is fully under control, and we are managing to somehow control really well the natural decline at Frade with mid-term actions, which are also on the slide. Our objective at Frade since the mid-run is to do what we call a water shutoff, a polymer injection that contain water -- that contain the water produced and also well stimulation primarily related to cleaning the well or eliminating fine solids in the wells. So these are the mid-term elections for Frade, which should help us maintain the field decline very much under control, and so we begin our drilling campaign, which I will address later on. Well, going to the next slide, we see our cost.

We can see \$24 per barrel -- \$24 per barrel in a consolidated fashion showed the importance of Frade in our operations. This number already includes everything related to operations and maintenance as well as air logistics all included, all synergies included. There was still some change in cost as part of the \$24 such as transition cost, which ended in August, and the land and sea logistics that were not yet captured. Actually we were still paying for some things twice because of the two companies.

There were vessel return schedules and so on and so forth, but now from August onwards, everything is running 100% optimized. So our expectation is that lifting cost will be lower than \$24 per barrel in a consolidated fashion, we should even be able to get to \$20 per barrel by year end, as we have said in previous earnings call. Moving to the next slide, Slide number 7. Regarding Polvo's drilling campaign, no great novelty here except that we have scheduled and are planning to start this campaign in September.

We have the possibility of drilling up to four wells. Obviously, that kind of depends on one another so when evolve as we are successful, but the targets are same more or less than two months for every well, and an estimated CapEx of \$30 million to \$60 million. Now if we moved to Frade field, perhaps this is the novelty, the drilling campaign at Frade. We are having global revitalization plan for the field and initial revitalization plan with four producing wells and three injection wells.

The first of this overarching global plan we defined two phases. The first as we can see, with one producing well and two water injection wells. We have to remember that at Frade, the main reason why the field is declining is the lack of reservoir, the lack of water. That's why these two injection wells are so important.

And one producing that is located in a well-known reservoir with discovery and all. So I say the risk is really well controlled. These three wells of the first phase will cost according to our present estimate, between \$190 million and \$200 million for 100% of the fields. And is interesting regarding PetroRio making investments in phases is that we can try to move this first phase forward to 2020.

Again, half by May 2020, this drilling campaign should be happening. Now of course, it all depends on the drilling rig and on equipment, but always moving ahead, and is aligned for us to get there. With that, I'll turn the floor to Nelson. I'd like to thank everyone, and thank Nelson for the possibility to return to my background area of interest, finance.

And good luck to who, as of next quarter, will be leading Operations. As Nelson mentioned, is a home-grown star. He has been here since the beginning of the company, since the beginning of PetroRio. He actually was -- before the birth of PetroRio, he was -- last year he was one of the main people responsible for the drilling campaign.

So good luck. Milton, over to you to talk about our financials.

Milton Rangel

Thank you, Roberto, and good afternoon, everyone. Well, moving to the financial part of our presentation.

Overall, the second quarter was quite emblematic with strong and positive result, considering the addition of Frade Fields to the company's result. With that, we hit some record marks, starting with our net revenue with almost BRL550 million. EBITDA was also very strong, around BRL260 million IFRS 16 effect, which was 643% higher than the adjusted EBITDA of Q1 2019. Reflecting the of Frade Field, which was not reflected in Q1 '19.

In terms of EBITDA per barrel, another record mark, an all-time high in our history of practically \$31 per barrel. Net income totaled more than BRL160 million, more than 130% up year-on-year. And not only in terms of accounting indicators, but also cash generation, free cash flow, we also had another record, reaching the highest cash generation in the history of this company. This clearly influenced positively our indebtedness metric because the net debt is reduced.

And with that, we can foresee the strong deleveraging trajectory for the coming quarters, which puts the company in a very comfortable, in a very healthy position as regards to our debt level. Moving to the next slide, we have our income statement. I'd like to draw your attention to some figures, especially the revenue line, up almost 130% in the quarter and

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almost 100% in the half year. Our revenue totaled almost BRL690 million and it's important to highlight that this was not just a change in terms of our revenue, but above all, of our profitability.

So if we compare the first half with the second half of 2019, excluding IFRS 16 effect, first half of this comparison, EBITDA margin increased to 39% from 28%, 11 percentage points of improvement. If we consider adjusted EBITDA, 14 percentage points of an EBITDA margin of more than 40%. Considering the impact of IFRS 16, our EBITDA margin in the quarter was almost 60%. In year-to-date, higher than 50%.

Therefore, in general, a very strong and positive result that makes us proud. Moving to the next slide. This is evolution of our results per barrel. We try now to follow this metric up EBITDA per barrel.

We can see that from the beginning of 2017 to date, we see a clear ascending curve and have been improving our profitability per barrel. Even in these year-on-year comparison, Q2 '19 against Q2 '18, we can already observe an improvement despite a reduction in Brent oil prices between these two quarters. It is also important to point out that synergies between Polvo and Frade have not been fully captured in Q2 numbers. There's a lot of work being done, and we have been focused on reducing costs to a minimum by capturing synergies between the fields.

With that, we posted this result of almost \$31 per barrel, similar to players and competitors in the industry that produce more than 2 million barrels a day. That shows how we -- despite being smaller company, we are able to generate a lot of cash per barrel, trying to reach maximum efficiency and profitability. This really reflects our DNA, which is to increase the size of the company through M&A deals and improve our profitability by managing our assets, and consequently, creating as much value as possible to our shareholders. Moving to the next slide, to give you more on our annual leverage.

Well, in 2018, the company did not have a relevant debt and that's why we observe a negative net debt. But this starts to change in 2019 with the loans granted by FINEP, ICBC and Chevron for the acquisition of Frade Field. So we see a significant leap of net debt over adjusted EBITDA ratio, which was 3.3 times. But this has reduced notably in Q2 '19, given the company's cash generation and cash inflow increment from Frade.

It is important to show that this indicator is at 1.5 times if we take into account the last 12 months. And considering that in these 12 months, only one-quarter had full contribution from Frade. Thus, we have a clear indication that our debt level will drop in the coming quarters. This puts the company in a very comfortable position for future funding and greater firepower for future acquisitions.

On the next slide, regarding our funding and the characteristics of the loans that we are getting, generally speaking, we have been building a stronger relationship with several banks, both Brazilian and international. We observed a number of banks approaching us wanting to do more business with us, and we have been able to get some loans at very attractive costs, as you can see on the slide. Today the debt of PetroRio with Chevron

through vendor finance at a cost of LIBOR plus 3% per annum. We'll also find the export prepayment agreement this year with PetroChina and with ICBC.

ICBC being the bank in charge of the operation at the cost of LIBOR plus 3% per annum. ICBC is one of the largest banks worldwide. And we also signed recently, as previously announced, a nice credit line with FINEP geared to innovation and improvement at Polvo Field and has a good thing to do with our business case. Also we have access to many short-term working capital credit facilities with a number of partnering banks.

Moving on with the presentation our the last slide, talking about duration. Currently, our duration is relatively short because the bulk of our debt will be repaid in the next two years through vendor finance. And this puts us in a very comfortable position to reduce our leverage and it gives us room for future leverage. So naturally, we are looking into extending this during, which is currently short to give us more and more strength and momentum to grow either for drilling campaigns or for the acquisition of new assets, incorporating new results for the company.

The fact is that we have good room in our balance sheet to find more and more credit deals to enhance our purchasing power and to develop our assets. With that, I end my participation in this presentation. I would like to thank all of you for joining us, and turn the floor back to our CEO, Nelson. Thank you.

Nelson Queiroz

Well, thank you very much, everyone, for participating in our Q2 '19 earnings conference call. I hope you have enjoyed it, and now we open the call for questions. Thank you.
(Question And Answer)

Operator

(Operator Instructions) Our first questions comes from the webcast.

Analyst

According to news published by the company, disposition of 18% from impact will not have a cash effect. So is it paid already? And if so, was this paid for the corresponding production?

Nelson Queiroz

Good afternoon, let me clarify regarding impact. The effective date of this deal is way previous to the current date. With the production of the field from that date to now, there is an adjustment in the price.

This price adjustment led the transaction or the deal to have a zero value. This has not been paid yet. However, when the deal is authorized -- actually, it's not authorized but when the deal is executed because it has gone through all levels and passed all levels of

authorization in Japan. So now, you're at a much more operational level and it depends on the Japanese.

So when this is done, we acquired the company that owns the field. So when this company comes with a positive cash balance and this balance will be used to pay exactly what we owe for the deal. So we'll have a zero cash --, but this has not been paid yet because the deal has not been completed. When it is executed, we expect this to happen in the third quarter, then this will become consolidated with balance sheet with production, EBITDA and so on and so forth.

Operator

The next question, also on the webcast.

Analyst

Regarding Frade Field, what are the expectations, will the drilling campaigns increase production? Any estimates for CapEx in this campaign? Do you intend to disclose reports of reserves? And in this drilling campaign, will you be accessing some targets in the,

Unidentified Speaker

Hello. This is speaking. To give you an overview, we are in the final phase of study for the drilling campaign.

We're estimating a CapEx of \$190 million to \$200 million for the full campaign. In terms of reserves, it's way too early. We are reviewing the study there. The G&G team is reviewing the report so we can have more to disclose on that.

I would just like to add to what regarding the result. At Frade, there is the prospect there is a possibility of drilling in the. It is not included in the initial drilling campaign now, one producing well and two injection wells, but Frade don't have a pre Salt prospect. It could be a future target of a future drilling campaign.

And this is not our core focus at the moment, which is we believe there are lower risk initiatives that we should tackle at the fields. Pre-salt at Polvo. Although, we do have a prospect in the which is normally the layer of production in the pre salt. For the logical reasons, Polvo does not have that layer.

So there's no possibility of drilling a well as we are used to readings in the media that is under the faults because we don't have that layer. But again, if that happens, there is some prospects that Polvo for later on for the future that are much less risky in terms of geological results and the pre-salt that's lower risk than in the pre-salt.

Operator

Your next question also comes the webcast, from.

Analyst

What about the royalty discount for matured fields? Does the company have this kind of benefit currently? Are you seeking to have it?

Unidentified Speaker

Our company, PetroRio, is entitled to that right so that we're going after that benefit.

PetroRio was one the precursors of this idea. One of the precursors this request to ANP. So according to ANP regulation, they are considering a reduction in the payment of royalties regarding the production of wells drilled last year. These wells would enjoy this benefit and the production from these wells instead of being 10% royalties towards sales less than that, down to 5%.

This is our expectation. But again, this is any regulation from ANP, it entails a long process. We believe that the process is moving ahead towards the end. So we estimate this benefit coming through this year.

So this is it. Though we are entitled to the right, we have not enjoyed the benefit yet, but we will happen eventually.

Operator

Your next question also from the webcast. It's from Tiago Noel, Athena Capital.

Tiago Noel

Hello, congratulations to the whole company for the results. What is the initial expected impact from the first phase of the development of Frade?

Unidentified Speaker

Tiago, good afternoon. I'm not going to tell you exactly the impact from the wells that we intend to drill. I'm going to give you an overall answer.

I think that the message is, at Frade Field, the wells that started producing at Frade, all of them started with an initial flow greater than 5,000 barrels a day. I'm not saying that this specific will begin at 5,000 barrels a day but what I'm saying that in this region in this reservoir with the opportunities that we've drilled before, all wells started with more than 5,000 barrels a day. So this could be the producing well. The other two wells are injection wells.

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They don't lead to spontaneous production increase but what they do is reduce the decline of the well so that's why we are going to inject water. we would not see an increase the production exactly when we start injecting water. The result of that will be seen over time, over months, we would start seeing a reduction in the natural decline of the field. But at the right time, when we have the whole campaign, designed and ready, then we will come back to that and talk about initial production and talk about wells.

I want to remind you that the company traditionally does not give you a precise guidance regarding initial production of well. Last year, quarter we did not give you a guidance is there because there are many uncertainties in this kind of project.

Operator

Your next question also on the webcast, from Eb Ravishing.

Analyst

We have a record EBITDA in the company.

But as mentioned, we have not incorporated all of the Polvo Frade synergies. How relevant can this be for the EBITDA per barrel in the next quarter?

Roberto Bernardes Monteiro {BIO 16616322 <GO>}

Good afternoon, This Roberto. Well, I look at this in the reverse way. This is related to the lifting cost but the analysis is basically is the same, it's a matter of looking at the glass half full or half empty.

Regarding the lifting costs in this quarter, we had a lifting cost of \$24 a barrel. The lifting cost includes total transition cost, and it also includes the cost offerings that we are operating in the it sounds too much, but when we acquire a new -- when you acquire an oil field, you have the well, the vessel, the wells organizing everything. So what we still have to but what was not included in this quarter was the whole land logistics piece and the sea logistics piece. And there's two things, sea logistics include support vessels.

To move the support vessels around you need to have them authorized by IBAMA, according to an emergency plan. You have to submit those emergency plans to IBAMA. And this was approved. So we went from 7 to 3 vessels with regards to Frade.

Regarding land logistics, we started the operation with one logistics base here in and another one in at Frade. But we consolidated the whole of the operation. And someone corrected me, we consolidated our operation in. And retuned the base.

So these things happened around the quarter and there were some transition expenses. We had a shuttling program with Chevron. We operated the FPSO with Chevron, people

on board to ensure safety, efficiency and so on and so forth. All of this is over and along ago quarter, in the next quarter, we will not have these cost.

So our estimate is to get to \$20 lifting cost in a consolidated fashion.

Operator

Your next question also from the webcast, coming from Hodrigo Cekata.

Analyst

Regarding the bond issuance process, what is the status of this operation? Two, what are you going to use these resources for?

Milton Rangel

Thank you, Hodrigo for the question. While we have seen considering some funding options for the company.

As mentioned by Nelson, the bond amount is an interesting alternative for us. I would say that one of the uses of the proceeds would be to enable a drilling campaign on Friday as explained by Roberto. And in terms of status, documentation is progressing, it's well advanced. This is a summer break period in Europe and the United States.

So we're waiting for them to get back to us and we are waiting for attractive market conditions. This includes the Brent oil price. Brent price should recover. The main thing is that we're ready.

In addition, we have a comfortable cash position. So we're in a comfortable position to choose the right market moment. But the company is ready. So I can tell you the process is way advanced.

Operator

Your next question from webcast, the Dellago.

Analyst

What is the profile of the assets that you are considering? Smaller fields? High producing year?

Nelson Queiroz

Hello, Dellago. Regarding the fields that we are considering. We tend to look at fields that would offer synergies to what we're having today, Frade and Polvo.

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Ideally, we would consider close by fields, fields we can derive synergies from in terms of logistics, personnel so on and so forth. That would offer an upside in terms of revitalization. It's not a matter of being a small field. But what truly matters is if it's a mature field, it's normally a field that was forgotten, not on the radar of large companies.

So fields that large companies are not paying attention to and with that, these kinds of fields becomes an opportunity for revitalization. You can see the economic principle, large companies, they have a large balance sheet, a large structure, so they tend to focus on development, large projects like the. And because they want to optimize their own resources, they comfortably leave smaller fields aside. And that's where we have a great possibility of adding value.

I know this is our quest and it is this kind of fields that would be in our pipeline.

Operator

Thank you. This concludes today's question and answer session. I would like to invite Mr.Roberto for his closing remarks.

Roberto Bernardes Monteiro {BIO 16616322 <GO>}

Well, again, I would like to thank all of you for joining PetroRio's earnings conference call. This quarter was a very strong one, a very interesting one. Once again, it shows the company's ability to create value with our strategy of acquiring matured fields, revitalizing matured fields and optimizing costs. I would also like to thank all of you who supported me during my time at PetroRio, and I'd like to wish good luck.

As of now -- but as of now. Last week, he became the COO and he will handle the operational highlights in the coming quarters. Thank you very much, and have a good day.

Operator

This concludes PetroRio's conference call for today.

Thank you very much for your participation, and have a good day.

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