

Q4 2015 Earnings Call

Company Participants

- Gregory S. Panagos
- Linda G. Sullivan
- Susan N. Story
- Walter J. Lynch

Other Participants

- Richard A. Verdi, Ladenburg Thalmann & Co., Inc. (Broker)

MANAGEMENT DISCUSSION SECTION

Operator

Good morning and welcome to American Water's Fourth Quarter and Year End 2015 Earnings Conference Call.

As a reminder, this call is being recorded and is also being webcast with an accompanying slide presentation through the company's Investor Relations website. Following the earnings conference call, an audio archive of the call will be available through March 3, 2016 by dialing 412-317-0088 for U.S. and international callers. The access code for replay is 10079115. The online archive of the webcast will be available through March 25, 2016 by accessing the Investor Relations page of the company's website located at www.amwater.com.

I would now like to introduce your host for today's call, Greg Panagos, Vice President of Investor Relations. Mr. Panagos, please go ahead.

Gregory S. Panagos {BIO 17562275 <GO>}

Thank you, Kerry. Good morning, everyone. And thank you for joining us for today's call. We will keep the call to about an hour. At the end of our prepared remarks, we will open the call up for your questions.

During the course of this conference call, in both our prepared remarks and in answer to your questions, we may make forward-looking statements to represent our expectations regarding our future performance or other future events.

These statements are predictions based upon our current expectations, estimates and assumptions. However, since these statements deal with future events, they are subject to numerous known and unknown risks, uncertainties and other factors that may cause actual

results to be materially different from the results indicated or implied by such statements. Additional information regarding these risks, uncertainties and factors is provided in the earnings release and in our 2015 Form 10-K each as filed with the SEC.

I encourage you to read our Form 10-K for a more detailed analysis of our financials and other important information. Also reconciliation tables for non-GAAP financial information discussed on this conference call including adjusted EPS and our O&M efficiency ratio can be found in the appendix of the slide deck for this call which is located at the investor relations page of the company website as well as our earnings release.

We will be happy to answer any questions or provide further clarification if needed during our question-and-answer session. All statements in this call related to earnings and earnings per share refer to diluted earnings per share from continuing operations.

Before I turn the call over to Susan, I would like to take this opportunity to introduce you all to Melissa Schwarzell. Our new Director of Investor Relations. Melissa has been a member of American Water's finance team in Lexington, Kentucky since 2009. Her experience includes supporting rate cases, infrastructure filings and other regulatory matters in seven of American Waters regulated states.

She has worked on most of the company's cost components and she has tackled challenging recovery issues. She's also provided rates related financing – excuse me, financial planning support throughout the American Water footprint. I know you will all find Melissa to be very helpful and a pleasure to work with.

And now, I will turn the call over to American Water's President and CEO, Susan Story.

Susan N. Story {BIO 3335156 <GO>}

Thanks, Greg. Good morning, everyone and thanks for joining us.

With me today are Linda Sullivan, our CFO, who will go over the fourth quarter and full year financial results; and Walter Lynch, our COO, who will give key updates on our regulated business.

On January, the 1st, Walter assumed additional responsibility for operational and safety best practices across our AWE market-based businesses. So periodically, he will give you an update on those efforts as well.

The employees of American Water delivered strong results in 2015 for both the fourth quarter and the full year. We invested significant capital into needed upgrade for our system to provide reliable and safe water and wastewater services. We continued our focus on managing costs and deploying technology so that our services remain affordable for our customers and we treated and delivered water that consistently met and surpassed EPA drinking water standards. This includes the lead and copper rule, which has generated a lot of news recently, due to the crisis in Flint, Michigan.

American Water samples for lead on a routine basis and our water systems continue to be in compliance with that rule. We expanded our regulated customer base in 2015 by nearly 42,000 metered customers; about 9,000 customers resulted from organic growth in our existing footprint. 24,000 customers joined our system from acquisitions that closed during the year, and additional 9,000 are from acquisitions, where we have written agreements in place and are just awaiting regulatory approval.

We also continue to grow our market-based businesses through new contracts and new customers. As you can see on slide seven, we reported operating revenues of \$783 million, a 7% increase above fourth quarter 2014. For the full year, operating revenues were nearly \$3.2 billion, an increase of about 5% over 2014. Earnings from continuing operations were \$0.55 per share for the fourth quarter, a 5.8% increase above fourth quarter 2014.

Annual earnings were \$2.64 per share, up 8.6% over 2014 adjusted EPS. The fourth quarter includes a \$5 million contribution to the American Water Foundation whose work I will discuss briefly before our Q&A session.

Turning now to slide eight; you can see that we delivered on our strategies in both the regulated and market-based businesses in 2015. We made about \$1.4 billion in total annual investment, the highest in our company's history. We invested \$1.2 billion in our regulated system, which improved our long-term service reliability and water quality for our customers.

We're able to increase our investment at this level because of the expertise of our hardworking employees and our continuous improvement in both O&M and capital deployment efficiency. We're proud of our ability to deliver on our growth goals and effectively manage every dollar to deliver excellent customer service while we keep our customer bills affordable.

Even more importantly, we know that our customers need to be able to trust that the water we provide is clean and safe. So while consistently meeting and surpassing all EPA requirements in 2015, we continued our focus on further strengthening our critical assets.

Let me give you a couple of examples. We upgraded two of our company's largest water treatment plants, which serve over 300,000 customers in St. Louis County, Missouri. In Champaign, Illinois, we upgraded chemical treatment facilities nearing the end of their useful life with improvements that included replacing gas coring facilities with safer technology.

In addition to these regulated system investments in 2015, we also grew our customer base organically and through regulated acquisitions. Our market-based businesses continue to grow as well. In December, our Contract Services Group was awarded a 10-year O&M contract in Camden, New Jersey with revenue of approximately \$125 million.

Our Military Services Group expanded to 12 bases with a successful 50-year contract bid for Vandenberg Air Force Base with revenue of approximately \$300 million. Our Homeowner Services Group expanded to 1.6 million service warranty contracts and we grew our utility partnerships by adding Rialto, California and the Orlando Utilities Commission. As you know, we expanded our business through the acquisition of Keystone Clearwater Solutions.

So, in summary, we produced excellent results for the year through our ongoing customer growth, highest annual capital investment in our history, and we continued our O&M and capital efficiency. This continues our progress toward achieving our goal of 7% to 10% EPS growth through 2020. Based on our performance, our board declared a cash dividend of \$0.34 per share during the fourth quarter, and we are affirming our 2016 earnings guidance range of \$2.75 per share to \$2.85 per share.

And with that, Walter will now give you his update.

Walter J. Lynch {BIO 6064780 <GO>}

Thanks Susan. Good morning, everyone.

As Susan mentioned, our regulated businesses had a strong year all around with historic capital investment, smart and strategic acquisitions and continued O&M efficiency gains while balancing customer bill impacts.

As you can see on slide 10, 2015 was a good year for growth. Through acquisitions and organic growth, we added in our pending regulatory approval, nearly 42,000 customers in our regulated businesses. In 2015, we completed 14 acquisitions adding nearly 24,000 customers to our existing footprint. Seven of these transactions closed in the fourth quarter including our purchase of the municipal wastewater system in Fairview Township, Pennsylvania. This newly acquired system provides wastewater service to approximately 4,000 customers including more than 200 businesses in commercial accounts, and it's a perfect fit and as Pennsylvania American Water already owns the water system.

This acquisition provides a long-term wastewater solution and a financial relief for the local community. According to the Township's board of supervisors because of the sale, Township residential received a 50% reduction in real estate taxes in 2016. The proceeds of this sale will also help payoff approximately \$21 million in sewer debt and avoid an anticipated \$14 million in additional debt that would have been required to complete planned projects.

Again this is a great example of how we can bring solution to municipalities struggling to finance the water and wastewater improvements while improving their service and keeping rates affordable for our customers.

At the end of 2015, we have 12 pending acquisition agreements that were signed and waiting for regulatory approval. These acquisitions would add approximately 9,000 customers to our customer base if approved and completed. In 2016, we completed a purchase of four of these acquisitions, one of which was Environmental Disposal Corporation in New Jersey. This investor-owned wastewater utility provides service to more than 5,300 customers as well as bulk wastewater treatment services for several nearby communities. Additionally in December, Pennsylvania American Water signed a memorandum of understanding for the potential acquisition of the wastewater assets of the Scranton authority (12:00), which serves approximately 31,000 customers. This MOU commits the parties to negotiate in good faith toward executing a final purchase agreement.

On the regulatory front, you can see a snapshot of our current activity on slide 11. Our Illinois and Kentucky subsidiaries fought rate request in the first month of 2016. In both space, we're seeking to recover a significant amount of needed capital investment, offset by reduced or flat O&M expenses.

In Illinois, we requested \$40 million in additional revenues based on a projected total of \$342 million of capital investment between October 2013, and the end of 2017. Our team in Illinois reduced their O&M expenses by about 3% since the last rate case in 2012, continuing the great work by our employees to keep those affordable for our customers.

In Kentucky, we request \$13.5 million in additional revenues, primarily driven by \$79 million of capital investment while keeping operating expenses flat since 2012. Again, this focus on expenses allows us to make critical infrastructure investment continuing the trend of keeping bills affordable for our customers.

In Missouri, our case is moving along to the process, and we expect the decision sometime before mid year. In West Virginia, we have not yet received the rate order, so it will stay at a high level and base my comments from the press release sent out last night by the West Virginia Public Service Commission.

The order provides an increase of \$18.17 million in water rates and \$151,000 in sewer rates. The Commission recognizes that the company reduced its O&M expenses from its last rate case, and the adjustment to base rate is driven primarily by the increased investment we made to ensure reliable water service for our customers. And consistent with our normal process, West Virginia American water will show a press release, once they've had a chance to review the order.

Moving to California, on February 1st, we received approval from the California Public Utility Commission to extend our cost of capital filing by one year. This will keep our authorized return on equity at 9.99% through 2017 for our California subsidiary. Meanwhile, despite some rainfall from the effects of El Niño, the drought continues in California. Our team continues to demonstrate leadership in dealing with the drought and we're certainly proud of all other efforts to help our customers during this time.

We also continue to make progress on the Monterey Peninsula Water Supply Project. Our test plant well is operational and the results are positive. The project is undergoing environmental and regulatory review by the California Public Utility Commission, and this review is scheduled to be completed by the end of the year.

Moving to slide 12; we ended the year with a 35.9% O&M efficiency ratio and we're on track to meet our 34% target by 2020. I know, we've talked a lot about this, most recently, at our Investor Day in December, but I think it's worth repeating, we've really made tremendous progress here. As you can see, the progress is evident by the amount of revenue requirement attributed to capital expenditures versus operating expenses.

For the general rate cases, we filed last year, we reduced our O&M expenses by \$10 million or 17%. This reduction allowed us to invest approximately \$65 million into needed infrastructure

upgrades without affecting our customers' bills. Our employees are doing a great job in this area through leveraging best practices, improved efficiencies, technology and innovation, and this produces results for our customers as well as our company.

So, with that, I'll turn the call over to Linda for more detail on our financial performance.

Linda G. Sullivan {BIO 7300156 <GO>}

Thank you, Walter, and good morning, everyone.

In the fourth quarter and for the full year of 2015, American Water continued to deliver strong financial results. As shown on slide 14, earnings per share from continuing operations for the fourth quarter was \$0.55, up \$0.03 or 5.8% over the same period last year.

This slide shows the contribution by business line to our quarterly and annual results. Let me walk through the numbers then I'll discuss the drivers of the key variances on the next few pages. For the quarter, the regulated businesses contributed \$0.54 up \$0.01, the market-based businesses contributed \$0.06 flat to the fourth quarter of last year and the parent which is primarily interest expense on parent debt was \$0.02 better than the fourth quarter of last year.

For the full year 2015, earnings per share from continuing operations was \$2.64 per share, an increase of \$0.21 or 8.6% increase compared to adjusted 2014. The contribution from our regulated businesses was \$2.63 per share, up \$0.18 or 7.3% over adjusted 2014. The market-based businesses contribution was \$0.24, up \$0.02 or about 9% over last year. And the parent improved \$0.01 per share. These annual increases are consistent with our long-term growth triangle.

Turning to slide 15, let me walk through the components of our quarter-over-quarter increase in earnings per share. The primary driver was higher regulated revenue of \$0.09 per share from infrastructure surcharges and other rate increases to support our regulated system investments. This was partially offset by higher O&M expense of \$0.03 mainly from the timing of maintenance-related work as well as higher claims and pension-related costs.

Depreciation, taxes and other increased \$0.05 per share driven mainly by our investment growth. The improvement at the parent of \$0.02 per share was mainly due to lower taxes from state tax proportionate (17:49) benefit, partially offset by the \$5 million contribution to the American Water Foundation that Susan mentioned. Also, please note that the market-based businesses were flat for the quarter as higher growth in our Military and Homeowner Services Groups was offset by a 2014 tax benefit.

Turning to slide 16, let me walk through to the elements of our \$0.21 increase in year-over-year adjusted earnings per share from continuing operations. The regulated businesses benefited from higher revenue of \$0.18 per share from authorized rate increases to support investment growth as well as increases from acquisitions and organic growth. In addition, there was a \$0.05 increase due to mild weather during 2014 and an improvement in O&M costs of \$0.02 per share offsetting these improvements, with higher depreciation and taxes of \$0.07 per share, driven by our investment growth.

Overall, the regulated businesses increased \$0.18 year-over-year. The market-based businesses were up \$0.02, mainly due to additional construction projects under our military contracts and the addition of Hill Air Force Base and the Picatinny Arsenal in 2014, as well as geographic expansion and Homeowner Services. Parent and other was \$0.01 better than 2014, due mainly the lower taxes from state tax proportionate (19:18) benefits, partially offset by the Foundation donation.

Now, let me cover the regulatory highlights on slide 17. As Walter mentioned, we should receive the rate order from the West Virginia rate case soon. And as such, we currently have four general rate cases in process: Missouri, Virginia, Illinois, and Kentucky for a combined annualized rate request of \$87.4 million. For rates effective from January 1, 2015 through today and including the \$18.3 million for West Virginia we received a total of \$98.6 million in additional annualized revenue from general rate cases and infrastructure charges. We encourage you to review the footnotes in the appendix of this slide deck for more information.

Slide 18 highlights our improved financial performance across the board. During the fourth quarter of 2015, we made total investments of \$386 million primarily for regulated system investments. For the year, we invested a total of \$1.4 billion. This includes \$1.2 billion for regulated system investments, \$64 million for regulated acquisitions and \$133 million for the acquisition of Keystone. Excluding the Keystone acquisition, capital investment increased about 27% from 2014. Going forward, we expect to invest \$6.4 billion over the next five years of which about \$5.5 billion will be to improve water and wastewater systems for our customers, \$600 million for regulated acquisitions and \$280 million for strategic capital.

For the full year, cash flow from operations increased \$82 million or 7% to about \$1.2 billion mainly due to the increase in net income and our adjusted return on equity for the past 12 months was 9.43%, an increase of 57 basis points compared to last year from continued execution of our strategies. We also announced in the fourth quarter of 2015, a \$0.34 common stock cash dividend payable on March 1, 2016.

On slide 19, as many of you will recall, during our Investor Day in New York, we gave 2016 earnings guidance of \$2.75 to \$2.85 per share. Today, we affirm that guidance range. There are certain important factors that could impact our 2016 results. And as we have done in the past, slide 19 outlines those factors that we have included in our earnings guidance range. Swings outside of these ranges could cause results to differ from guidance. Weather is generally the largest variable impacting our earnings.

Our range of plus or minus \$0.07 represents what we consider to be normal weather variation that we have included in our earnings guidance range. For our regulated businesses, we see variations of plus or minus \$0.03 primarily from the timing and outcome of rate cases, the timing of completion of capital projects as well as variations in O&M and production costs.

American Water Enterprises variability is driven mostly from the timing of future capital upgrades in Military Services and realization of our expected growth as well as claims costs in Homeowner Services.

Variability for Keystone is primarily driven by natural gas prices and drilling activity in the Marcellus and Utica. I would also like to mention that our 2016 earnings guidance range includes estimated legal defense costs of about \$0.03 per share related to the 2014 Freedom Industries' chemical spill in West Virginia. As you may recall, we included \$0.02 per share of legal costs in 2015. And lastly, I would like to address the expected impact from the five-year extension of bonus depreciation.

From a cash perspective, we are in a federal tax net operating loss position. So, we do not receive a current cash benefit from bonus depreciation. We look at electing bonus depreciation on a state by state basis. In those cases, we're adopting bonus depreciation would be in our customers' best interest and where we expect to be able to utilize our NOL, we will do so. Assuming, we elect bonus depreciation in our regulated states, this would increase our NOLs and push out the expected timing of when we would become a cash tax payer by about one year to 2021.

From an earnings perspective, while this would be expected to reduce rate base and earnings, we do not see a significant impact to our 2016 earnings guidance range, nor do we see a significant impact to our 7% to 10% compounded annual EPS growth rate for 2016 through 2020 because the rate base impact is largely offset by lower financing needs in 2020.

We also have flexibility to mitigate some of the rate base impacts by redirecting a portion of our strategic capital already included in our five-year plan to our regulated businesses, as well as accelerating certain investments that continue to strengthen our critical assets for our customers.

And with that, I'll turn it back over to Susan.

Susan N. Story {BIO 3335156 <GO>}

Thanks, Linda.

Before taking your questions, let's review the American Water investment thesis we shared with you at our Investor Day and briefly discuss the American Water Foundation.

On growth, we affirm our EPS growth goal of 7% to 10% for the next five years. We talked about our unprecedented 2015 capital investments, our continued O&M and capital efficiency and our plans for 2016. We know that reputation, operational excellence, reliability, and dependable water quality are critical to our growth. Where and how we expanded our customer base in 2015 leverages these strengths, growing through tuck-in, adding wastewater customers where we are ready to serve water and growing our market-based businesses.

Our people have deep utility expertise and diversified experience and they are our biggest competitive advantage. They also care deeply about our customers in the communities in which they live and serve. This was clearly demonstrated about what our employees dealt with in both Missouri and Illinois during the last week in 2015. Record rainfall of up to 12-inches fell during a powerful three day storm across the Midwest, hitting the St. Louis area hard and causing record

flooding. Homes and businesses were submerged, highways closed and water and sewer utilities faced extraordinary challenges.

Missouri American has two plants on the Merrimack River, supplying water to about 20% of our customers in the St. Louis County area. Thanks to early planning and the construction of a system of temporary pipes and pumps. Our customers never loss service and we maintained excellent water quality throughout the event.

Our wastewater teams also worked around the clock during the heavy rain to remove pumps and motors that otherwise would have been lost to flooding. But it's not just what our Missouri team did for our own customers; it's what they did for the surrounding communities in need.

A local public water district had a flooded plant and lost the ability to serve its 20,000 customers. By opening a connection between the systems, Missouri American was able to help the district, serve many of those without water. Additionally, they worked with the National Guard to fill more than 500 tanker trucks that delivered our water outside of our service area, which brings me to the American Water Foundation funded by American Water's parent company which keeps the communities we serve and have a better quality of life.

One key Foundation partnership is with the Union Sportsmen Alliance, where we have worked with local union members to build walking trails, public access areas and fishing facilities for communities, including projects for special needs kids. The Foundation also has a partnership with a National Recreation and Parks Association in support of building better communities. Here, we focus on building or enhancing nature-based playgrounds for children and educating people on water and environmental stewardship practices. The Foundation also matches employee donations to qualified charitable organizations up to \$1,000 per year per employee.

Earlier this month, the Foundation made a \$50,000 donation to the Flint Child Health & Development Fund to help the children of Flint, Michigan, get the resources they need to deal with the lead exposure many have experienced. These examples of doing good as we do well, demonstrate the dedication, expertise, strong character and the work ethic of the 6,700 people I get the privilege of working with every day.

Certainly, our employees' commitment translates into our strong financial performance, but it also let you know as our investors that we are a company, whose people believe not just in what we do, clean water for life, but also in how we do it. And we believe that it is critical for a company, who wants to be as successful in the coming decades as we are today.

So, with that, we're happy to take your questions.

Q&A

Operator

We will begin the question-and-answer session. Our first question comes from Richard Verdi of Ladenburg. Please go ahead.

Q - Richard A. Verdi {BIO 15139674 <GO>}

Good morning, everyone, very nice quarter and thank you for taking my call here. Just a couple quick and easy questions; first, I guess Susan can you please speak to the strategy for capital raises the next few years to fund your program and how you think about raising the dividend versus buying back stock versus issuing equity?

A - Susan N. Story {BIO 3335156 <GO>}

Sure, Rich, and thanks for the question. I will start, and then Linda may want to jump in.

So, when we look at all of the different uses of our capital in terms of growth, in terms of raising our dividend, in terms of regulated investment, all of those different things, we look at a balance in optimizing those and also where we get the biggest value from every dollar that we spend. So, we look at growth and the returns we get there. We look at regulated investment and let me be clear that in our investment plan, the first thing we do, is we invest whatever is needed in every one of our state to ensure that we provide safe clean water that meets all EPA standards. So, then beyond that is what we refer to as discretionary. But there is a base amount which is significant well over half of our capital that we spend to ensure that we provide those services.

Then beyond that, we look at our dividend growth, which is, we have said, we want to keep consistent with our EPS growth. So, we want those to be correlated, so that's the guidance we've given and we have a 50% to 60% payout ratio and currently we're at the lower end of that range. So, there is room there.

When we look at things like debt and I'll let Linda talk about this more, the question we ask is what is best for our customers and our shareholders with the next dollar that we invest or whether we pay down debt or whether we're able to provide dividend. So, as you know, to have a - to be in a strong financial position as we are, we have a lot of optionality and we're always looking at how we optimize that optionality.

A - Linda G. Sullivan {BIO 7300156 <GO>}

And Rich, I would add to that that as we look and as we outlined in our Investor Day, when we look at the capital structure over the next five years, we continue to look at about 45%-55% equity to debt capital structure.

Q - Richard A. Verdi {BIO 15139674 <GO>}

Okay, excellent. Thank you. And next on the O&M and efficiency ratio, clearly, this has been a great part of the story very successful, excuse me, couple of years back the stretch target was 35% for 2018, now the stretch target is 34% for 2020. It's 100 basis points lower in three years. I know a portion of these stretch targets were based on the ERP program a while back. Now they are predicated upon automation technology such as the Badger Meter contract recently announced. Without holding you to it, just trying to get a grasp on what lies beyond 2020, how possible is it that American reduces the O&M efficiency ratio by another 100 basis points by 2022 to 33%. And would automation and technology be the driver of that reaction or is there

something underneath the American umbrella that could drive the third phase of O&M efficiency reduction?

A - Walter J. Lynch {BIO 6064780 <GO>}

Hey, Rich; Walter. I'll take that question. Thanks for it.

We're not going to forecast beyond 2020 and a 34%, but I can tell you our teams are geared towards continuous improvement and that's what's driving this, and technology is going to be a big part of it. As you know, we are about 90% implemented with AMR. We're also looking at AMI and the technology that we're buying now is easily transitioned into AMI. So it's a long-term solution. But I'd tell you looking at the people in our business understand the why and why we are reducing expenses. So we can invest in our infrastructure and provide excellent customer service. So it's really throughout the business sharing best practices, leveraging our supply chain and reverse auctions and power and chemicals, so it's a mindset and it's a commitment by our employees that we're going to get to where we need to go and they understand the why, and I think that is the key to this whole things, and that's been the foundation for our success.

Q - Richard A. Verdi {BIO 15139674 <GO>}

Okay. Great, thank you very much, and I appreciate it. And that's it for me, I'm going to jump in queue, but I just want to say thank you very much for slide 36 and that's very helpful.

A - Susan N. Story {BIO 3335156 <GO>}

Thanks, Rich.

Operator

Seeing no further questions, this concludes our question-and-answer session. I would now like to turn the conference back over to Susan Story for any closing remarks.

A - Susan N. Story {BIO 3335156 <GO>}

Well, thank you, Kerry. And thank you all for participating in our call today. If you've got any questions, please call Greg and Melissa and they will be happy to help. I'd like to remind everyone that our 2016 first quarter earnings call will be on May, the 4, and our Annual Stockholders Meeting would take place on Friday, May, the 13. Thanks again for listening and we'll talk to you in May if not before then. Thanks.

Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect your lines. Have a great day.

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