26-May-2020

Regions Financial Corp. (RF)

Deutsche Bank Global Financial Services Conference

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MANAGEMENT DISCUSSION SECTION

Matt O'Connor
Analyst, Deutsche Bank Securities, Inc.

Okay. We're ready to get started with the next company. We've got Regions Financial. And joining us today several members of senior management. David Turner, CFO, will be joining in a minute or two here. We've also got Barb Godin, Head of Credit; Deron Smithy, Treasurer; and other folks from risk management and the business lines.

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QUESTION AND ANSWER SECTION

Matt O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

As we wait for David to jump on here, Deron, good opportunity to both walking you through the conference and to jump right into some net interest margin questions because this is obviously an area of focus for the banks overall. And I think in Region's case, as is well known at this point, you essentially anticipated lower rates, put on some hedges and had more NIM stability and an outlook for such? Maybe if you can give us some updates on the net interest margin trends and how you're feeling about that from here?

M. Deron Smithy
Executive Vice President & Treasurer, Regions Financial Corp.

A

Yeah. Sure, Matt. Thank you. Good morning, everyone. I would say one of the things we've tried to do with our updated disclosures is really to make a distinction between our outlook for the net interest margin calculation here in the short run. That's really going to be impacted by some things that are unique to the environment that we're going through here for the next few quarters, but in fact are somewhat accrete – either neutral or somewhat accretive to net interest income.

And so we tried to give some updated disclosures, bringing forward our outlook for net interest income, reflecting not only the acquisition of Ascentium that we'll see the first full quarter impact of this quarter, but also reflecting the growth in the balance sheet, draws on existing lines of credit which have been somewhat expensive during this period. But also include the outlook for funded PPP loans that will begin accruing this quarter. So, really our update for the outlook for NII, we previously had a range coming out of earnings that we thought we would see NII growth 2% to 3% in the upcoming quarter.

We've updated that to be 3.5% to 4.5%, really reflecting the PPP loan fundings that we expect here in the quarter. Most of that change in outlook is really driven by that. I will just touch on the PPP program, as you know is a two-year potential maturity on these loans. But it's expected that many of them will get forgiven in a much shorter period of time.

But the way that we will account for the earnings initially is on the more protracted period. So we'll earn 1% coupon on these loans and the origination fee, that is a major part of the economics, will initially be accretive into income over that longer two-year period. But once the forgiveness period starts, then we'll see an acceleration of that fee into the quarter in which the forgiveness starts.

So initially the PPP loans will not have much contribution to net interest income and then so therefore will be somewhat dilutive to the margin. But then we'll have a big acceleration of that at some point in the future when the forgiveness does begin. So what we wanted to highlight here is that the underlying story with respect to NII growth and the margin is still intact. Hedges are performing as expected. Lower long-term rates does have some impact on us, obviously, as free payments increase and reinvestment at lower levels increases. I would say it's in line with expectations of where we would be at this point. Premium amortization was quite low in the first quarter. It was expected to improve into the mid – or increase into the mid-30s, not improve. I would say that that's roughly in line with our expectations today.

So if you were to carve out the impact to balance sheet growth, we think the underlying net interest margin sort of is in that mid-330s to high-330s range. But here in the short-run because of tremendous impact from a growth in

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deposits, primarily from stimulus, we're going to see excess cash; and that excess cash will weigh on the net interest margin. It will be neutral to earnings. It will weigh on the net interest margin here for the short-run as well as the two other balance sheet items I've mentioned. So we'll see a contraction in the net interest margin of 20 to 25 basis points really just from balance sheet issues. But we'll see growth in net interest income that is greater than we expected. And I think that's a trend that holds here for the next couple quarters.

Matt O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

And if you think about kind of the temporary hits from the PPP, the deposits, the line drawdowns driving that 20, 25 basis points then drop and then start thinking about those drivers kind of reversing themselves, does your NIM – what's the outlook versus kind of that mid-330s, high-330s? I assume there's still a little bit of a downward pressure from there just given the rate environment. But can you help parse that out?

M. Deron Smithy
Executive Vice President & Treasurer, Regions Financial Corp.

A

There is. Yeah, if you would peel back those layers that are the short-term impact, and I think that those normalize over the next couple of quarters as we've sort of seen the defensive draws peak and now start to moderate a bit. And obviously PPP will play out over a shorter period of time. And I think some of what we've seen from a deposit flow standpoint will moderate as stimulus dollars get spent and/or put to work through the programs. And so, we'll see the cash pressure moderate over the next couple quarters.

And so, I think that sort of mid – and then we'll see quarter-to-quarter if long-term rates remain at these levels. We'll see a bit of a headwind, a basis point or two a quarter from a reinvestment standpoint for the next several quarters. And so, yes, there is a bit of a headwind, but it's pretty modest from that normalized level.

Matt O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

[indiscernible] (00:07:04).

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President, Regions Financial Corp.

A

Hey, this is David, Matt. I apologize for being late. But I do want to add the – there's a driver here of excess cash coming from our corporate banking group as well. And this is money that had been excess cash. It was seeking the best return, had not been with us. These are our corporate customers we define as owning the operating account. So their excess cash may have been off balance sheet, pick your favorite fund. They brought that money back into the safety and soundness of the banking system.

And so, the question is even if the PPP money and stimulus money – I'm sorry – stimulus money starts to run out, the question is how long will the corporations keep that excess cash, which is in noninterest-bearing accounts with us. So that could weigh on margin a little longer if it stays with us because it's just sitting at the Fed earning 10 basis points. So a few moving parts here.

Matt O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. That's helpful. And, yeah, probably – we appreciate you joining, David, and we got right into some of the nitty-gritty questions here on the NIM as you heard. But I do want to ask a kind of bigger picture, like any kind of opening big picture thoughts that you have. I'll give you the first little lead in there. Many of your markets that you

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operate in have opened sooner than other parts of the country. So maybe you can address what you're seeing there and then just how you're feeling about things overall?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President, Regions Financial Corp.

A

So I think we have started to see our markets reopen a bit. If you look at continuing unemployment claims, it looks like the South and the Midwest are probably outperforming a bit relative to the Northeast and the West. We still have – not clear on the benefit of stimulus in terms of economic rebound and what that means for credit costs going forward. So that's probably one of the uncertainties we're all trying to deal with.

But it is encouraging that we're starting to see consumer spending a bit. As I've mentioned on the earnings call relative to debit and credit card spend, we were down some 30% at that time and that was going to weigh on us up to $25 million a month going forward. We have seen incremental improvement there is uneven in terms of where that's occurring, again, seeing it in the states that have reopened a bit quicker than others. But if – at the end of the day, the linchpin of all this is really getting a vaccine. And so what we don't want to do is open up too quick and end up going through round two, which is what the fear is. And so I think states are continuing to watch that, put some precautions in place. So we're not likely to get back to the spending levels we were pre-COVID-19 any time soon but it's getting incrementally better.

Matt O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

I guess that's a good lead into as you think about Regions and kind of the longer-term impact of the crisis, I realized kind of we're all quite collectively trying to get through this right now. But what are some of your early thoughts on how this might impact your strategy just across from everything with management and how you do business, where you do business?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President, Regions Financial Corp.

A

Yeah. So it's a great question, one we don't have all the answers to. But we are learning a few things. So let's take our 19,000-plus workforce. We've really done a pretty good job of figuring out how to work remotely. When this thing hit about the middle of March, right when we were trying to close out the quarter, prepare for earnings releases and 10-Qs and things of that nature. And we didn't miss a beat. So our technology was where we needed it to be. Thank God we had made the kind of investments in our digital channels. We've made both online and mobile. You can see our mobile transactions are moving up dramatically. Obviously our branch channel transactions are down. And so while sales had been about 85% to 90% in the branch channel pre-crisis, COVID-19 that is, we are seeing the possibility of digital sales increasing dramatically.

As a matter of fact, today, if you try to open up a new checking account through our digital channels, it will take you about five minutes. So we're in pretty good shape there. I think it's too early to call that a paradigm shift coming, but we can certainly see where digital becomes a much bigger player which means less reliance on branch infrastructure. As you know, we have more branches than our peers do on a relative basis. We're continuing to challenge ourselves on how many of those we ultimately need, how big they need to be, how many people need to be in them.

So I think there's an opportunity for some pretty reasonable cost savings over time there. And I think if you look at office space, so we have about 13 million square; 6.5 million square feet of that's in the branch, 6.5 million square

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feet of that is in operation centers and headquarter buildings. I could see that square footage in the office and operation centers to be down over time as well.

I'm not sure that we get back to the same place we were before. We've got to figure out how to transition back to more normal and see what it looks like, but I think there are some savings in occupancy that will be coming with that. Just an awful lot to learn. This thing has hit us pretty quickly, and I think where we're all trying to figure it out. But stay committed to making sure our people are safe, our customers are safe, and that we ensure if there's ever a time that our customers need their banker, it's now. And so, we're good at customer service and we're going to leverage that big time in taking care of our customer base going forward.

Matt O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

And how about from a risk management perspective? You've had years of de-risking the kind of broader loan portfolio. Any thoughts on what we're seeing now and how it impacts the risk management a little – I guess about six months ago you started running off the GreenSky loans, increasing exposure to SoFi. Just any kind of little turns of the dial there as you're thinking about the environment and looking forward?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President, Regions Financial Corp.

A

Well, certainly, our de-risking efforts that we've had over time have been incredibly important to us. So let's kind of break it down between consumer and corporate. And Ronnie is here and he can add some on the corporate side. But we don't have the concentration risk in investor real estate like we did. As a matter of fact, we have one of the lowest investor real estate portfolios of our peer group and that's been really important to us.

On the consumer side, consumer is 40% of our book. We did have a number of consumer portfolios. GreenSky, you had mentioned. We made a decision not to renew that contract. We did purchase some SoFi loans. We do have a limit. We're there on that already. So we shouldn't see that changing over time. We chose to exit our indirect auto book because its risk-adjusted returns were unacceptable to us. And focusing on risk-adjusted returns on all of our businesses and portfolios from not just a risk but a risk-adjusted return standpoint was really important, i.e., we sold our insurance as a result of that. If we think about the corporate side, a couple of opening comments, we had a larger concentration in the oil and gas energy space back in 2014-2015 when that crisis hit. We managed through that pretty well.

We had, at that time, right at 5% of our portfolio was in that space. Today, it's about 2.7%. And we're going to manage through that. We'll have higher losses, but we have pretty good solid reserves for it as well. What we've found is client selectivity has been incredibly important. Making sure you've got a bank for those people who are going to take care of you and take care of their obligation is really important.

We have a number of other industries, but none of them, individually, are at that type of concentration level that we had back in the crisis with real estate. So, yes, we have some restaurant, but the restaurant space is getting hit. It's that fast casual. We do have some hotels but not that much and it's inside well-structured REITs.

So how we've allocated our capital with regards to the corporate banking space has been really important. I think it will prove out while losses will be up, we shouldn't have anywhere close to what we had experienced in the Great Financial Crisis.

Ronnie, you want to add any more on that for me?

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M. Deron Smithy
Executive Vice President & Treasurer, Regions Financial Corp.

A

Yes. So, David, I don't know that I can add any additional comment other than just to reiterate what you said and diversification within the corporate book is really what's happened over the past six or seven years. We've put into place some strong guidelines about limits by industry and have adhered to those, have a lot of self-discipline around what we were willing to risk for any one industry and that has created the diversification.

David's right, we will have stress in some of the portfolios. But given the size and the exposures that we have in those particular areas, we will work through this much better than what we did back during the Great Recession.

So I know that Barb Godin is on as well, Barb and David now both hit that but anything else as Chief Credit Officer you would like to add?

Barb Godin
Executive Vice President-Consumer Banking Credit Executive, Regions Financial Corp.

A

Yeah. The only other thing I would like to add and thanks, Ronnie and David, is if you look at page 32 of the deck that we did provide, you will see that we have listed out those portfolios with some of the higher risk given the COVID environment. And we've also listed for you as a percent of deferrals that we've had up until that point, and they've slowed down an awful lot, the overall deferrals as well. But just to give you a sense for what the book looks like, what the utilization rate is, how much is leveraged, etcetera.

Matt O'Connor
Analyst, Deutsche Bank Securities, Inc.

Q

And, David, you said earlier, it's too early to tell kind of the impact of all the stimulus on asset quality, whether it's a fiscal help, obviously the Fed efforts. But as you're trying to plan going forward, what are some of your kind of thoughts or guesses on where charge-off levels may go and kind of equally difficult to answer, when do they start going up materially because 1Q quality was still very good, I think 2Q the view is maybe a little bit of an increase but not that much in charge-offs. So in other words, how high and when?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President, Regions Financial Corp.

A

Yeah. Well, that's a great question. So it's very hard to tell from a timing standpoint. The stimulus though, over $6 trillion is getting into the economy at a much faster pace and a little over $2 trillion in the Great Financial Crisis. There's still a lot that's not in yet. So, I think it's going to be a little slower probably on the consumer side because there's been a lot of stimulus is in their hands. There's a lot of forbearance that's out there and we've talked about levels of forbearance with different portfolios if you want. But I just don't see the consumer losses picking up anytime soon.

But can they be there – if unemployment stays high, we're going to have higher consumer losses. There's no doubt about it. The commercial side could be different. I do think there's a continued pressure on certain portfolios, we've laid them out. Energy would be one where you would see losses sooner rather than later.

As we think about losses though in CECL, we think about that in the context of capital adequacy and the good thing about having gone through stress testing now for over 10 years, our industry is a source of strength to the economy today versus being the problem child it was. And so I think we all have plenty of capital today to absorb losses that we can see. We also generate, we have higher reserves today.

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We have still generating for Regions a little under $600 million of PPNR every quarter. So we have a lot of ability to absorb pretty substantial losses this go-around. The timing of them coming in though and the ultimate magnitude is really hard to tell, Matt, because like I said there's a ton of stimulus and we just need to wait and see.

So, consumer would be out. We've got 10% of our mortgage book that's in some deferral period and that's 90 days and at the end of 90 days, they're going to come back. Some may want 90 more and we'll probably give it to them. We have people asking for deferrals that don't even have a hardship but it didn't matter. And so, I think what that does is it, in some cases, gets people through a hump; in other cases, it will defer maybe their losses, it will come after that. It's just hard to tell at this point. We'll see some commercial charge-off increases coming sooner rather than later. And – but I can't tell you the ultimate magnitude of those.

Barb, Anil, do you all want to add to that?

Barb Godin
Executive Vice President-Consumer Banking Credit Executive, Regions Financial Corp.
A

Yeah, I was going to jump in for a second just to comment on what our practice has been through this crisis, which is we are continuing to risk rate our portfolio as we normally would. So, if we're hearing that there is a cash flow issue irrespective of if it's caused by COVID-19 or not, we are actually downgrading those loans into criticized and classified and nonperforming levels if need be, as well as charge-offs. So, we are being very active on that front. So, again that will impact clearly our numbers for this quarter.

Matt O'Connor
Analyst, Deutsche Bank Securities, Inc.
Q

And how are you thinking about the reserve build? You obviously had a big build of day-one CECL adoption, big builds at the end of the quarter, reserves at 1.8%. What's the outlook for 2Q reserves for what you're thinking right now and potentially beyond?

Barb Godin
Executive Vice President-Consumer Banking Credit Executive, Regions Financial Corp.
A

Yeah. Anil, why don't you take that one?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President, Regions Financial Corp.
A

Yeah. I'll start and then turn over to Anil. Matt, if you recall, on the earnings call, the economy had gotten slightly worse than when we closed the books. And we said if the economy continues at this pace when we get to the second quarter and our outlook continues to be that the economy is declining, then we could have a provision in excess of charge-offs. We have since put in our Q. If that happens, that provision could be material in excess of charge-offs.

And so, we still have some time. We're right here at the end of May, we've got another month to see what the impact is of stimulus. And that's one of the big counterweights. I think if we were all to run models using, just as a proxy, Moody's latest, would be a pretty big number with regards to what we and our peers are seeing. But I think you're going to see some qualitative adjustments actually taking into account the fact that models can't pick up. They weren't built for this.

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And so, I think you're going to see some qualitative overlays going the other way a bit. I was on the phone with my peer group, as a matter of fact, last week and just talking in generalities and feel like we're all kind of right there trying to figure this thing out. And so, again, if the quarter finishes where it is right now, you will see provision in excess of charge-offs. How material that is, is really going to depend on what we see when we get to the end of the quarter.

Anil Chadha
Executive Vice President - Head of Shared Risk Services & Analytics, Regions Financial Corp.
A

Yeah. David, you framed that up very well. So, clearly, as we've gone through this quarter and you can see what we disclosed in our 10-Q with respect to the economic assumptions we used at the end of the first quarter. Unemployment rate as we've seen it mid-14% has gotten worse. GDP contraction for the quarter has gotten worse. And we expect the unemployment rate to stay higher for a longer. So to David's point, if you just put all that into a model, it's going to suggest a rather large reserve build. However, what the model can't estimate is how do you take into consideration that $6 trillion of stimulus that David mentioned.

And so, what we're doing is we're breaking apart our portfolio as we have in this deck, looking at high risk industry segments, running alternative analytics on those, looking at our consumer, taking into consideration what we know and don't know with respect to forbearance and deferrals. And, ultimately, at the end of the day, when it comes to this qualitative component that David mentioned, most banks had an add to the reserve based on their qualitative. I'd expect most banks will have a reduction in the second quarter. And, ultimately, what we'll all have to do is look at our portfolios and do our best to understand where we think loss content really is based upon what we know and don't know at the end of the second quarter.

Matt O'Connor
Analyst, Deutsche Bank Securities, Inc.
Q

And maybe switching topics a little bit. On the dividend, I think concern over bank dividends in general being cut or reduced has died down on recent weeks, but it is something still that we're asked pretty frequently about. I think most people look at the industry including Regions and see lots of capital, lots of liquidity and lots of ability to pay the dividend and you did kind of reiterate all those themes back in April. So I guess the question would be under what circumstances would you or kind of just banks in general have to face in order to think about cutting or even suspending the dividend?

David J. Turner, Jr.
Chief Financial Officer & Senior Executive Vice President, Regions Financial Corp.
A

So couple things on that. First off, we said our dividend payout ratio to be 35% to 45% and we set it there as an indicator to us because we wanted to be sustainable even in a period of time where there's stress, realizing that the payout ratio could go higher in over 100% as you saw. We really have to think about capital adequacy. And so, our limit structure is based on, first and foremost, prompt corrective action of 4.5% on common equity Tier 1 and to that we've added the 250-basis-point buffer. And that's been in our capital planning process before the word buffer was even talked about for a regulatory standpoint.

So we have 7% as a limit. And that is if we ever forecast it will breach 7%, then we have to start taking action today. Those actions would include reducing the dividend, constraining loan growth and the like. So we do not anticipate that. Today, we're at 9.4% common equity Tier 1. The difference between 9%, 4% and 7% is about $2.4 billion after-tax, and then you've got to think through again the PPNR generation that we have already and the allowance that we have already.

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So, we and the others and peer banks have all said the same thing and we feel pretty confident about our ability to sustain the dividend even in these stressful times at this point. Doesn't mean that it ultimately can't get there but we don't see it right today. So, that's why you don't see banks talking about the need to really cut and that's why we haven't said it.

Now you got this other piece and that is the political side of it where Congress saw what they did in Europe and which was cutting their dividend. And so, they start questioning the bank regulators about why haven't you forced the banks to cut theirs. And what the banking regulators are saying is we don't see any need to do that but we will do some extra stress testing. We'll do a COVID-19 overlay and we're expecting that to come and we'll see what it says.

But Congress started that conversation not understanding the big difference between how the European banks are structured from a capital standpoint. Their PPNR generation is not as strong as ours. And so, we've gone into this far stronger, and that's why we can be different than our European counterparts. That being said, if there's a lot of pressure, political pressure, ultimately the banking regulators can come to the industry and say, you need to cut your dividend. We've cautioned against doing that clearly on an idiosyncratic basis, but it needs to be based on facts. And we've gone through the stress testing so that we can sustain our dividend and sending and cutting that before it needs to be is sending a pretty tough message to our investors. And we don't want to do that. But if conditions warrant and the economy continues to decline, and the impact of the stimulus is what it needs to be, there could come a time where that needs to be done. And as I said, and I'm repeating myself, we don't see that today but we'll watch it every quarter.

Matt O'Connor

Analyst, Deutsche Bank Securities, Inc.

Okay. That's helpful color and I think a month ago concerns over dividend cuts were high on the list. And if things keep moving in the right direction, we'll probably be asking when buybacks resume one month from now. And obviously, you're well positioned for that as things improve. We are out of time, but I want – David, thank you very much for you and your team joining. And that ends the session. But thank you again.

David J. Turner, Jr.

Chief Financial Officer & Senior Executive Vice President, Regions Financial Corp.

Thank you much.

Barb Godin

Executive Vice President-Consumer Banking Credit Executive, Regions Financial Corp.

Thank you, Matt.

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