

Q1 2021 Earnings Call

Company Participants

- Dennis Herszkowicz, Chief Executive Officer
- Gilsomar Maia, Chief Financial Officer

Other Participants

- Enrico Trotta, Analyst
- Fred Mendes, Analyst
- Gabriel Meneses, Analyst
- Marcelo Audi, Analyst
- Maria Tereza Azevedo, Analyst

Presentation

Operator

Good morning, everyone. Welcome to TOTVS First Quarter 2021 Earnings Conference Call. Joining us today are Mr. Dennis Herszkowicz CEO and Gilsomar Maia CFO. We would like to inform you that all the key measures defined by the legislation and health protocols defined by the regulators have been followed for organizing and conducting this video conference. We would also like to inform you that during the company's presentation, all participants will be in a listen-only mode.

After the company's remarks, there will be a Q&A session for investors and analysts when further instructions will be given. In case anyone is attending this conference over the phone and needs assistance during the call, please press star zero to reach the operator.

The audio and video feeds of this event are also being broadcast live over the Internet at the address ri.totvs.com.br. Before proceeding, let me mention that forward-looking statements that may be made during this teleconference about the company's business perspectives, projections and operating and financial targets are based on the beliefs and assumptions of Total's management and on information currently available to the company. Forward-looking statements are no guarantee of performance. They involve risks, uncertainties and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur. Investors should understand that macroeconomic conditions, industry conditions and other operating factors can cause results to differ materially from those expressed in such forward-looking statements.

Now I will turn the conference over to Mr. Dennis, who will begin the presentation. Starting on slide number three, Mr Dennis, you have the floor.

Dennis Herszkowicz {BIO 17998338 <GO>}

Good morning, everyone. I hope you're all well safe and healthy. Health and well-being continue to be top priorities in our work and in everything we do. That's why I would like to start by thanking all TOTVSers for yet another quarter of hard work and dedication. Because of this dedication, we were able to start off 2021 at the same pace we closed 2020, stepping on the gas. The building of technology ecosystem for small and medium enterprises has been consolidating based on a journey of digitalization that aims to exponentialize TOTVS.

Moving on now to slide number five. This quarter TOTVS has reached financial and operating levels that we had not seen in a long time and in some cases we have even broken historical records. Our net revenue grew by 20% year-over-year and our EBITDA margin achieved 26.3% adding up to 46%, 18 percentage points above the first quarter of 2020, which shows a balance between growth and profitability keeping us within the Rule of 40 for the third consecutive quarter.

Our Technology recurring revenue totaled BRL539 million, up 15% year-over-year. This is the greatest growth since 2014 and with a quality mix since it was boosted by SaaS, which reached BRL199 million in the quarter, up 27% compared to the first quarter of 2020. We also hit a new record of credit production at supplier exceeding BRL2 billion of which BRL800 million produced in the month of March. These were the main factors that boosted our EBITDA consolidated growth of 49% resulting in the cash earning of BRL97 million, 43% higher than the first quarter of 2020. As Maia will show you on Slide 7 onwards, these results have only been possible due to advances made in the management and taxing dimensions.

Maia, I turn the floor over to you now.

Gilsomar Maia {BIO 16400533 <GO>}

Thank you, Dennis. Before talking about our improvements dimension, I would like to invite those of you who have not had the opportunity to see the material shared during our Investor Day in February. To do so, there are presentations and videos of the sessions available as well as an internal study conducted by our Market Intelligence Team that clearly shows that the Brazilian market of management software made evolution such as ERP, HR and verticals is far from mature and still has a great growth potential, especially now that we're seeing this increased digitalization of businesses.

In this context, we've been focusing a lot on SaaS with continuous improvement in product quality, with an increase in NPS and cloudification. An example of that was the launch of the new version of T cloud, a platform that expand service offering, improves customer experience, allowing them to manage integrate and expand applications in only a few clicks on the platform itself, providing them with greater productivity speed and efficiency.

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Another example that illustrates the focus we've been given to product quality and innovation is the launch of TOTVS Assinatura Electronica, the first product of the 100% product led growth in the management dimension that aims to simplify and speed up the process of signing documents for our customers in an agile manner that is integrated with our solution, it's safe and it has 100% legal validity. This quarter's such emphasis on SaaS and cloud translated into a 72% growth in cloud signings year-over-year which in turn contributed to a 40% growth in SaaS signings.

And then our SaaS revenue went from 19% growth year-over-year in the fourth quarter to 27% growth this quarter as we can see in the chart in the center of the slide. In addition to the cloud and SaaS signing performance, inflation readjustments of recurrent contracts also led the company to hit two new records. The first one, a non-organic addition of BRL90 million as we can see in the chart in the lower right corner, exceeding by 63% the same metric achieved in the first quarter of 2020 and in 12% that of the fourth quarter of 2020 and the second record was the mark of 81% of technology recurring revenue as you can see in the chart in the lower left corner of the slide. Also the technology recurring revenue was 15% higher than that of the first quarter of 2020, which enabled us to achieve a net technology revenue of BRL665 million, an 11% increase year-over-year.

Now moving on to slide number eight. Here we talk about our technology adjusted EBITDA, which closed the quarter at BRL173.5 million up 37% year-over-year and 18% quarter-over-quarter. This EBITDA level resulted in a margin of 26.1% up 500 bps year-over-year and 290 bps quarter-over-quarter.

This evolution in our technology EBITDA margin is associated in addition to the discipline and managing our operating expenses to a gross margin of 72%, the ever highest recorded by the company up 220 bps year-over-year. This level of gross margin is due to a combination of the following factors. First, any increase in the total recurring revenue in technology as a consequence of the accelerated growth in our recurrent revenue in SaaS and cloud. Second, we were able to maintain our level of remote implementations over 90% and we reduced the representativeness of this type of service. This non-recurring service in the composition of our technology revenue as a consequence of better cloud penetration. And third, the continuous advancement in product quality with consecutive increases in NPS and a lower demand for support.

In sum, the scalability of the SaaS model has provided TOTVS with the ability to consistently obtain EBITDA margin gains and it's worth noting that we're not guided by the quarterly margin. Since the investments in portfolio innovation in building our ecosystem and the three business I mentioned as well as marketing and sales activities may cause oscillations in the quarterly margin.

Now on slide number nine, we see our taxing dimension or credit products. In this quarter, supplier continued its V-shape recovery, which had started in quarter two 2020 reaching more than BRL2 billion in credit reduction as you can see on the left of which BRL800 million were produced only in the month of March. And we give special highlight to the segment of manufacturing particularly in connection with agribusiness and civil construction. This quarter's reduction was a record-breaking number for supplier and exceeded by 25% quarter one last year, which was impacted by the pandemic only in the

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12 last days of the month of March. As a consequence, our credit portfolio closed the period up 21% year-over-year and 25% quarter-over-quarter and also reached the ever highest position recorded by supplier.

In parallel, the commercial integration with TOTVS continue to advance at TOTVS Mais Negocios closed the quarter with six signed contracts of which three are already in production and this performance in production occurred without any prejudice to our discipline in credit granting which was reflected in the delinquency levels, which are below the levels observed before the pandemic as you can see on the bottom right of this slide. This delinquency level resulted in a provision for expected losses corresponding to 3.3% of the credit revenue for the quarter, which is significantly lower than the average 6.7% of 2019 and 13% of quarter one 2020, when there was an increase in delinquency levels in the start of the pandemic before the credit limits were reviewed by supplier.

And the comparison with quarter four 2020, this provision increased by 1.4 million once the provision for quarter four represented only 0.8% of the credit revenue and this was due to the reversion of provisions made in the start of the pandemic and this explains part of the reduction that we've seen the EBITDA margin for the quarter as you can see on the right on slide number 10.

Another major factor that is associated with this reduced EBITDA margin in the quarter was a temporary increase in the cost of credit, and this was due to the average cash balance of FIDC in this quarter, which was up 45% quarter-over-quarter as a consequence of the funds raised in December 2020 which reiterates the quality of FIDC, which is well recognized by the market. This capital structure has allowed supplier to significantly expand its return on equity, which in the accumulated numbers for the last 12 months reached 43%, up 24.6 percentage point year-over-year, 19.6 percentage points quarter-over-quarter.

Now, I hand it over to Dennis. And he will continue on Slide 11.

Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Maia. In business performance, we took an essential step with RD which is seen in the market as a synonym of digital marketing. It adds to TOTVS state-of-the art team with an additional 600 employees, more than 25,000 clients, and an estimated revenue for 2021 of more than BRL200 million with an average growth rate of 50% between 2015 and 2020. This deal has already been approved by the Brazilian Competition Authority CADE and we are only depending now on the verification of other usual conditions to close the deal. And despite this not yet being consolidated in our result, its performance in quarter one '21 was much above the business plan that we use for acquisition.

Now moving on to slide 13. As the largest tech company in Brazil, we want to strengthen our role in positioning in ESG and not just in the way we behave but we also want to evolve these concepts in our ecosystem and in our relationships with stakeholders. For

this reason, starting this quarter we will always give highlights to our developments and initiatives in ESG.

This year we held our General Shareholders Meeting on April 20 with a participation of more than 72% of TOTVS capital. Our clarity and transparency and the explanatory and supporting documents for the matters proposed were complemented by a great part of our shareholders and we had approval for 100% of the matters discussed, such as the change in the capital limit authorized for execution of the business plan of the company, the payout of dividends and the new share based incentive plan. We also held on March 9th our TOTVS Investor Day 2021 with more than 350 attendees, 76 more than in 2020. The highlights of the event included TOTVS exponentialization and digitalization journey and the live announcement of RD stations acquisition having us background soundtrack, the song Thunder by AC-DC.

As a final take away, I'd like to highlight on slide 14 that we will continue to build our technology ecosystem for small and medium businesses. In the management dimension, our focus is SaaS and cloudification, also the continuous innovation of our portfolio, such as with [ph]age exam for HR, TOTVS Assinatura Electronica and the new T cloud platform, which further strengthened our position in the market. We also understand that the Brazilian management software market is still far from being mature and therefore there is a lot of room to grow. In texting, we will keep accelerating with our record-breaking credit reduction. We will advance in commercial integration and launch new products.

And in business performance, as I just said, we took an essential step to better establish this dimension. Finally, we know that TOTVS is well prepared for these challenges. We have a team united by the same ambition and aware that we have a unique opportunity to become the main partners of our clients.

And now we will open for questions.

Questions And Answers

Operator

We shall now start our Q&A session. (Operator Instructions)

Our first question is by Enrico Trotta from Itau. You have the floor, Enrico.

Q - Enrico Trotta {BIO 16742911 <GO>}

Good morning, Dennis and Maia. Thank you for your presentation. I have two questions.

My first question is about supplier. So the credit production was quite strong and even with all the factors related to seasonality, you had a strong quarter. I know that you can't give a lot of guidance, but what are the expectations for the second quarter considering the new wave of COVID that can impact credit production? The second and third quarter of last year, you also had an increase in delinquency levels because of the pandemic. So

what are your expectations now looking ahead considering the pandemic and credit production as well as delinquency levels?

Now, my second question is more about technology gross margins. it's impressive to see the levels that you have achieved. You know a historical record that reflects everything you've done in terms of cloudification initiatives and remote applications. But my question is how much more can we expand our gross margins considering cloudification? Do you think we can -- is it still possible to improve gross margins in the Technology segment?

These are my two questions. Thank you very much.

A - Gilsomar Maia {BIO 16400533 <GO>}

Thank you, Enrico for your questions. Good morning. So starting with your first question about supplier. We believe that we're going to have another good quarter. We're starting the month of May now and we see a positive dynamic supplier is still leveraging important competitive edges it has and its business model and making the most of the fact that most of the chains and which strong are still performing really well. It has a degree of exposure to commodities and we know that commodities are performing really well right now. It's also exposed to agribusiness, which is also performing really well. So I believe that at least in the short term, we'll continue at this positive pace. A concern we always have is related to funding so that there is progress can continue to happen. And this has already been addressed as we saw this has had an impact on margins because we raised important funds in the beginning of the year. This is already being deployed in origination. So once again, I would like to state that we believe that supplier will probably keep a good performance in the near term.

Now about gross margins. As I said in my presentation, we have a 72% margin, which is the highest level we've ever achieved in our company. So, where can we get? It's hard to say. It's very hard to define a number, but this is related to the change in business model that we've had, and this gives a capacity to gain scale especially when we talk about non-recurring revenues that are losing space in our revenue and we increase our recurring revenue universe. So I think that it's just the natural way to go. You know, to gain margins and gain scale, but it's really hard to say where we can get what we can achieve

Q - Enrico Trotta {BIO 16742911 <GO>}

Great, Maia. Thank you very much.

Operator

Our next question is by Fred Mendes from Bradesco BBI.

Q - Fred Mendes {BIO 17221617 <GO>}

Good morning everyone. Thank you for this presentation. I have few questions. My first question is about RR. In the last quarter, you had BRL80 million and you had a net addition now. Is that due to the grace period that we saw this quarter? Or is that due to the volumes that increased? Thank you very much.

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A - Gilsomar Maia {BIO 16400533 <GO>}

Thank you, Fred. Good morning. Well, I would say that this was due to many different factors at the same time. You're right, the factors you said has a positive impact. We knew that with the grace periods going back to normal levels. That would be an advantage for us. But we also at a first quarter that was really strong in signings, especially the month of March we hit all time records in the month of March in spite of the challenging scenario with restrictions on mobility and economic activity. But we had a month of sales production that was really, really strong and this addition was really strong and recurring in the recurring sphere. So this evolution will probably be capped with possibility of being accelerated in future quarters. So I'd say that the main factors was production signing and we wanted to reinforce that in our earnings release. Thank you very much.

Q - Fred Mendes {BIO 17221617 <GO>}

Just a follow-up question, can you tell me if this comes from the largest customers you have, and you are now selling new licenses to them or is that due to new customers?

A - Gilsomar Maia {BIO 16400533 <GO>}

Hi, Fred. Yeah sure, we can talk about that. We did not have strong concentration. That was actually quite diversified throughout the quarter. March had a big account that also contributed. But the main point about signing I mean this was boosted by many different factors not only one specific factor. So if you look at those from all different perspectives, you see that the performance was really strong in terms of signings and the closing of the month of March. So the quarter as a whole was really good.

Q - Fred Mendes {BIO 17221617 <GO>}

Thank you, Maia.

Operator

The next question is from Gabriel Meneses JP Morgan. Gabriel, you may proceed.

Q - Gabriel Meneses {BIO 20578931 <GO>}

Good morning, Dennis and Maia. Thank you all. First, could you give us an update about the pipeline of affiliates for the supplier? I see that you had a very strong production in this quarter. So I want to understand how this will continue from now on?

And the second question is about your M&A pipeline. You had some very important acquisition in this performance in texting. So maybe now, the next step is something focused on software.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you. Gabriel. Well, about the pipeline of new affiliates, we continue to increase the share of the leads generated by TOTVS in the total new affiliates of supplier. So we believe that during this year and at the latest in the start of next year, more than half of this

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pipeline will be composed of leads generated by TOTVS. It is a product that has a very good fit with our customer base.

And this funnel of lead generation is starting to widen greatly because the work of our commercial team, our AR team as we call it, is being accelerating now. So the probability of this funnel being expanded and the number of new opportunities increasing over time is very high. It's a very high chance of that happening. But of course, the sales cycle of this product, the Mais Negocios, which is the original supplier product, the sales cycle is a little bit longer.

You don't close a deal in a few days. It takes a few months actually of negotiation and the rollout itself, yes, of course, we are working to shorten the rollout period. The average is six months and we want to decrease that to half, but of course, there's all this setup work so that it can function properly. But as soon as it is rolled out, the speed at which these affiliates start working is very high. And this is the beauty of suppliers business model as it is.

And your second question about the M&A pipeline. I'm going to start answering your question. And then I'll hand it over to Maia. Well, our pipeline is still very good. We have a significant opportunities inside. We have actually dozens of targets that we are constantly assessing. And in many of these cases, we have constant negotiations conversations in our everyday work. So we have enough targets. And considering that we have four different pillars and we are genuinely present in the three dimensions that we want to be present, with number of targets and the variety of targets is very large, both in terms of segment and also the sizes of these companies, the level of maturity, I can't really give you much more information right now for obvious reasons, but what I can tell you is that we will continue to work on M&As at a very good speed. Maia would you like to add anything?

A - Gilsomar Maia {BIO 16400533 <GO>}

No, that's it basically what you said. The transactions that we have been announcing are making TOTVS even more attractive. RD itself was seen by the enterprise market, which is in a very strong development phase right now. They see that this is a clear alternative. There is not just one alternative. And as a publicly traded company, you have to continue this journey. And this is what TOTVS is doing. This has been attracting a lot of people. A lot of people want to talk to us and better understand what we have in mind for this type of transaction. So our list of target companies is even more prominent right now.

Q - Gabriel Meneses {BIO 20578931 <GO>}

Thank you for answering my question.

Operator

The next question is by Maria Tereza Azevedo, Santander.

Q - Maria Tereza Azevedo {BIO 16178885 <GO>}

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Hello. Thank you for taking my question.

My first question is about RD. I read in your release that the first quarter's results were above the business plan. So can you please tell us what are the products that are having the most traction in terms of volume? And if this changes your level of optimism looking forward?

And the second question is about the strong evolution in cloud and SaaS and if may be we can think about a target, when will the company be close to 100% SaaS? Thank you.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Hello, Maria Tereza. Good morning. Thank you for your questions.

Maria Tereza, regarding your question about cloud. Yes, we have been making important investments and we have been able to advance as planned. And of course, Maia can say more about this. But about RD, we can say that the results were considerably better than the business plan that we used for this acquisition. And it was better virtually in all lines, so when we look at revenue and profitability of course there is always a concern when you have a company with a significant growth rate. Right?

But they are significantly better than we had projected when we work in the negotiation and the closing of the deal for acquisition of the company. So this makes us really happy. It is clearly a demonstration of the company's strength and this is a natural reflection of the leadership position that it holds in the market. Because RD in the end of the day, as I said in my presentation, is a synonym our digital marketing platform. I always say that it is the Coca-Cola, the Gillette or the Danone of its market.

And since we know this is a market that is strongly expanding, RD is truly the company that is capturing a great part of this evolution. And this was clearly reflected in its results in quarter one. Maia?

A - Gilsomar Maia {BIO 16400533 <GO>}

About SaaS and cloud, well, I get the impression that this is just the beginning. This is just the beginning of this trajectory. The demand is really strong and the pandemic came to make it even more evident how important it is to use this type of resource and to be able to operate from anywhere remotely in a lighter way of taking some of the load from the company, some of the burden from the companies to provide the infrastructure for the use of these solutions.

And as customer start to clearly see these benefits, they also clearly see in TOTVS the best provider for this type of service. So there is no one better than TOTVS itself to manage an environment, whether a private environment, others environment. And that's what we're doing, we're advancing the infrastructure to manage our own applications. We have a deep knowledge of our applications. We know all of its characteristics. We know how to extract the best of them. Our cloud team, as we said, has seen some very important developments and advancements during the year both in terms of building and evolving

this platform, which is providing a lot of visibility and transparency to our clients on one side and also the capacity to gain efficiency in the management of this infrastructure. So I can see a very long optimistic successful tragic trajectory in the future because this is very much in line with our interests and those of our customers. So I'm very optimistic.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

And Maia. I would just like to add one last thing, but if it is a -- well in the end of the day we see today that all the barriers all the concerns that clients had in the past after one year or a little over one year of this pandemic clients are working remotely. This is widespread.

So today it's just a matter of managing this flow of clients interested in the products and services. And since TOTVS continues to make important investments in its cloud structure and the quality of its products and services and not just in terms of the equipment in physical structure, but also the management of our layer, our tier, the T cloud tier as we call it, this is really helping us provide the level of quality that our clients expect from us.

And also we have the advantage of having our own structure. So when we look at the foreign exchange situation in the past 12 months or maybe a little longer than that, the foreign exchange has been an important competitive edge for us. So in addition to clients, as Maia said, seen us as the best company to manage its own applications.

We also made all this continuous investment in improvements and we still have the additional advantage of having our own infrastructure located in Brazil which brings us this price advantage, which is something that we certainly have been tapping lately.

Q - Maria Tereza Azevedo {BIO 16178885 <GO>}

Great. Thank you very much and congratulations on the results of the quarter. Thank you.

Operator

(Operator Instructions) Our next question is by Marcelo Audi, Cardinal Partners.

Q - Marcelo Audi {BIO 1550731 <GO>}

With the distribution network, and RD..

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Marcelo, can you please start over? There was a connection problem and we lost the beginning of your question.

Q - Marcelo Audi {BIO 1550731 <GO>}

Okay. My question is about the adaptation of contracts with the network in terms of commercial targets and other adaptations that you had to make for the new product offered by supplier and RD. I know this is not something that happens overnight. This is a cultural change that is required. So what are the next steps and when do you think this is

going to happen? You know, so that you can see that you are 100% integrated in these products in terms of the contracts and remuneration terms.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you, Marcelo, for your question. As you said, so well, this is a process. It is a journey, it's not something that we can simply press a button and have it solved and of course this will have many trial and error processes. But this is actually happening faster than we expected. In terms of RD, nothing has been done because the closing of the transaction hasn't happened yet. CADE, the anti-trust authority just approved those last Friday. So we had practical limitations in order to start anything related to that. But in terms of tech fin, and more specifically about supplier, we've been working on that for about a year now. So we are quite advanced in that process. We run several pilots last year that were all successful. So this year, we started with a regular production base. So overall, all our AR represented by our own units as well as franchisees. They all have the specific tech fin targets already established. We also already have a remuneration model that has been negotiated and approved for our own resellers and franchisees and we are seeing great acceleration. As I said, if we look at Mais Negocios which is our supplier's main product, we have over a third almost 40% of the pipeline of new affiliates generated by leads, our customers coming from TOTVS itself. So I'm pretty sure that throughout the year, this rollout will happen quite intensely and any adjustments that might be needed in terms of format or remuneration will be made.

Our goal is to make the most of this footprint and the commercial strength of TOTVS, which is one of the main competitive edges that we have and we believe that we need a omnichannel approach. In this omnichannel approach, if we don't have this remuneration or compensation model and in alignment model for any model we have either in the management or the Tech Fin dimension or even in the business performance dimension, then we would be losing some of the strength of this asset so this alignment in remuneration or compensation is key. So we're focusing on that.

Q - Marcelo Audi {BIO 1550731 <GO>}

And Dennis, do you think that the implementation of the remuneration model in RD will be more complex or simpler than the Tech Fin model?

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Well, Marcelo. I think it's going to be different, it's not going to be more complex or more complicated, but it will certainly be different because RD'S products and ways of selling are different. This is a PLG company and that means that its product sometimes expand within the product itself. And we will try to insert this PLG feature and the evolution of PLD products and other RD products and TOTVS products in the future as well. Of course, this is going to be yet an omnichannel approach but we're talking about a significant difference when it comes to at least part of the Tech Fin offer.

Q - Marcelo Audi {BIO 1550731 <GO>}

Okay, great. Thank you very much.

Operator

(Operator Instructions) So we are now closing the Q&A session. Now I'd like to turn the floor over to Mr. Dennis for his final remarks. Mr. Dennis, you have the floor.

A - Dennis Herszkowicz {BIO 17998338 <GO>}

Thank you. Well, this conference was our first a dry run of a video conference with a video feed as well. So I hope you have enjoyed it. Maia and I have been participating in audio conferences for a very long time without showing our image. So today we had to be more careful. You know we're assured and be more mindful of the way we act, but we wanted to provide you with a bit more color and a bit more flavor and I hope you have enjoyed.

Sergio has just reminded me that we have our new Investors Relations website. It's more agile, more attractive and very user friendly. So we hope you all enjoy it and make the most of it. Thank you very much. Have a great day and a great week.

Operator

TOTVS video conference is now closed. We thank you all for joining and have a great day and thank you for using Chorus Call.

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