

Q3 2017 Earnings Call

Company Participants

- Grace Cury de Almeida Gonçalves Tourinho, Chief Financial Officer
- Pedro Henrique Rocha Nocetti, IR Manager

Other Participants

- Joseph Giordano, Analyst
- Leandro Bastos, Analyst
- Luciano Campos, Analyst
- Marco Calvi, Analyst
- Rodrigo Gastim, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and thank you for holding. At this time, we would like to welcome you to Qualicorp's Conference Call to discuss the results of the Third Quarter 2017.

We have with us today Mr. José Seripieri, the CEO; Mrs. Grace Tourinho, Financial and Investor Relations Officer; Mr. Pedro Henrique Rocha Nocetti, the IR Manager.

This event is being broadcast live via webcast and may be accessed through Qualicorp's website at www.qualicorp.com.br/ir and at the MViQ platform, www.mviq.com, where the presentation is also available.

We would like to inform you that this event is being recorded and participants will be in listen-only mode during the company presentation. Ensuing this, we will go on to the question-and-answer session when further instructions will be given.

I would now like to turn the floor over to Mrs. Grace Tourinho, who will begin the conference call. Mrs. Tourinho, you may proceed, ma'am.

Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

A good morning to all of you. Thank you for your presence. It is a privilege to once again speak about the results of the company for the third quarter and the nine months of the year. We concluded the acquisition of Aliança that we began 15 years ago. We began with a purchase of 75%. We bought more in 2014 and now we have bought the additional 25%,

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paying BRL 227 million. Now, these two companies will become part of Qualicorp and they will continue on with the corporate structure that they began 10 years ago. This company strongly generates cash, and this quarter, there was no difference between January and September. We reduced net debt by almost 82%. The EBITDA margin, the adjusted EBITDA margin had a growth of 8 percentage points when compared to the previous year. And we were able to obtain 2 percentage points more than in the previous semester with the EBITDA reaching BRL 75 million, which means that we continue to deliver value to our customers and, of course, to our shareholders.

When it comes to regulations, we spoke about this broadly during this quarter. We have formalized three issues. The first regarding the AMS, the national health industry, and the GAR (03:42), the PGR which is the general attorney of the republic. All of these regulations, without exception, focus on regulation and have shown the importance of this health management in terms of supplementary health.

I would now like to give the floor to Pedro, IR Manager, to refer to the administrative and commercial part.

Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

A good morning to all of you. Thank you very much, Grace. I would now like to go to slide number 4 that refers to our portfolio. When we look at the differences in the third quarter, the growth lives compared to the third quarter of 2016 and the second quarter of 2017, the lives added were due to an organic growth. There was no effect of the migration of portfolio in the third quarter of 2016 and in the second quarter of 2017.

It is important to highlight this when we carry out comparisons and when you assess the performance of the company. Of course, the company has been working in a very complicated macroeconomic scenario, a scenario that has continued to be challenging since the second semester of 2014.

Because of this, along with the loss of the purchasing power of the population, and when you include in this the fact that we have had very difficult readjustments, it is natural that in 2017, we have a lower sales volume compared to the previous quarter.

Nevertheless, if you look at the organic growth in the third quarter 2017, we have had 30 lives added every month, which is very aligned with what we saw in the first semester. What is it that we're truly able to sell health plans with a lower ticket and we are able to offer these throughout the territory. We're thinking of having more accessible products to sell them more. And wherever we do not have these accessible products, we tend to sell our health plans to a very reduced bracket of the population when it comes more specifically to churn. We need to keep in mind that the third quarter when we begin to make readjustments in our portfolio we began in July. We made readjustments of 80% in our portfolio between July and September. Now, when we have readjustments, the Qualicorp invest in training, invest in its sales channels or with in the quest of developing more accessible products.

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But, once again, we are undergoing a very difficult scenario that is why the results are somewhat worse. But the churn, as you can see, has been quite good and we ended the semester with 79,000 less than in the second quarter of 2016 simply to end this issue about portfolio, which is a point of attention for analysts and investors since December of 2014. The beneficiary base of product lines has dropped by more than 3 million people in Brazil and Qualicorp, of course, is part of this context.

What we do understand is that because of the resumption of the economy, we will be able to grow our portfolio. This has been a very challenging period. We are developing products, we're combative and we are going to use this strategy. The customers are seeking good attention and alternative products. Despite the fact that this is a difficult period, we have not remained still and with the presumption of the economy and the purchasing power of consumers, we will once again grow our portfolio with a great deal of strength. This is a resilient product and something that the Brazilian population as a whole desires.

With this, we would like to go on to slide number 5 to speak about our revenues. At the consolidated figures, show a growth of 5% compared to last year due to the price readjustments specifically, but also due to the impacts that I mentioned before. Now, we are able to increase revenues in Affinity just because of the readjustments in the portfolio, the lower sales ticket because we can only sell more accessible products along with the fact that we have a loss in the number of lives. Now, if you compare the accumulate figures of the nine months of 2017 with 2016, we were able to have a growth of 8% in revenues up to present.

We go on to slide number 6, speaking about the cost of services for the company, and this shows the work that we have been carrying out during the last quarter. And you have begun to see the results somewhat more strongly at the beginning of this year.

In the year-on-year comparison, we have a reduction in personal expenses due to the restructuring of sales. We have savings with third-party services and it is important to highlight the following aspect. Since July of 2017, we have insourced the operations of the health club that used to be outsourced. We are now carrying out this work in-house. This enables us to improve the margins of health products and also has enabled us to have a lower head count and a more efficient structure in our labor.

When we look at royalties that refer to the contracts, we have a reflection of the readjustment of prices. Now, the gross margin of the company has been growing when you observe the graph below. And to the right, in the last 12 months, we have almost 75% of gross margin on the whole, 65.5%, and in the third quarter we reached 77%, an increase of 1.6 percentage point vis-à-vis last year.

Now, we go on to slide number seven to speak about our administrative expenses. I am going to harp once again on personnel expenses year-on-year comparison, once again due to the readjustment in the company. We had an increase between the third quarter of 2017, compared to the second quarter of 2017, an increase in personnel expenses due to an adjustment of provisions we have set forth internal goals for our focus. We're doing

very well in the fulfillment of these goals and this is readjustment in the profit participation program. This is something that we have focused on since last year and at the beginning of this year. Three of our affiliates are now close. We have sold some of the floors at our headquarters in Plínio Barreto, and this has allowed us considerable savings of approximately 25% quarter-on-quarter.

Through this, we have also been able to reduce our administrative expenses in the 12 months comparison. We went from 29% two years ago to less than 23% of our net revenue. We're continuing on with this very efficient working, optimizing our expenses and the company's resources when we speak about resource optimization.

I would like to go on to slide number 8, selling expenses, before I give the floor to Grace. In selling expenses, we have to speak about our portfolio once again. We are investing in sales as this is one of our great concerns. Qualicorp is optimizing its commercial resources. We're investing where we believe we will become ever more efficient and we will continue to invest if we feel the need for this and if we believe this will bring a return for the company.

A large part of the savings that you'll see in the third quarter is due to an optimization of our commercial resources. When we compare the third party commissions, well, there is a reflection of the lower volumes sold, Qualicorp always seeks the best strategy, the most efficient one to be able to increment its sales.

And we will not be hesitant in doing this. What we are seeking the works that we have been carrying out is the works to develop products that will be accessible. Accessible products sell well and this is what we are going to attempt to do and what we have been doing. And once we have these products, we will be able to have liquidity and we will have a sufficient structure for all of this.

Having said this, I would like to return the floor to Grace Tourinho who will speak about our financial highlights.

Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

We go on to slide number 9 to speak about our debt, very similar to that of last year, well below the third quarter in 2016. Once again, I would like to remind you of the efforts carried out in the company to reduce the bad debt and the continuous work to recover on paid portfolio.

Most of our portfolio was readjusted in July and we always have a worsening in the third quarter of this year, reaching the worst moment in the fourth quarter which is our next quarter. Nevertheless this year since May, we have the coming into effect of a new resolution that forces the companies to immediately cancel plans when requested by the customers.

With this, as we are forced to cancel plans when requested by the customer, we have been able to reduce part of our losses from those who have canceled their plans simply

because they're not able to pay for the additional readjustment, and of course, all of these would go into our bad debt or uncollectable receivables.

We go onto slide number 10 that refers to our financial income. The main line item refers to the stock option of Aliança that we have already mentioned. As part of the contract, we had 9.5 times the net-debt equity ratio. Throughout the years, we have carrying restatements every semester. And this quarter, we paid BRL 22 million, BRL 228 million in the previous quarter and still regarding our financial expenses, we had the monetary statement in the third quarter to a company, the new (17:08) in the market.

And we show a growth of 27% in our EBITDA vis-à-vis the third quarter of 2016 and for the nine months of 2017, we were able to overcome last year by 25%. The work carried out here is continuous, consistent, and this has been ongoing for some time at the company. This enables us to go through more challenging periods such as the one we're undergoing now. Especially due to the long duration of the crisis.

In the last 12 months, you can see the operations curve with the new margins. This once again based on our merit. And I would once again like to reaffirm the work that has been carried out internally in the company. We are focusing especially on expenses. In the first nine months of the year, we reduced expenses by 14%. We still have a great deal of opportunities that can be grasped (18:26) in this area, and that is why we are always very determined in terms of this in the company.

We now go on to the slide number - on page number 12. 53% of net income, which is the change we have had operational gains here. In the third quarter, we stood at 35% when compared to the previous quarter with 40% and with the second quarter of 2017, we're 38%. What is important here is the complexity and the importance of each of the operating companies in the Qualicorp Group. Despite some of the restrictions that we have to comply with, we're always attentive to generating value.

We would like to thank you for your attention and we're now open for your questions.

Q&A

Operator

Thank you very much. And we'll now on to the question-and-answer session. Mr. Rodrigo from BTG Pactual would like to pose a question.

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Good morning to everybody. I have two questions. The first referring to your growth. I would better like to understand the resumption of the economy and your results. Do you think that this will be accelerated during 2018 at the end of the year or will we have a lag between the economic resumption and your acceleration?

My second question refers to the dynamic of commercial expenses, which has been the gain of efficiency and how variable is this? Will this have an inverse impact when you are able to once again increase your sales? I would like to gain an understanding. Which is the margin that you would not have if the sales dynamic have been greater compared to previous quarters? Thank you. And these are my two questions.

A - Operator

Rodrigo, thank you for your two questions. The first question that I can respond to is the following. We have had very good sales even during the crisis and Qualicorp, during this entire time, has been delivering consistent results - positive results. We have not had many losses and this shows that the company is very resilient.

Now, what is happening, it is in this resumption of economy that we have the worst period. It's worst because we have to revise our plans and because we have been facing a very continuous and prolonged crisis. What we believe is that the resumption of the economy for Qualicorp will take place at a specific moment. Well, I think this will be the second cycle of economy.

We continue to be very confident. We're going to make money and we will be able to achieve savings. Qualicorp's main client is not the customer that is employed where our main customers are liberal professionals and they're having a very difficult time at present. We believe that once the economy starts moving, the customers of Qualicorp will come back and we will once again be able to grow. Once again, we have fully proven that this is a very desirable project, but access to the product has been difficult because of price. We don't believe that the resumption of the economy will be very strong and accelerated. It will be a slow resumption but it will happen with those people that I have mentioned and with greater confidence. We have to wait for this resumption cycle.

A - Pedro Henrique Rocha Nocetti {BIO 20904123 <GO>}

This is Pedro Henrique. Rodrigo, when you think about commissions and campaigns, whatever is linked directly to sales, when we think about losing (24:02) speed in terms of sales, we get to 14% or 15%, it's what we signed the first semester. I think that we could have one or two additional points of expenses based on net sales, if we have stronger sales.

Q - Rodrigo Gastim {BIO 19694950 <GO>}

Excellent. Thank you very much for your answers.

Operator

Mr. Marco from Itaú BBA would like to pose a question.

Q - Marco Calvi {BIO 19854632 <GO>}

Good morning to all of you. I have two questions. The first is a more specific question on royalties. Evidently considering the increase in the average price year-on-year, this is

question to be able to gain an understanding if there has been an increase in terms of the amount paid in royalties? This is my first question.

The second question is a follow-on on Rodrigo's question. This is the third consecutive quarter of increases in expenses and cost. A more subjective question in terms - which is the adjusted EBITDA margin that we can expect in two or three years? There are still a great deal of opportunities with SG&A and further reduction of cost and expenses. This is my question.

A - Operator

Hello, Marco. Good morning. Well, we are following up on this expense very closely. You can see that price indeed (26:11) has increased with the readjustment and it increases more because of the life plans and we're following up on this and holding internal discussions. Very similar to our other operating expenses, we're analyzing this expense. We're holding discussions and without a doubt, we will be reviving this in terms of our future EBITDA margins.

I would like to turn the floor over to Grace.

A - Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

Well, I think you know me quite well when it comes to margins and in terms of reducing expenses. Once again, it is important to underscore that our intention is not to cut down on expenses. What we do want to do is offer value to our customers. We're willing to invest. We want to retain our customers in the company. We want to ensure that the customers have a more positive experience. That is our great focus. And oftentimes, we listen to our customers saying that we're offering more and that we're adding up much more value. The complaint in the past was that some companies did not create value. In my view, there is a great deal of work to do to be truly able to deliver what we would like to deliver. And when it comes to our investments, I offset some of the investments with the savings that we have generated.

And of course, we constantly keep our eyes on this. Now, this is a company that is growing. We're cutting down on expenses internally. This is not a simple task. This is something that we have building through time. And nowadays, it has become easier to have savings compared with the first year of the company because we have created a new culture, but the opportunity for saving are more difficult, but they still exist.

I am not able to specify in how much time we're going to obtain these results. We have a team - an in-house team that is attentive, focusing on this day-after-day. And the work we're doing today at present perhaps is not the right one and we will have to change. We're open to changing. I cannot explain to you which will be the margin. The margin should remain at this level.

Obviously, we expect that with the resumption of the economy, we will be able to sell more and with the sale, we will be able to pay more to our third parties and we will be able to reduce some of our expenses. We're not going to remain at that level of 48%.

We're fighting, we're engaged in this game. And this is what I would like to convey to you but I don't want to make any promises.

We are going to continue to invest wherever we need enhancements and we are going to seek these enhancements whenever necessary, even though we have to offer the margins that we have been offering now, categorically, we study this step by step. We assess our data and we carry out a very careful analysis quarter after quarter. The level could be 47, 46, 45 (30:22). This is really not that important. We're more focused on having satisfied customers doing all of these work in-house and also offering alternative, continue on further reductions but this is not a simple task. Well, this is something that we do in our day-to-day work. I hope that I have been able to respond to your question.

Q - Marco Calvi {BIO 19854632 <GO>}

You have, Grace. Thank you.

Operator

Mr. Leandro Vasquez (sic) [Bastos] (30:59) from Credit Suisse would like to pose a question.

Q - Leandro Bastos {BIO 21416405 <GO>}

Good morning to all of you. I have a question. While, in truth, these are two questions. The first question, if you can foresee an impact on sales because of the internal work carried out since 2016 and in your commercial expenses, if you're thinking of changing your marketing policy in the company and going back to more traditional investments. These are my two questions. Thank you.

A - Operator

Leandro, it's not only about reducing our in-house sales people and it's important to convey this to you. We are not hesitant in investing if we think that we're going to become ever more effective. What we are trying to do is create more accessible products. It's never worth having very high-priced products in a market where you have a low-income bracket.

Once again, we are able to sell these high-end products but only in some markets. And we have been able to sell more accessible products they are selling. And this is not an issue of investing in traditional media. What we feel is that if we invest in traditional media, we're simply going to continue on working as we have. What we're focusing on the great bottleneck at present is to have the right products for sale.

Julio (32:45) is on the line and he is going to speak to us about these new products.

I have just reached the international airport and would like to say the following. The reduction of investments in traditional media and let us see what traditional media is. We have a good product and it is followed by our distribution channels and sales systems, as

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anything else in the world, are prone to failure and unfortunately in the health plan system, we still have operators that even though they're not able to have a good margin are paying 300% to 400% in commissions in reals. This is something that we do not practice, have never practice, and will never practice because this is not feasible. There is no product in the world where you can pay 200%, 300%, or 400% commission.

This is what traditional media is and we're completely out of this system. We are developing a product that I can bet will be revolutionary for the São Paulo market. We will launch this product until the end of the year. We're going to begin full-string, full-steam in 2018 but our intention is to launch this product at the end of the year. This is not a minor product (35:07) contrary.

It will be selling access to the network and not only medical services. Now, everybody would be happy if we could do this. Based on our experience, we are now in a very well-advanced stage of a highly-differentiated product geared to the São Paulo market, in detriment (35:46) perhaps of some of the products that we already have. We're betting our strategy on - well, we're not betting our strategy on distribution, on advertising or anything else.

Once again, this will not give strength to the product. We could have lots of - the great goal here is to sell in a consistent fashion. And once again, as I mentioned before, the focus of the company is retaining our consumers. The focus is greater in that than in selling. We're not here to obtain financial records. This is not what drives us. What drives the company is sustainability and more specifically longevity and we understand that going forward, we will be able to do this. We will have more specialized product for the user and, of course, the user is at the center of everything. I hope to have answered your question.

Q - Leandro Bastos {BIO 21416405 <GO>}

Yes. It has been made very clear. Thank you for your response.

Operator

Mr. Luciano Campos from Bradesco BBI would like to pose a question.

Q - Luciano Campos {BIO 16181710 <GO>}

A good morning to all of you. My first question is to go back to a comment that Pedro mentioned of creating lower cost products to increase sales. I would like to gain an understanding if this availability of products have changed somewhat or if it hasn't been enhanced since the second quarter? And in terms of churn this quarter, we have seen all of the churns associated to 80% of the beneficiary base and due to the price rise implemented. Now, will there be any price rises during the fourth quarter? Those are my questions.

A - Operator

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I don't know if I will be able to respond to your question, Luciano. But perhaps the team can help me with this. Our focus is not doing any downgrades. Nobody wants to do downgrade. Our understanding, once again, is not working with downgrade. What we want to do is offer the user whatever will allow the user to be satisfied.

We want to offer the user a network of a thousand hospitals where they can have free access. At present, they can use two or they only use two. Now, if you improve the access, the user will become more satisfied. Our focus, once again, is not on upgrades or downgrade. Our focus is completely different.

Our focus is in optimizing the product for the users, so that the user can feel satisfied, can feel that that we have fulfilled their expectations, especially in the long term. And churn is a very relevant point for the company, perhaps more important than sales. And we cannot sustain a system that is requesting specific levels of readjustment.

I'm not going to enter this discussion of readjustments because it would be too lengthy. We're not working on downgrades or upgrades.

What we feel is that people were not very happy with the plans they already had. Imagine with extremely steep price readjustments what would happen.

Luciano, simply to add to the answer, we were able to develop some products for some operators. We have been able to sell them. This works very positively and we're now trying to develop new products to increase our sales. This continues to be a challenge for the company, but we are working on that.

Q - Luciano Campos {BIO 16181710 <GO>}

And the impact of the churn on the 80% of the beneficiary base that has had this price increase and what will happen in the fourth quarter?

A - Operator

Luciano, when you have gone through 80% of your beneficiary base, of course, you concentrate the churn in the third quarter. October will still have that reflection of the readjustment. If you made readjustments in July, August, and September, several of the people will cancel their plans. We do have a readjustment in October, but the trend is to begin to suffer somewhat less from churn.

Historically, the third quarter has been the worst for us. What I'm thinking about is the third quarter of 2018. And the company wants is focusing on this issue of the readjustment based on the present day level. It's not something very acceptable. Our concern will be 2018. We would like to create movements to revert this problem in 2018. Once again, we're faced with difficulties. We continue to renew ourselves. We have continued to grow in the situation. We'll not be different in 2018. Thank you very much. I would like to thank you, Luciano, for your question.

Mr. Giordano from JP Morgan would like to post a question.

Q - Joseph Giordano {BIO 17751061 <GO>}

A good morning to all of you. I have two very quick questions. I would like to better understand which is your outlook with the slight decrease in inflation. What has happened to the average prices of your portfolios nowadays and what is it that we can expect in terms of price readjustment for 2018? And to continue onward is, we have a vote in the congress referring to the continued increase in pricing for a specific age bracket between 59 years of age and 65 years of age. I would like to know if you have carried out a study to see how this would change your price dynamic going forward?

A - Operator

I'm simply going to give you a conceptual preamble not to hamper the question for the team. Now, the price elasticity for the consumers over for any product in the field of health, whether it is individual or not, for SMEs, once again, in the future, we can no longer think about doing what was done in the past of having constant price increases and why is the part of claims increasing. What is it as an operator that we can do to reduce this curve.

We have thousands of users that simply cannot pay for these exorbitant price adjustments and we have to adopt a new system. What is it that the user considers as service, which is a service that the user truly needs. And then, we have to set forth a final price based on this.

We can no longer imagine that the medical cost readjustments in real values in Brazil can continue. They're even greater than they are in the United States. And once again, we cannot depend so much on these financial issues.

When it comes to the issue of an eventual change that may take place based on the vote for the user, for the beneficiary, conceptually, we believe that this will be better. We haven't truly carried out an analysis on this, but we think that this is something real. There is a high rate of customer evasion when they reach the age of 59 years. And the readjustment for that age bracket is much too expensive in practice when a person reaches 59 years of age. They're paying an actuarial rate as if they were 69 years of age, 89 years of age or 99 years of age.

Evidently, the rule as it stands at present creates a lack of sensibility. Those who cannot pay have to leave the plan and those who are outside they are unable to purchase a health plan. And all of this contingent on a deeper analysis, I think the situation will improve for the users, the beneficiaries.

Once again, we cannot continue to having these price readjustments and transferring them. Once again, the system cannot transfer each and every cost to their users. Users will not be able to pay for these in the long run. But once again, I would like the team to respond to this question.

Q - Joseph Giordano {BIO 17751061 <GO>}

Well, thank you very much. And if you allow me a followup and to speak about the control of expenses. If you could explain to us what you're doing with CRC/Gama if the idea is to continue working jointly? What is happening in Qualicorp?

A - Operator

Once again, this technical question I would like to send to the technical team. We have a very positive, very good projects for South America called QualiVida (48:26). We're following up on a group of people with very high claims. But once again, I would like you to discuss this with our technical area.

Now, the issue of CRC/Gama is very simple. Now, it's natural to think that they're going to become an operator. Now, we're bringing down barriers. We're acting alongside with the operator and this resistance drops very quickly, and I think that this is the right path. The operators will run a great deal of risks and we know that users will be enabled to pay more. And because of these operators will have to work more effectively in the health fee much more than what they're doing at present. They have the knowhow. They have the concern and the idea is to unite efforts to work jointly. Of course, life is full of obstacles. We know that. Any movement creates a zone field of lack of security, but once again I would like to reiterate the great focus for us is the users as they pay the bill and of course another concern refers to the operators.

Q - Joseph Giordano {BIO 17751061 <GO>}

Thank you very much.

Operator

With this, we would like to end the question-and-answer session. I would like to give the floor back to Mrs. Grace Tourinho for her closing remarks.

A - Grace Cury de Almeida Gonçalves Tourinho {BIO 17244138 <GO>}

Thank you very much. One again, the company is at your disposal for any doubts or if you need any clarifications, Natália, myself and others are at your disposal for any subsequent questions that you may have. Once again, thank you for your participation. And once again, the company is not standing still in terms of its figures. I would like to repeat that our focus is not on profitability and, of course, this does not mean that Grace will not work towards rationalizing our figures. We're very concerned with the change in the market.

We are going to become part of that change 24 hours a day. We're focusing on looking towards the future. Thank you very much and have a nice day.

Operator

The Qualicorp conference call ends here. We would like to thank all of you for your participation. Have a good day.

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