

Q3 2015 Earnings Call

Company Participants

- Claudio Bergamo dos Santos, Chief Executive Officer & Director
- Martim Prado Mattos, Chief Financial Officer & Controller

Other Participants

- Alexander Robarts, Analyst
- Andrea F. Teixeira, Analyst
- Irma Sgarz, Analyst
- Marcel Moraes, Analyst
- Robert E. Ford, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. Welcome to Hypermarcas' Third Quarter of 2015 Results Conference Call. With us today we have Mr. Claudio Bergamo, CEO; and Mr. Martim Mattos, CFO.

We would like to inform you that this event is being recorded and that all participants will be in a listen-only mode during the company's presentation. After Hypermarcas' remarks, there will be a question-and-answer session for investors and analysts where further instructions will be given.

We would like to inform that questions can only be asked by telephone. So if you are connected through the webcast, you should e-mail your questions directly to the IR Team at ir@hypermarcus.com.br. Today's live webcast may be accessed through the company's Investor Relations website at www.hypermarcas.com.br/ir.

We also would like to inform you that statements during this conference may constitute forward-looking statements. Such statements are subject to known and unknown risks and uncertainties that could cause the company's actual results to differ materially from those set forward in the forward-looking statements.

Now I'll turn the floor over to Mr. Claudio Bergamo, who will begin the presentation. Mr. Bergamo, you may begin your conference.

Claudio Bergamo dos Santos {BIO 16015846 <GO>}

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Good morning, everyone. Thanks for attending Hypermarchas' third quarter 2015 earnings call. I'd like to start this call remembering that yesterday we announced to the market a transforming event for the company with the signing of an agreement for the sale of our cosmetics business to Coty, a transaction amounting to around R\$3.8 billion. This business includes brands such as Bozzano, Monange, Paixão, BIOCOLOR, Risqué, Cenoura & Bronze, among others. This business generated net revenue of around R\$978 million last year, equivalent to 20% of our total sales.

The close of this transaction is subjected to certain conditions described in the agreement, including the approval of the transaction by the anti-trust authorities and the execution of certain actions that make the business independent to cover (02:52). The payment for the transaction by Coty is estimated to be no later than the second quarter of 2016.

The proceeds from this transaction will be mainly used to reduce our net debt with substantial improvement in our capital structure and value creation to our shareholders. By the end of the third quarter 2015, our net debt after hedge was around R\$3.3 billion; meaning that after the transaction, the company should become net positive cash of around R\$500 million.

In addition, this transaction is part of our business strategy of restructuring of our portfolio. When completed, this restructuring will allow us to have a bigger emphasis and focus on our pharmaceutical business, a sector which offers excellent growth opportunities in Brazil and superior profitability, a sector in which Hypermarchas is nowadays the national champion ranking number one in the markets with about 14% market share.

We should also highlight that our participation in the pharmaceutical, we are not only the biggest company in the market, but also we are the most complete with the best set of businesses with leadership in many relevant markets.

In the OTC market, for example, we are the number one with about 30% market share and leadership in many segments such as the flu symptoms and generic assets among others. Our brands are widely traditional and established in the market for many years. In some cases, we are synonymous of categories such as brands like Benegrip, Engov, Rinosoro, Epocler, Estomazil, Atroveran, Alivium, Tamarine, Hemovirtus. We are also the number one company in the branded generic market with a now clinical brand. We are the number three company in the acute generics with also (05:42) clinical brands. In this market, which has been growing a lot, we are gaining market share constantly in those three tiers (05:53).

In RX drugs, we have a portfolio of well established brands in many markets and in many therapeutical classes such as Predsim, Celestamine, Maxsulid, Diprospan, Mioflex-A, among others. This segment is supported by a few teams, which visits more than 150,000 doctors per month. We also have leadership in other consumer health markets such as in condoms, where we are the number one player as well with about 55% market share with the famous brands Jontex, Olla and Lovetex.

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We are the number one player in nutritionals with more than 50% market share with the brand Zero-Cal, Finn and Adocyl. And we are the number two player in dermocosmetics sharing the leadership with the brand Mantecorp Skincare. So as we all can see, our position in pharmaceuticals in Brazil is quite outstanding in all the segments; and we believe after this transaction, we will be able to further leverage our position in this marketplace.

I would like also to remember that even after the sale of our cosmetics business, our consumer divisions will continue acting in the diapers and infant product market under the brands of Pom Pom, Cremer Disney and Sapeka and also in the incontinence diapers with the leading brand Bigfral, which business which were not included in the transaction with Coty.

We are very confident that this transaction is very attractive to the Hypermarcas shareholders. We will substantially improve our capital structure, which in turn will allow us to further invest in our most attractive sector in pharmaceuticals where we have a clear competitive advantage.

Now I'll turn the floor over to Martim, who will briefly discuss our results in the quarter and some more details about the transaction. Thank you very much.

Martim Prado Mattos {BIO 16015889 <GO>}

Good morning, everyone, Martim speaking. I would like to briefly discuss our Q3 results and talk about some implications of the sale of our beauty business.

Starting on page three of our presentation, we had organic growth in the consumer division that was consistent with growth that was seen on past quarters. This time, however, growth was concentrated on price increases as the first consequence of our focused shift as announced on the last earnings conference call.

In pharma, growth was in essence driven by volume increases and was in line with our objective for the quarter. We have consistently managed to keep the pharma demand for our products above average of the average of market growth, and this quarter was no exception. On consolidated numbers, we posted organic growth of 11.2%, two-thirds of which due to price increases and one-third to volume expansion.

As seen on page four, gross margin dropped 3.4 percentage points. The devaluation of the Brazilian real caused a 4.7 percentage points impact on margin, while price increases only caused a 3.4 percentage points increase. Additionally, a mix leaning more towards diapers, deodorants, and hair care led to an additional drop of 1.8 percentage points.

SG&A ex-marketing kept its dilution spend (10:06) net revenue contributing to balance the gross margin drop by 1.2 percentage points. In the same manner, marketing also increased less than net revenue following the guidelines for the year.

On the next page, as a result from what I have just mentioned, there was a 3% adjusted EBITDA drop to R\$278 million in the quarter. Net income was reduced by 37% in the quarter as a combination of lower operating results and heavier weight from financial expense.

It's important to put into perspective that the 4.7 percentage points margin reduction because of FX can be translated into an impact of about R\$50 million on adjusted EBITDA or R\$40 million on net income. We know that we only had aggressive price increases on the quarter to offset the devaluation effect. Even so, these increases were not yet enough to neutralize this effect.

As you can see on page six, we ended the quarter with gross debt of R\$5.5 billion and robust cash position of R\$1.6 billion, plus R\$524 million in non-realized hedge gains on top of that. So our net debt after hedges ended the quarter at R\$3.3 billion or 2.9 times last 12 months adjusted EBITDA.

Flipping over to next page, I would like to recall the main features of the transaction we announced and its implications for the call. First of all, the portfolio of the transaction comprises our entire beauty and personal care businesses of our consumer division and includes the Senador Canedo factory. It is interesting to highlight that this scope was formed from eight different acquisitions carried out by Intermarket from 2008 through 2010.

Without this brand, as Claudio mentioned, we took up big factors turning our company even more into a specialist in the Brazilian pharmaceutical market. The relevance of the beauty business was (12:38) 20% of Hypermarcas total revenue in 2014; meaning that from silicon branded products now represents 70% of our sales. With this new competition, we will have (12:54) increase in the company even that margins in the pharma division are structurally higher than in the consumer.

The total value of the transactions is R\$3.8 billion, 45% of which should be received during the current fiscal year and the remainder is estimated through Q2 2016 after the segregation of the business is over. The capital gain resulting from the closing of this transaction should be neutralized by goodwill amortization, absorption of accumulated losses carried forward, as well as with the usage of tax credits. The proceeds will be used to reduce our R\$3.3 billion net debt, a fact that will change the company's net income level because of the reduction of net financial expenses; as well it will also change the level of our free cash flow after interest.

Finally, as you can see on page eight, we will like to invite you all to join us on our Hype Day, which is scheduled to take place in December 7 afternoon here in São Paulo. During the event, we will be glad to share with you more information about the implications of this transaction for the future of Hypermarcas.

Thanks, everyone, for the attendance and we may now proceed to the Q&A session.

Q&A

Operator

Thank you. The floor is now open for questions from investors and analysts. And our first question comes from Robert Ford of Bank of America Merrill Lynch. Please go ahead.

Q - Robert E. Ford {BIO 1499021 <GO>}

Thank you very much, and good morning everybody, or good day everybody; and congratulations on the transaction. I know you guys have been working very hard to get something like this done. Martim, you used the term neutralize capital gains and I was curious, or I was hoping you could go into a little bit more detail in terms of the tax structure of the deal. Is there going to be any kind of cash payment on capital gains? And if the net proceeds are expected to be the full R\$3.8 billion or if it's going to be something less than that? And then if you could just touch on your remaining tax assets post the transaction? That would be very helpful, please?

A - Martim Prado Mattos {BIO 16015889 <GO>}

Hi, Bob. Thanks for the attendance and thanks for the questions. Initial calculations that we have and what I mean by the neutralization is that in terms of the fiscal side, the fiscal equation of this, the cost that we have for this transaction on the fiscal side is approximately R\$1.3 billion, which means that we'll have at best capital gains of close to R\$2.5 billion.

But the way that it works here in Brazil and Bergamo has been highlighting that constantly, we still have amortization of goodwill, which has its implication for the calculation of (16:24). We also have a pretty large amount of losses carried forward which we will be able to use. And in addition to that also we have federal tax credit in the amount of approximately R\$500 million. So doing these initial calculations, we estimate that we will not have any significant cash impact to pay for the capital gain resulting from this transaction.

After the transaction, we also estimate that we still have a fairly good amount of balance of goodwill still to be amortized, approximately R\$1.7 billion. And we also still have losses carried forward that we will be able to use in the future amounting to approximately R\$2.5 billion.

Q - Robert E. Ford {BIO 1499021 <GO>}

That's pretty big. And then there was some news on the state of São Paulo proposing a reduction on ICMS in pharma and I was curious if there's been any additional developments and how likely you think that that could be? And if other states might envision something like this to take some of the pressure off the consumer?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

FINAL

Bloomberg Transcript

Hi, Bob. It's Claudio here. This change in São Paulo is particularly beneficial for generics given that it will reduce the distribution to (18:08) that you have on the products. So there's nothing new on that. It's just an idea and a discussion.

Q - Robert E. Ford {BIO 1499021 <GO>}

And do you have a view on maybe how probable this might be? Or is it a non-starter, given how tight the fiscal situation is for the state?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Still too soon to say.

Q - Robert E. Ford {BIO 1499021 <GO>}

Okay. And then Claudio, could you comment a little bit about the dynamics within the pharmaceutical sector in general, right? The overall economy is clearly slowing. That seems to coincide with some deceleration within your pharmaceutical business, but at the same time you're reining in some of the working capital, right. And I was wondering if you could talk a little bit about if there is any destocking in the channel, competitive dynamics that they're getting a little bit more aggressive, maybe if you could comment on mix. And then there was a little bit of margin pressure in the period too. Do you have the power to take a little bit of pricing by reducing discounts in the current environment?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

So the pharma sector for the year has been growing around 11% in Brazil already net of discounts for the full market. So it's still very, let's say, healthy growth for a moment like the one we are living in now. So I still believe that we have moving forward a good potential for the consumption increase given the secular change in terms of our demographics that the population is aging in Brazil; and that this is a must-have type of product.

On the other hand, the whole increase in cost especially due to the change in exchange rates has been pushing the manufacturers to reduce their discount levels to (20:43) especially in the generics and in the branded generics market, which on the other side they are reducing the discount to the consumers. So I see these trends entering 2016. And we shall continue to see a reduction in discounts in the next couple of months to offset the increase in costs.

All these (21:19) happens when you increase prices, you ended up having a (21:28) and later on this is recovered; still very happy in the last levels. But when you increase prices (21:44), that's very radical. It's just a very smooth transition that we have seen specifically in the third quarter where our selling was slightly lower than our sell-out, and we shall continue seeing that probably in the fourth quarter as well, once that continues pushing our prices up and reductions on discounts.

On the other hand, it's good to have in perspective that the formula for government to increase prices for medications always takes into account that inflation minus a second

productivity factor to allow price increase by April of every year so that next year we shall see a little higher price increase than we have seen in the last three years even that the inflation is higher than in the past. So it's going to be good news next year because we want to be able to recover margins based on this higher price increase that we might be allowed from the government.

Q - Robert E. Ford {BIO 1499021 <GO>}

That's very helpful. Thank you and, again, congratulations.

Operator

Our next question comes from Alex Robarts of Citi. Please go ahead.

Q - Alexander Robarts {BIO 1499637 <GO>}

Thanks and hi everybody. I have two questions and I did want to start off first with the pharma industry outlook and what we saw in the quarter. I mean I guess and appreciate the comments in the earlier call in Portuguese as well, but I'm kind of thinking about the sell-out rate you've mentioned first nine months pharma sell-out in Brazil 11%. But this quarter, we saw sell-out at 7%, which I guess looking back from the beginning of this year, it's about half the growth rate that we saw early in the year, and you've talked a little bit about the FX pressures causing the price increases and reduced discounts. How has it been going with the OTC market? I mean I guess, in this third quarter, I guess, 40%, right, of the portfolio is in OTC. We have some brand and have been seeing price softness in this or some demand softness particularly in this category. And if we think about, I guess, you're signaling that fourth quarter, we should still have this single-digit sell-out growth it seems in pharma, how can we think about the recovery as we go into next year? I mean, things seem to be getting a little bit more pressured for the consumer, but again the category is relatively resilient. So if you could talk a little bit about that pace of sell-out recovery in early bits of next year. And then my second question is on the deal. So I just was keen to hear what you could tell me industry in pharma?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Hi. Actually, as I said, the year-to-date of the market has seen around 11% and our growth was 10%, so the difference is 1%. So I think it's not fair to compare year-to-date with the quarter figure. For the quarter, the market grew around 9%, we grew around 7%. As I said, we are currently in the process of increasing our prices and reducing likely some of our terms that results into a slower selling compared to that is not affected at all our sell-outs which continues to be very healthy.

For the company, this is good news because that allow us to increase prices and reduce somewhat adherence in order to better manage our working capital. So that's basically what it is, that's what I said in the Portuguese and that's where we are now. I don't know - I mean, what's the other question?

Q - Alexander Robarts {BIO 1499637 <GO>}

Yeah, sorry. What I was trying to get at is your kind of sense, sorry, Claudio, on demand, right, on the sell-out demand in pharma, right, which was 7%, right, in the core?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

It's not 7%. Actually, it's at 10%, it's (26:59) 7%.

Q - Alexander Robarts {BIO 1499637 <GO>}

The growth in the pharma, you've been talking about rates in kind of high-single-digit, 7.1% I guess is the growth that you talked about in the press release.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

But this is sell-in. Again, this is a sell-in. A sell-out, that's measured by IMS, I think you can call Breno, Breno will explain that more in detail.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay. So regarding the sell-in then, okay, if you could talk to us about the sell-in, how do you see that kind of recovering into the - as we think about early next year? Do you feel we can get back up to the double-digit? I mean, is that a fair assumption in the first half, or is it too early to tell?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

I think it's too early, I would rather not give any guidance of that now.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay. Fair enough. And just on the deal, very, very interesting transaction for sure. In the earlier call, you mentioned that R\$500 million, is what you expect to have net cash, right, after paying down the debt. And you talk about, however, not being perhaps looking into further M&A over the medium term. And it sounded like you're focused on maybe giving shareholders back the money through some dividend. Could you talk a little bit about medium-term where will you be as far as looking at opportunities to consolidate the pharma sector 14% share as the leader, clearly, highlights the fragmented nature of the businesses? And so might we think about in the medium-term with this debt reduction, you looking toward some M&A in pharma, or will it really be just, at this point, focused on dividends?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Well, we don't have any focus on M&A at this point. We believe that we still have many opportunities to launch new products innovation. As I said, we have currently (29:39) around 51% coverage of all the molecules around Brazil. We still have many opportunities to entering in new (29:50) and in new molecules. And I think that's probably the next best opportunity and that's where we should be focusing moving on.

Q - Alexander Robarts {BIO 1499637 <GO>}

Okay. Fair enough. Thank you.

Operator

And our next question comes from Marcel Moraes of Deutsche Bank. Please go ahead.

Q - Marcel Moraes {BIO 20057766 <GO>}

Hi. Good morning, everyone. My first question is related - well, in fact both questions are related to the transaction. The first is just to know is the R\$3.8 billion would be denominated in reis first and then if there was any correction to that price like inflation or SELIC rate? And the second question is about working capital. How much of that will be transferred to Coty? I mean, are you transferring inventory and received all of that? How much is that? Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Marcel, no, there is no correction. It's a fixed amount, but it's important to mention that we have two installments, one of 45% of the total amount which is around R\$1.7 billion, which will be due right after the Anti-Trust Authority approval. So we expect prior to the year that amount. The remaining piece, which is around the R\$2.1 billion, should be after we will finalize the capital (31:26). So regarding working capital, Martim?

A - Martim Prado Mattos {BIO 16015889 <GO>}

Working capital that was included in the deal, Marcel, is approximately R\$500 million, and that's included in the R\$3.8 billion.

Q - Marcel Moraes {BIO 20057766 <GO>}

Thank you, Claudio and Martim.

Operator

Our next question is from Irma Sgarz of Goldman Sachs. Please go ahead.

Q - Irma Sgarz {BIO 15190838 <GO>}

Hi. Good afternoon. I just wanted to ask whether you had any specific plans for the brands that are left in the consumer division after considering your recently announced sale as well as the potential sale of the disposable business, I guess you still have Zero-Cal and Jontex, and the broader spaces of artificial sweeteners and condoms. So was wondering what's your plan for those two smaller divisions? I expect that that's in the order of magnitude of R\$250 million to R\$300 million. So I appreciate it's not a huge business, but if you could just comment how you're strategically thinking about this business?

And then, maybe if you can just in broad strokes talk about when you look at your pharma portfolio, are you kind of happy with where you are? I know you have lot of approvals still going through ANVISA, but strategically speaking, do you think there is specific sub-segments that are particularly attractive where you could be growing either organically or

potentially and I know it's obviously theoretical at this point, but potentially through acquisitions still? Thanks.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Irma, I'll start from the second. As I said, we nowadays, despite the fact that we are the number one player and we have around 14% share, we still have many white spaces in our product portfolio. We compete around 51% of the existing molecules. We have a very strong pipeline in the waiting list now at ANVISA. This pipeline has been working for the last couple of years and we should see them maturing as we move forward in order to reduce these white spaces and this product gaps. That should allow us to have an important factor to maintain and even to sustain our continuous growth in the pharma channel. So with the current capital structure, we believe that we will be able to even to further accelerate some of our initiatives to close these gaps in the next two years, three years.

Regarding the consumer business that staying with us, we consider both the OTC as well the nutritional or sweeteners to be as consumer health related type of sectors. And as such, they should be included in this, as considered as pharma business. Regarding the diapers, I don't have comments from this point. We are working very hard, continuously delivering value for this business. The business has been going at very good momentum. And we will take the opportunity now by divesting the cosmetics to further reduce its costs in order to generate good profitability.

Q - Irma Sgarz {BIO 15190838 <GO>}

Okay, thanks. Claudio, just if I can follow-up, when you talk about the pipeline and the coverage ratio that you have currently of 51% (35:37) of molecules, can you give us an idea of when you look at the end of this current pipeline that you have, what's your rough estimate of where the coverage ratio in terms of molecules will get to once you're through that pipeline?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

So our pipeline is expected to improve around 17% to 18% of the current gaps. So we are still now in the process of developing new products. As you probably know, we just created about couple of months ago, a new innovation area for the pharma sector, and we are moving ahead and accelerating (36:29) our initiatives to go after all the remaining product gaps that we still have in this sector and this division. I think that is a major level of growth that we will pursue in the next two years, three years into this area.

Q - Irma Sgarz {BIO 15190838 <GO>}

Okay. Thanks.

Operator

And our next question comes from Andrea Teixeira of JPMorgan. Please go ahead.

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Q - Andrea F. Teixeira {BIO 1941397 <GO>}

All right. Thanks. Just a follow-up from the Portuguese call and some of the comments earlier. I mean, we - obviously, it's great to have pharma, it's a high growth and all of that, but I know you have a tough comp ahead of you on the fourth quarter given some of the tactics that you used in the fourth quarter of last year. So I was wondering if (37:28) as you have pretty much almost half of the quarter already, what are you looking? Would we probably assume a sell-in, in the flattish, given that you're comping against 18% growth last year? And how should we think, I think, from your earlier comments, you were saying overall the sell-out has accelerated, but you're gaining share. So it's really a lot of moving parts here. So if you can help us kind of navigate through the comps and the most recent trends? I would appreciate. Thank you.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Hi, Andrea. In fact the comps is challenging. But again, as I said to Robert, we are pursuing a focus on some better management in our working capital as well increasing prices. That type of initiatives have the objectives to improve the economics, but we're doing it in a way very carefully that it doesn't jeopardize our market position in terms of market share and sell-out. So I think all is when we look in perspective above the sell-in, we have always to keep in mind that we have to look both sell-in and sell-out as standard figures (39:08) in order to not make the wrong conclusions about if I have, for example, a 7.1% that means that we are decelerating. That's not true. That's exactly what happened in our industry. So we have to do combine sell-in and sell-out figures and that's pretty much that how we have it.

Q - Andrea F. Teixeira {BIO 1941397 <GO>}

Yeah. So if I interpret it well, the fourth quarter sell-out is still in the double-digits for pharma?

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

We cannot talk about fourth quarter. The fourth quarter hasn't ended. So you know that the...

Q - Andrea F. Teixeira {BIO 1941397 <GO>}

I understand, but the trends are still - because from what I understood, Claudio, from the previous comments is that it is decelerating, the second half is decelerating against the first half.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

It's not - no, it's not decelerating, I'm saying is pursuing such initiatives in order to improve our management, economically speaking. On the market position, nothing has changed, we're still very healthy and I cannot anticipate what's going on in the fourth quarter.

Q - Andrea F. Teixeira {BIO 1941397 <GO>}

Okay. Thank you.

Operator

We have a follow-up question from Alex Robarts of Citi. Please go ahead.

Q - Alexander Robarts {BIO 1499637 <GO>}

Thanks for taking the follow-up. Look, I wanted just to revisit the M&A point again, local media have talked about and you've discussed the interest in looking at alternatives for the diaper business. And I'm wondering if you could give us an update on just your thinking there and what might be any change to what you've been seeing among the interested parties or such? Any update on the thoughts around the M&A possibilities with the diaper division would be great. Thank you.

A - Martim Prado Mattos {BIO 16015889 <GO>}

Hi, Alex. This is Martim. This is coming from us, not the media. We are now expecting that we have hired banks to analyze alternatives for our diapers business. And we said there in that material fact and the situation remains absolutely the same that we will not be able to give any comment on any development of that process before it comes to a conclusion. Okay?

Q - Alexander Robarts {BIO 1499637 <GO>}

Thank you.

Operator

This concludes our Q&A session. I would like to turn the floor back over to Mr. Claudio Bergamo for his closing remarks.

A - Claudio Bergamo dos Santos {BIO 16015846 <GO>}

Thank you very much, all, for participating. If you have any further questions, our IR department is available. And have a nice day. Thank you.

Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.

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