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EDITED TRANSCRIPT

AYI - Q1 2019 Acuity Brands Inc Earnings Call

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OVERVIEW:

AYI reported 1Q19 net sales of $933m, reported diluted EPS of $1.98 and adjusted diluted EPS of $2.32.

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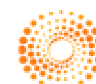

CORPORATE PARTICIPANTS

C. Dan Smith *Acuity Brands, Inc. - Senior VP, Treasurer & Secretary*

Richard K. Reece *Acuity Brands, Inc. - CFO & Executive VP*

Vernon J. Nagel *Acuity Brands, Inc. - Chairman, CEO & President*

CONFERENCE CALL PARTICIPANTS

Christopher D. Glynn *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Deepa Bhargavi Narasimhapuram Raghavan *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Jeffrey Todd Sprague *Vertical Research Partners, LLC - Founder and Managing Partner*

John Fred Walsh *Crédit Suisse AG, Research Division - Director*

Matthew Schon McCall *Seaport Global Securities LLC, Research Division - MD and Furnishings & Senior Analyst*

Ryan James Merkel *William Blair & Company L.L.C., Research Division - Research Analyst*

Timothy Ronald Wojs *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

PRESENTATION

Operator

Good morning, and welcome to Acuity Brands Fiscal 2019 First Quarter Financial Conference Call. (Operator Instructions) Today's conference is being recorded. If you have any objections, you may disconnect at this time. Now, I would like to introduce Mr. Dan Smith, Senior Vice President, Treasurer and Secretary. Sir, you may begin.

C. Dan Smith - *Acuity Brands, Inc. - Senior VP, Treasurer & Secretary*

Good morning. With me today to discuss our fiscal 2019 first quarter results are Vern Nagel, our Chairman, President and Chief Executive Officer; and Ricky Reece, our Executive Vice President and Chief Financial Officer. We are webcasting today's conference call on our website at acuitybrands.com.

I would like to remind everyone that during this call, we may make projections or forward-looking statements regarding future events or future financial performance of the company. Such statements involve risks and uncertainties such that actual results may differ materially. Please refer to our most recent 10-K and 10-Q SEC filings and today's press release, which identify important factors that could cause actual results to differ materially from those contained in our projections or forward-looking statements.

Now, let me turn this call over to Vern Nagel.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Thank you, Dan. Good morning, everyone. Ricky and I would like to make a few comments, and then we will answer your questions. Our results for the first quarter were solid despite continuing inflationary cost pressures. We took several actions in the quarter to address these cost issues, including price increases and productivity improvements. Further, our top line growth this quarter continued our long trend of outperforming the overall growth rates of the markets we serve while diluted earnings per share grew 17% to $1.98, a first quarter record.

I know many of you have already seen -- have seen our results, and Ricky will provide more detail later in the call. But I'd like to make a few comments on the key highlights for the first quarter of 2019. Our net sales for the first quarter were a record $933 million, an increase of 11% compared with

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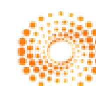

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the year-ago period. Reported operating profit was $116.4 million compared with $120.2 million in the year-ago period. Reported diluted earnings per share was $1.98 compared with $1.70 in the year-ago period. There were adjustments in both quarters for certain special items as well as certain other add-backs necessary for our results to be comparable between periods as Ricky will explain later in the call.

In adding back these items, one can see adjusted operating profit for the first quarter of 2019 was $134.1 million compared with adjusted operating profit of $135.5 million in the year-ago period, a slight decrease of 1%. Adjusted operating profit margin was 14.4%, a decrease of 170 basis points compared with the margin reported in the prior year.

Adjusted diluted earnings per share was $2.32, a first quarter record, up 20% from the year-ago period. Net cash provided by operating activities was a solid $132 million this quarter, while our cash position at the end of the quarter grew to $215 million even after repurchasing $25 million of the company's stock during the quarter, leaving us with plenty of liquidity to execute our growth strategies.

Looking at some specific details for the quarter. Net sales increased almost 11% over the year-ago period. Overall, net sales volume grew approximately 11% while price/mix of products sold was essentially flat this quarter. Acquisitions, net of divestitures, added about a point to our growth, which was essentially offset by the negative impact of changes in foreign currency and the adoption of the new accounting standard, ASC 606. Our significant growth in net sales this quarter was due, in large part, because of continued efforts to expand our customer base and the introduction of new products and solutions. We also believe our net sales were favorably impacted somewhat this quarter by customers accelerating orders in advance of the effective dates for announced price increases.

Overall, we experienced solid growth in net sales in most channels and geographies as well as most product categories. The largest contributors to the increase in net sales volume were due to greater demand for our Atrius-based luminaires and lighting control solutions as well as our building management solutions created by our Distech team and greater shipments of certain high-volume, more basic, lesser-featured LED fixtures primarily for applications on smaller and midsized commercial projects as well as our infrastructure and utility products.

Solutions sold through our independent sales network, which serves the C&I, utility and building management channels, grew 10% this quarter compared with the year-ago period. This network comprises approximately 70% of our total net sales. This growth was impacted somewhat by continued weak demand for larger, nonresidential lighting projects as well as continued product substitution to lower-priced alternatives for certain lighting products.

During the quarter, we announced 2 price increases to recover higher costs for both component and other input items due to inflation as well as the impact of government tariffs enacted on certain Chinese-sourced finished goods and components. As noted earlier, we believe some of the increase in net sales this quarter was due, in part, to customers buying products this quarter in advance of the effective dates of the announced price increases.

It is impossible to quantify the exact impact this had on our sales growth this quarter. We expect this to have a small dampening effect on our growth rate in the second quarter, historically our lowest net sales quarter in any given year due to seasonality. Though, again, it is impossible to quantify the impact.

As you all know, changes in price/mix have been a headwind each quarter for the last few years. So to experience a very slight favorability, call it neutral, this quarter was a welcome change. While it is not possible to precisely determine the separate impact of changes in the price and mix of products sold, we estimate the neutral impact of price/mix this quarter was primarily due to changes in channel mix, mostly offset by both product price and mix, which included substitutions to lower-priced alternatives, primarily for more basic, lesser-featured LED luminaires sold in certain channels as well as a modest decline in shipments for larger commercial projects as noted earlier.

Lastly, while we believe the price increases we've put in place will be realized, much of the sales in the first quarter were at pre-increase levels due to both the timing of price increases implemented in various channels as well as shipments of orders at pre-increase prices were previously committed projects as part of the company's backlog. Based on the information from various data collection and forecasting organizations, we believe the overall growth rate in the first quarter, as measured in dollars for the lighting market in North America, was up low single digits, reflecting continued improvement in demand, reversing the sluggish trend over the last several quarters.

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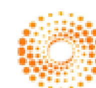

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Our net sales growth rate of approximately 11%, even excluding any potential pull forward of sales due to the announced price increases, stands in stark contrast of the overall growth rate of the luminaire market in North America. We believe our channel and product diversification as well as our strategies to better serve customers with new, more innovative and holistic lighting and building management solutions and the strength of our many sales forces have allowed us to continue to gain overall share in the North American market this quarter.

Our profitability measures for the first quarter were solid given overall market conditions. They were impacted mostly by significantly higher costs, particularly for certain commodities and components; as well as freight and wages, which I will address in a moment; and to a lesser degree, continued product substitution to lower-priced alternatives; as well as weakness for larger commercial projects.

Our adjusted operating profit for the quarter was $134 million, down approximately 1% compared with the year-ago period, while adjusted operating profit margin for the quarter was 14.4%, down about 170 basis points from the adjusted margin in the year-ago period. The decrease in adjusted operating profit margin was primarily due to the decline in adjusted gross profit margin.

Adjusted gross profit margin for the first quarter was 39.5%, a decrease of about 200 basis points compared with the year-ago period. It is very important to understand the underlying factors that drove the decline in our margins this quarter and the actions we took to counter those factors as well as the timing of financial impact of those actions.

Adjusted gross profit increased $19 million this quarter over the year-ago period driven primarily by higher sales volume and productivity improvements, partially offset by higher input costs. Our adjusted gross profit and margin were negatively impacted by higher input costs for certain items, including electronic and oil-based components, freight and certain other commodity-related items such as steel. Many of these items experienced dramatic increases in price over the last half of our fiscal 2018 due to several economic factors, including new tariffs and wage inflation caused by tight labor markets. We estimate the inflationary impact of these items reduced our gross profit this quarter by approximately $16 million and lowered our gross profit margin by approximately 170 basis points.

As noted earlier, we took significant actions this quarter that we believe both help and will continue to help offset these and other cost increases, including wage inflation as well as the impact of currently enacted increases in tariffs. These actions included announced price increases and other measures to improve productivity and reduce costs. We believe that due to the timing of price increases, they had limited positive benefit on our first quarter results. We believe these price increases will begin to offset higher input costs, including recently enacted tariffs, in our second quarter and beyond.

It is important to note that our adjusted gross profit margin increased 60 basis points on a sequential basis this quarter from the fourth quarter of 2018 on lower revenues, primarily due to the improvement in sales channel mix and actions to improve our cost structure.

Next, our adjusted SDA expenses were up approximately $20 million compared with the year-ago period. Adjusted SDA expense as a percentage of net sales was 25.2% in the first quarter, a decrease of 20 basis points from the year-ago period, demonstrating the leverage of our SDA investment as our net sales volume grows. The increase in adjusted SDA expense was primarily due to higher freight and commission costs to support the increase in net sales, greater employee-related cost and, to a lesser degree, added expenses from recent acquisitions, partially offset by actions taken in prior periods to streamline the organization.

Excluding the impact of higher freight and commission expense due to the increase in net sales volume, more than half of the increase in SDA expense compared with prior periods was due to greater employee-related costs. While our salaried headcount remained essentially flat year-over-year even after acquisitions, we expect that employee-related costs will continue to rise in fiscal 2019 as markets for certain skills remain tight, contributing to a rise in wage inflation.

Our adjusted diluted EPS was a first quarter record of $2.32 compared with $1.94 reported in the year-ago period, an increase of 20%. The increase was primarily due to the favorable impact of the new tax law and the lower average shares outstanding due to stock repurchases during the past year, partially offset by a slight decline in operating profit in the quarter. As I noted earlier, we believe the year-over-year increases in certain input costs reduced our gross profit by approximately $16 million in the quarter and, obviously, negatively impact our diluted earnings per share.

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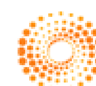

Before I turn the call over to Ricky, I would like to comment on a few important accomplishments this past quarter. On the strategic and technology front, we continue to make great strides setting the stage for what we believe will be strong revenue growth and profitability over the long term. We continue to gain market share in many important product categories and sales channels. Our Tier 3 and 4 solutions were up over 25% this quarter.

From a commercial perspective, we continue to accelerate the number of Atrius-enabled deployments and increase active programs with several of the largest U.S.-based retailers. Our Atrius-based IoT luminaires and solutions are becoming the industry standard in the retail segment. Additionally, we continue to expand these solutions into other channels as awareness by customers grows as they come to recognize the full benefits of these solutions, including superior visual comfort and energy savings as well as the capabilities of our IoT solutions, providing them with the opportunity to transform their spaces from nothing more than an expense item into a strategic asset.

As I mentioned in prior earnings calls, it is clear that certain Chinese-based lighting companies, many obviously being subsidized in some form, are influencing pricing for certain basic, lesser-featured fixtures sold in certain channels. We will not yield this space for many strategic reasons. As such, we continue to aggressively expand our Contractor Select portfolio to profitably compete in this portion of the market.

Also, as I mentioned last quarter, we introduced in late 2018, the next generation of our industry-leading lighting control system, nLight AIR, a wireless control system with a wide range of options and functionality for which there was strong customer demand this quarter. We believe Acuity has the most comprehensive and feature-rich wired and wireless lighting control systems available in the nonresidential construction market. And importantly, they are connected to our growing BMS solutions.

Lastly, we initiated many actions last year to further streamline our operations to reduce costs and improve our productivity. We believe these initiatives both enhanced our performance this quarter and will continue to benefit our operating and financial performance in the future as well as allow us to accelerate investments in areas with higher growth opportunities. Ricky will have additional comments on this in a moment.

We've been able to create these capabilities while providing industry-leading results because of the dedication resolve of our many associates who are maniacally focused on serving, solving and supporting the needs of our customers. I will talk more about our expectations for the balance of 2019 later in the call.

I would like to now turn the call over to Ricky. Ricky?

Richard K. Reece - *Acuity Brands, Inc. - CFO & Executive VP*

Thank you, Vern, and good morning, everyone. As Vern mentioned earlier, we had some adjustments to the GAAP results in the first quarter of fiscal 2019 and 2018, which we find useful to add back in order for the results to be comparable.

In our earnings release and Form 10-Q, we provide a detailed reconciliation of non-GAAP measures for the first quarter of fiscal year 2019 and 2018. Adjusted results exclude the impact of acquisition-related items, amortization expense for acquired intangible assets, share-based payment expense and special charges for streamlining activities. We believe adjusting for these items and providing these non-GAAP measures provide greater comparability and enhanced visibility into our results of operations. We think you will find this transparency very helpful in your analysis of our performance.

During the first quarter of fiscal 2019, we recognized a pretax special charge of $1 million, primarily related to move costs associated with the previously announced transfer of activities from a planned facility closure. In the first quarter of the prior fiscal year, we recorded a pretax special charge of $200,000. We expect to continue to incur additional costs, primarily attributed to early lease termination and moving costs in future periods associated with the closing of certain facilities related to the streamlining actions announced in fiscal year 2018.

Fiscal 2019 first quarter results were impacted by the adoption of Accounting Standards Codification 606, Revenues from Contracts with Customers, which negatively impacted current period revenues by $2.4 million, gross profit by $1.1 million and operating profit by $1.2 million, as compared with the prior year period.

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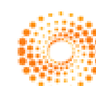

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Additionally, fiscal 2018 results were restated to reflect the impact of adopting a new accounting standard regarding retirement benefits, which resulted in an increase in operating profit of $1.6 million, with an equal offsetting increase in other expenses, resulting in no impact on fiscal 2018 reported net income or EPS. Please refer to Note 4 and 5 to our financial statements included in our Form 10-Q filed earlier today for additional details of the impact of the adoption of new accounting standards on both the income statement and balance sheet.

As part of adopting ASC 606, you can see in our Form 10-Q filed today that we are providing disaggregated revenues by the major sales channels of: one, independent sales network, which includes C&I agencies, infrastructure utility agencies, system integrators and showrooms; two, direct sales network; three, retail network, which includes home centers and digital retail; four, corporate accounts; and five, all other, which is primarily OEM, international and catalog.

The effective tax rate for the first quarter of fiscal 2019 was 25.2% compared with 35.5% in the prior year quarter. The effective income tax rate for the first quarter of fiscal 2019 was significantly impacted by the provisions of the Tax Cuts and Jobs Act, which was enacted during the second quarter of fiscal 2018. We currently estimate that our blended effective income tax rate before discrete items will approximate 24% to 26% for fiscal 2019.

We generated $132 million of net cash flow provided by operating activities during the first quarter of fiscal 2019 compared with $140 million for the year-ago period. Operating working capital, defined as receivables plus inventory less payables, decreased $31 million during the first 3 months of fiscal 2019. This decrease is largely due to reduced accounts receivable balance.

Our operating working capital days increased 10 days to 60 days, primarily due to higher inventory at November 30, 2018, compared to August 31, 2018. At November 30, 2018, we added cash and a cash equivalent balance of $215 million, an increase of $86 million since August 31, 2018. This increase was due primarily to cash flow from operations, partially offset by cash used to repurchase common stock, to invest in plant and equipment and to pay dividends.

We repurchased 200,000 shares for $25 million during the first quarter of fiscal 2019. In addition, we have repurchased an additional 200,000 shares for $24 million since the end of our first quarter. We have 4.8 million shares remaining under our current share repurchase board authorization.

Our investment in capital expenditures was $14 million for the first quarter of fiscal 2019, an increase of almost $4 million compared with the prior year period. We currently expect to invest approximately 1.5% of net sales in capital expenditures in fiscal 2019.

On June 29, 2018, we entered into a new credit agreement with a syndicate of banks that provides us with a $400 million, 5-year unsecured revolving credit facility and a $400 million unsecured, delayed draw, 5-year term loan facility.

Our total debt outstanding was $357 million at November 30, 2018. Our debt to capitalization at August 31, 2018, was 16.9%, and net debt to capital was 7.5%. We had additional borrowing capacity of $795 million at November 30, 2018, under our new credit and term loan facilities which do not expire until June 2023.

We clearly enjoy significant financial strength and flexibility to support our growth opportunities, which may include acquisitions, and we will continue to seek the best use of our strong cash generation to enhance shareholder value.

Thank you, and I'll turn the call back to Vern.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Thank you, Ricky. While current market conditions in the lighting industry continue to be challenging, we continue to be optimistic regarding our long-term future. We believe our many actions to improve our market reach, enhance our customer solutions and capabilities and to drive company-wide productivity, will help optimize our financial performance in the future while affording us the opportunity to continue to invest in areas we believe have high-growth potential over the long term.

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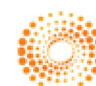

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Our robust sales growth, significant cash flow and upper quartile return on invested capital are reflective of our strong operating performance despite some of these current industry headwinds. Our views on overall market demand for the lighting market and items influencing costs have not really changed over the last quarter. So let me reiterate some of those key items that could influence our performance for the balance of fiscal 2019.

Many independent third-party forecasts continue to suggest the overall construction market, as measured in dollars, will grow in the low- to mid-single-digit range. We still believe the lighting industry will lag the overall growth rate of construction market somewhat, primarily due to continued product substitution to lower-priced alternatives for certain products sold through certain channels, though recent industry pricing actions should have a favorable impact on growth as measured in dollars.

Additionally, we expect that labor shortages in certain markets could continue to negatively impact growth rates for both construction and lighting. While the U.S. government delayed the implementation of increased tariffs to 25% from the current 10% for certain imported Chinese-made finished goods until March 1, we believe the outcome of the entire tariff situation could have a dampening effect on overall demand due to higher component cost and finished good prices.

Further, it is evident that the global trade issues have certainly created greater volatility in demand in our various end markets. And we expect that to continue. As previously mentioned, we believe the announced price increases and other actions taken will, in time, offset the increases in cost for various items noted earlier. While increases in some input costs such as steel have leveled off for now, we expect other costs and expenses such as imported electrical components and finished goods, freight and wages, will continue to rise. These potential cost increases

(technical difficulty)

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Matt McCall from Seaport Global Securities.

Matthew Schon McCall - *Seaport Global Securities LLC, Research Division - MD and Furnishings & Senior Analyst*

So Vern, maybe start with the comment you made about expanding Contractor Select to profitably compete in that market. Can you talk about the -- just the trends since the reinvigoration or reintroduction of that product, the trends in the profitability in recent quarters and then expectations, just trying to understand what you were referencing when you made that specific comment.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Sure. Well, just to further make a comment, I wasn't able to finish the prepared remarks. So there are probably some other important things that I'll touch on as we get towards the end of the call but, Matt, let me begin to address your questions. Yes, Contractor Select was a relaunch of a product portfolio that was directed at, if you will, lesser-featured, more value-oriented products. And what we did is we had a number of products, branded maybe under Lithonia, but we created -- re-created, if you will, a Contractor Select to have a more fulsome portfolio directed specifically at that market with new products that had better cost structures for us, better price points. Some of those products continue to be manufactured both in Asia as well as in our North American manufacturing footprint, so our margins in those have improved and we continue to see growth. Contractor Select is designed to serve both the home center channel as well as the electrical distribution channel and then, to a lesser degree, showrooms and our digital retail capability. So we continue to see growth in those -- in that portfolio and it did have or has had some positive impact on our margins. As we said in the quarter, which was really exciting for us, price/mix overall was very slightly favorable, let's just call it neutral, which is the first time we've experienced that, geez, Ricky, in probably in the last 2 to 3 years. So part of that benefit has been due to actions taken like the introduction of Contractor Select.

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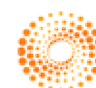

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Matthew Schon McCall - *Seaport Global Securities LLC, Research Division - MD and Furnishings & Senior Analyst*

Okay. And maybe continuing on that thought, the -- you mentioned some of the product comes from Asia, your manufacturing part of it. I guess I'm trying to understand the impact on your gross contribution margin. Do you still get the same leverage opportunities from that sourced product? And will that -- I'm really thinking about the substitution effect of just the product coming in out of Asia. Do you sacrifice some maybe leverage opportunity, but you benefit from lower costs, I'm assuming or I'm sure. Just help me understand the impact and how we should think about gross contribution margin from just pure volume just given the shifts in substitution or trends with substitution.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Sure. So as we stated in our 10-K, approximately 20% of our total sales are produced by others. About 15%, Ricky, is produced in Asia?

Richard K. Reece - *Acuity Brands, Inc. - CFO & Executive VP*

Correct. 15%, yes.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

I think that was the number. So that's up a little bit from, say, prior years. We obviously have a very strong supply chain in Asia. When you say we lose a little bit of leverage, sure. When you're not manufacturing in your own facilities, increases in volume, you're not able to really leverage that across your fixed cost base, but we like the margin profile of our portfolio in Contractor Select. And as we think about product substitution, again, this quarter, it was essentially a wash. Price/mix was essential a wash which, again, first time in a long time. So the efforts that we're putting in to products like Contractor Select, not just Contractor Select, allowed us to, again, have price/mix be a wash. I would tell you that product substitution, it will continue. And the way we are attacking that to offset product substitution -- and what that simply means is that we are moving from a product that has one price point to something that has a lower price point. It's entirely possible that the gross profit margin on the lower price point item is actually higher as a percentage of the sale than on the higher price one. So we continue to push our mix as a company into those areas that we realize both higher profit dollars as well as higher profit margin. A good example of that is in our controls business, our controls overall business. And it's impossible to call it a separate business because so much of our controls are embedded into our luminaires, but we're seeing great uplift as we continue to introduce new products and solutions, such as nLight AIR, into the marketplace with great demand. So that benefit of that price/mix was also because of the introduction of products like that.

Operator

And our next question comes from Jeffrey Sprague from Vertical Research Partners.

Jeffrey Todd Sprague - *Vertical Research Partners, LLC - Founder and Managing Partner*

Two from me. First, on substitution. I wonder if you have a sense of how much is happening kind of at the front end relative to the initial bid versus a response to price-cost dynamics in the project later in the construction process and a need to get cost out given other inflationary pressures that may have arisen during the project itself. Is there a discernible difference there?

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Well, let me take a cut at it, and then Ricky can take a cut. Product substitution is occurring in 2 key areas and it's just -- it's interesting. It's trends of how people want to, if you will, use light. The shift from certain 2 by 2, 2 by 4, 1 by 4 fixtures to flat panels, for example, is a trend that has been in the marketplace for a while. So as Acuity ramps up its capabilities in the flat panel business, and I believe that, today, we are the largest seller of

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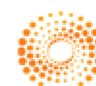

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flat panels in the North American market, at least that's what our data would suggest, and that's over the last, call it, less than 18 months that, that's occurred. Well, that product is replacing certain other form factors and those other form factors were simply at higher prices, and so that's an example. Another example is slim form wafers replacing certain types of down lighting. Again, profitability off of those products for us is, from a margin percentage, is favorable. But yet just pure dollars because the physical construct of that product is meaningfully different than something that it is substituting in certain applications. So it is both upfront, but it's also in our stock business. It's also being sold through, whether it's the electrical distribution channel or whether it's being sold through the home center or the showroom or our digital retail capabilities for what I'll call renovation projects. It's just people looking at different choices that they have in terms of how they want their space to look and how they want it to operate. And so that product substitution or that shift is having some change on top line, if you will, dollars. Units are obviously up higher, but dollars tend to be lower. And this is again why, for me, it's very exciting for us to show an almost 11% top line growth, while all of this is going on.

Jeffrey Todd Sprague - *Vertical Research Partners, LLC - Founder and Managing Partner*

And also just on Tier 3, Tier 4, you continue to see good growth in units. Can you give us a little update though in terms of actually turning the capabilities on, what's happening there, service revenues associated with it, et cetera?

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Yes. We're seeing nice growth but off of an incredibly small base. And so what we've learned in this process is that people who deploy our Atrius-based luminaires are looking for some level of critical mass within their own facilities or number of facilities. So as they install, they're now beginning to experiment use. We have certain customers that are much further along than others and they are now actually starting to use apps within their space. We're helping them do that. That obviously creates an increase of, if you will, revenue stream for Acuity. But the Tier 4 SaaS revenues are still really small but growing -- I mean, they're doubling. So we're very, very excited about the prospects of what that SaaS revenue looks like, particularly as customers start to use the solutions or use the capabilities of the solutions that they purchased. And so as expected, it's now starting to ramp and you're seeing that multiplier effect occur. But again, against the $3.8 billion Acuity Brands, it really does not move the needle just yet, but it will. It's moving the needle, by the way, in us selling IoT-enabled luminaires in a very significant way. The part of our growth is because of our enterprise solutions capability, which is selling virtually all IoT-enabled luminaires, and that piece of our business continues to grow nicely.

Operator

Our next question comes from John Walsh with Credit Suisse.

John Fred Walsh - *Crédit Suisse AG, Research Division - Director*

So I'm going to apologize because I don't know if I fully understood the answer to Jeff's question, but maybe I can just ask it again in a little different way. As we think about the product substitution, is that when the project first starts? So when the initial bid happens? Or are you seeing the general contractors actually break the spec later in the construction process and then seeing the substitution happening there where you have to go and fight what the contractor is trying to do to the spec? Just trying to understand that dynamic a little bit better.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Yes. That's a great question. So generally speaking, for projects, products like this are spec-ed in, but the normal cycle of just general contracting capabilities is that they may spec something else, and this has happened historically, for years, for decades. You get down to now at the end of the project because lighting is some of the last stuff in. Someone may say, "Listen, I need to alter the specification to a degree because I'm out of budget, and I need to be in budget." So some of these products provide great alternatives, but their features and benefits are not the same as what may have been spec-ed in, so you can have a combination of both. But for Acuity, again, if you go back to more traditional lighting, Acuity never participated in the lamp ballast replacement business. Today, we have a product portfolio that is amply suited for replacement of existing luminaires. So when we sell these types of products through certain channels, very often, they are for renovation projects, which we have said for a long time

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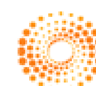

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is a growth-rich opportunity for Acuity. Or they may be part of smaller projects where there is not a specification and the builder is saying, "Hey, this product looks like it's a fantastic opportunity" or the owner says, "This is something that I like." Flat panels as a form factor are becoming very popular. And so, again, that product substitution is because that product category is growing significantly because people like those form factors. It's simply displacing other types of product that may have had a higher price point and they're willing to accept any feature or benefit difference should there be any. So it can be both. But generally speaking, someone is not using that flat-panel to break a spec. They're using it as something that they have specified in and Acuity will be introducing a spec-grade product or a flat panel family, which is a whole different opportunity. But no, I would say that it's part of the normal course of business and these features and benefits that these products have are attractive at those price points.

John Fred Walsh - *Crédit Suisse AG, Research Division - Director*

Okay. And then just thinking about this potential or the prebuy impact ahead of the price increases, obviously very difficult to parse that out, but you did say you thought there could be some dampening impact in the next quarter. I mean, is that to think a couple of points? Is that kind of the order of magnitude that you have in your head when you use the word dampening? Or is there a more specific range that you would point us to?

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

I would say, to the extent -- because it's impossible for us to precisely quantify it, I would say that to the extent we assume there was some and we've seen some evidence, but to quantify that and say, okay, here is a number, we just -- we didn't even try because it wouldn't have been worth that effort. But to the extent that there was some, it would have been, generally speaking, a pull primarily from Q2 into Q1. We can't estimate it. Ricky, any other thoughts on that?

Richard K. Reece - *Acuity Brands, Inc. - CFO & Executive VP*

No. I mean, we've looked at it in a lot of different ways. Some of the pull forward was within the same quarter. So, obviously, it has no impact on our quarterly results. So it's pretty hard to put a bread basket around it.

Operator

The next question comes from Tim Wojs from Baird.

Timothy Ronald Wojs - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Just on -- I'm just curious, just if you could give us a little bit of color on just what you're seeing around pricing traction in the marketplace. I know there's a lot of variabilities between price and mix. But if you just look at like-for-like pricing and based on some of the increases that you've put in the market, is there any sort of estimate you could give or what you're seeing in terms of how much of those price increases are starting to stick?

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Ricky, you want to tackle that?

Richard K. Reece - *Acuity Brands, Inc. - CFO & Executive VP*

Yes. In the quarter is, as Vern said in his prepared remarks, very little impact in this first quarter. Most of the price increases were implemented mid-quarter and we protected certain channels as well as the delay due to projects, as Vern mentioned, that were in our backlog. But we are committed to the price increase and do see evidence that, in most of the channels, it is sticking. It is coming in at different time lines in different

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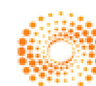

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channels, but we are continuing to be pretty firm in our resolve with the increases because they were real cost increases, inflationary as well as the tariffs that we're needing to offset and we are holding firm. Most of the major competitors have announced similar, if not identical, price increases to us. So that is encouraging. But as we always see in price increases, it varies by geography. It will vary by channel somewhat as to how quickly they get implemented and to what extent, but we still are very committed to the announced increases we put out.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

And Ricky, if I could just pile on a little bit, 2/3 of our total business is bid business and so -- and that hasn't changed. We have experienced real cost increases. We will continue to aggressively look to recover those both through price increases that we've announced as well as productivity improvements. We look at every project and decide whether that's something, a piece of business that we're after. As Ricky pointed out, different channels have different contractual obligations. So we are implementing our price increases because these cost increases are real to us. And we're evaluating, as we always do, what our product portfolio looks like relative to how we serve and support our customer base relative to how we make money, and so we are aggressively focused on pushing through price. Generally speaking, the industry is pretty disciplined when cost increases come about of putting those into the marketplace. And to the extent that those things ebb and flow, again, on the bid business, we look to optimize our profitability by all measures. So we have seen our price increases be implemented into the marketplace and we're pleased with the progress that we've made so far.

Timothy Ronald Wojs - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Great. Great. And then just thinking about seasonality and just trying to make sure we're all on the same page, the second quarter is typically your weakest revenue quarter. So while I think price would probably have a little bit of a sequential impact, you'd also lose some leverage. So is it fair to assume that the gross margin sequentially are down some from Q1, just in line with historical seasonality before seeing a more market improvement in the stronger months in your fiscal year?

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Yes. I would say that the seasonality is normal. We've had this for forever, and you're absolutely correct in assuming that the leverage of volume does have an impact. We are looking to recover some of the cost increases that we've -- through price. Again, as we said earlier, the timing of some of these things, depending on the channel, the contracts that you have with the customer. But, no, our expectation is that as we enter into Q2, it will not be materially different than other Q2s as it relates to the seasonality. I do have -- well, we are optimistic. We're seeing positive signs within the construction market. We continue to see some of the volatility in demand that is caused by people's concerns around tariffs and what's going to happen in trade negotiations. I wish I could tell you differently. We have a positive view of the overall market, but it's still tempered by what happens intra-quarter from one quarter to the next because someone says, "Hey, I'm going to wait to see what happens with this trade policy." It's just -- it's frustrating for us because we believe that there is momentum out there and there is a real need. If I look at all of the demographics of rising employment, vacancy rates going down, rental rates going up, absorption of real estate, these are all favorable signs and longer-term bullish signs for nonresidential construction. So it's a bit of a Dr. Jekyll and Hyde kind of thing. But overall, we're net positive in what we see going forward.

Operator

Our next question comes from Ryan Merkel with William Blair.

Ryan James Merkel - *William Blair & Company L.L.C., Research Division - Research Analyst*

I just want to follow up on the gross margin question. So do you think that you're going to recover the 170 basis points of price cost in the fiscal second quarter? Or might it take a little longer?

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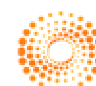

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Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

So as Ricky and I said, the price increases that have been enacted, some of those take time to roll in because of contractual obligations, because of our backlog. I think we will make good progress on recapturing those costs. We don't give guidance on that entirely. I don't want to comment completely on that, but our price increases and our resolve around capturing those price increases are important for us to recover our costs.

Richard K. Reece - *Acuity Brands, Inc. - CFO & Executive VP*

And I would just comment, Ryan, that -- and Vern had it in his prepared remarks, we are still seeing inflationary cost increases beyond what we've historic -- what are in our first quarter results. So wage inflation is alive and well. Our merit increases went into effect mid- or second, last 1/3 of our first quarter so all of that impact will be in our second quarter. So we will continue to have some inflationary cost increases we need to offset, all the reason why these price increases were so necessary.

Ryan James Merkel - *William Blair & Company L.L.C., Research Division - Research Analyst*

Got it. So it sounds like you expect to make progress that we shouldn't expect you can recover the full amount in the fiscal second quarter?

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

We don't give guidance.

Ryan James Merkel - *William Blair & Company L.L.C., Research Division - Research Analyst*

Okay. Fair enough. All right. And then back to the issue of pull forward, maybe just comment on the order rate in December. Potentially, that could tell us a little bit about what's going on and what the pull forward could be.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Yes. We have not seen a meaningful change compared to the prior year in our order rates. Again, my concern is less around the pull forward and more around just how do people release projects, how are people feeling about their businesses. It is becoming more and more evident to us that labor shortages in large markets are having a dampening effect on construction in general, and then lighting to a lesser degree. So we are looking at the overall demand and why are people doing things. We continue to see strength in smaller and midsized projects, which may not be as impacted by labor shortages as larger projects, so we can continue to see this dynamic going on. It gets exacerbated to a degree or the fluctuation/volatility to a degree because of Q2 weather-related things. But no, we continue to see what we would call normal trend. So again, that's why it's impossible for us to say, "Oh gosh, it's this percent that will impact first quarter versus second quarter."

Richard K. Reece - *Acuity Brands, Inc. - CFO & Executive VP*

I would just mention, while not directly part of your question, another uncertainty out there is this potentially next round of tariff increases on finished goods coming from China. March 1 is the date the administration said those would become effective, which is obviously the end of our second quarter. Will those go forward? What impact may that have on demand but also on potential pull forward because we've indicated, as others, that we're going to have a price increase contemporaneous with that tariff increase. So that's another uncertainty we're looking at here in the second quarter. It could have an impact on order rates depending on whether that tariff increase goes forward or not.

Operator

Our next question comes from Rich Kwas with Wells Fargo Securities.

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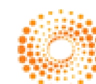

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Deepa Bhargavi Narasimhapuram Raghavan - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

This is Deepa for Rich Kwas. Two quick questions from me. First one is, can you comment on the state of nonres cycle and what you're hearing from the field, especially commercial versus institutional? Large commercial softness, obviously, you continue to mention that in your project commentary, but do you think that it's cycle driven? Or is that more like a short-term impact from all the headline uncertainty, tariffs, et cetera, that we see?

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

So on the nonres piece for small, medium projects, I think that, again, the portfolio of solutions that Acuity and, to a degree, others have to offer are favorable energy saving, so good returns on investment. So I think that people continue to move those along, particularly to the extent that they have access to electricians in their local market. So I see that as being favorable. Larger projects, all of the big indicators: rental rates, rental vacancy, absorption of real estate, employment, all of those are usually leading indicators of construction, particularly around medium and larger projects. Without getting into the specific verticals of nonresidential construction, we still have favorable -- but our favorability or optimism is somewhat tempered by, again, in some of these key markets, the availability of electricians to do some of these projects. And by the way, what we're talking about here is growth, right? All of these folks have good backlogs. They have projects out there whether they're the electrical distributor or the electrical contractor. It's just that if their workforce is a limiting factor to their ability to grow and, again, in the lighting space we continue to experience a bit of deflation for the reasons we've all articulated, I think that there should be legs there in terms of what's going to happen in nonresidential construction. But we have to solve some of these labor issues.

Deepa Bhargavi Narasimhapuram Raghavan - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Got it. Can you comment on your residential piece of business? I mean, what was your resi growth in the quarter? And have you seen any deceleration or stability in that piece of your business?

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Yes. So we don't measure it exactly as residential because we sell product that has residential applications and/or light commercial applications through multiple channels. We would sell those products through the home center channel. We would sell them through the electrical distribution channel. We would sell them through the showroom channel. Those products or those channels, as Ricky pointed out earlier, are network sales for us. That represents about 70% of our business, which would have some resi in there. It was up about 10% on the retail channel, Ricky, which would be also resi and light commercial. We saw favorability there. So we continue to see favorable movements. I know that residential construction has kind of moved sideways here a little bit, but I think that, that is just temporary. I mean, you look at the number of workers, the population continues to grow. Rental rates continue to increase. I just -- I'm still bullish over the long term on residential construction and capabilities, and I think Acuity is well positioned to play there.

Deepa Bhargavi Narasimhapuram Raghavan - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Got it. Final one for me. So just given all the prebuy and all the -- due to the price increases, can you comment on the state of inventory in the channel? Should we be concerned at all? I mean, you talked about some pull forward, but just curious on the inventory in the channel.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Yes. I don't know that I'm saying that there's inventory in the channel. I think that the channel manages its inventory pretty well, both on residential and nonresidential. But from our perspective, our inventories are up a bit because we have extended some of our supply chain to Asia. That's increased a little bit, adding a little bit more inventory into the system, but we also continue to grow in certain markets. Pick our enterprise solution market, where as that business grows, we're required to maintain certain levels of inventory to support store renovation construction, and so that's

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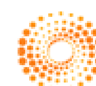

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caused us to have to carry a little bit more inventory. But I think that the channel of electrical distribution, the channel of the home center, so on and so forth, all those inventory levels seem to be appropriate given the economic activity that's out there.

Operator

And our final question comes from Christopher Glynn with Oppenheimer.

Christopher D. Glynn - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Vern, did I catch that someone out there maybe thought you should tighten your prepared comments, I guess. So...

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Thank you, Chris. I think that was you. And by the way, all the questions that folks asked, that was in my prepared remarks.

Christopher D. Glynn - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

I'm sure. So your volume outgrowth was pretty profound in the second half of last year. I'm wondering how to think about those comparison run rates there. In the absence of guidance, how would you advise we consider that? And maybe part of that context is if you could describe the trend with the building breadth of customers now creating critical Tier 3 mass for themselves pursuant to entering the Tier 4 base.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Yes. Our business continues to diversify both in terms of -- within channels. So if you look at the home center business, we continue to diversify our customer base there. Also, looking to evaluate our portfolio in some of those things. So there's a little bit of ebbing and flowing going on. I love what we're doing in our enterprise solutions capabilities. This is really where we're selling our IoT and Atrius-enabled luminaires into retail and other segments, specifically on how they purchase. Well, those -- the acceptance of those products are significant. But the problem -- not problem, the opportunity is that, that's very lumpy. I mean, when someone says, "Hey, look, we don't want you in our retail stores from the beginning of November until the kind of middle of January." You could appreciate that's when they make most of their money in terms of a lot of these retailers. So anyway, I expect our growth to continue to outpace the overall growth rate of the markets that we serve. We've had a good track record of doing that. Some of the influences that we've had here over the last couple of quarters, as we mentioned, we expanded our customer base in certain channels, which caused us to have a bit of, call it, load in of certain things. Some of those things will come back to normal volume and activity. So it may not be quite to the level because you don't have those load-ins happening every quarter that we experienced in fourth and first quarter. But again, I think that we will -- we have a long track record of outperforming the overall growth rates of the markets that we serve. And I think that, that's probably a pretty good indicator as you think about your models of how did we grow last year, how do you think the markets going to grow, where do you think Acuity is going to be. I think you can get yourself into a reasonable range around that.

Christopher D. Glynn - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Yes, that works. And then just the inventories up on the magnitude of a quarter year-over-year. Just wondering if you could comment on the strategic aspects of that inventory build versus whatever working capital execution factors and the free cash flow conversion outlook for the year.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Sure. So we continue to have good cash flow conversion. Our inventory levels as we bring on, whether it be through enterprise solutions or customers in certain other channels, we are working that into our business. But our expectations would be that we would improve our inventory

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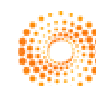

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turns as our business processes to support that -- those growing aspects of our business come into both focus as well as we get our processes honed out. Said simply, we have too much inventory right now relative to the service levels. It's just getting those processes honed between ourselves and the customers, their POS, their store increases, some of the projects that we have worked on within our utility channel. Our utility business continues to grow significantly. Well, there are requirements for inventory until we get that pipeline really smoothed out. We've added inventory to support the service levels. So our expectation as a company and it's really critical to us to get our inventory turns back to where they should be with levels of service that are commensurate with customers' expectations. So I believe that by the end of the year, you will see our inventory turns and our inventory levels improve relative to the [volumes]. It's days on hand that's important and it's service that's important. It's not the dollars that are important. So we want to get those metrics back to where we think we ought to be operating.

Operator

I would like to turn the call back over to Mr. Vernon Nagel for closing remarks.

Vernon J. Nagel - *Acuity Brands, Inc. - Chairman, CEO & President*

Folks, thank you so much. Yes, some of my remarks were cut off a bit. But I think we answered some of the things I would have said during the Q&A. So again, I'd like to thank you for your time this morning. Again, we strongly believe we are focusing on the right objectives, deploying the proper strategies and driving the organization to succeed in critical areas that have the potential over the longer term to deliver strong returns to our key stakeholders. Our future is bright. Thank you for your support.

Operator

Thank you. This concludes today's conference call. You may go ahead and disconnect at this time.

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