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# EDITED TRANSCRIPT

LLL - L3 Technologies Inc at Barclays Industrial Select  
Conference

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## CORPORATE PARTICIPANTS

**Ralph D'Ambrosio** *L3 Technologies, Inc. - SVP, CFO*

## CONFERENCE CALL PARTICIPANTS

**Carter Copeland** *Barclays - Analyst*

## QUESTION AND ANSWER

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**Carter Copeland - Barclays - Analyst**

Hello, Miami. Good morning and welcome to our first session. Have to kick it off with L3 Technologies. I have to remind myself to say technologies. I had it circled so I didn't say L3 Communications.

But we are pleased to be joined by Ralph D'Ambrosio, who is the Chief Financial Officer at L3 and has been for some time, a company we've known since the IPO and been close to back in prior years for lots of reasons.

So, look, pleased to be joined. Thanks, Ralph, for coming. Before we get started, remind you to email in questions at the address that's on the screen. Additionally, I want to kind of kick off and figure out who we have in the room as we -- and we have people still coming in, and ask our first two audience response questions.

Question number one, do you own this stock, yes or no and the weighting? Let's see the opportunity set for you, Ralph. So, a lot of non-owners, a couple of owners.

And we'll ask question number two. And what's your general bias on the stock right now, positive, negative, or neutral? All right, so lots of positives, lots of neutrals. I don't think you'll have much convincing to do.

But to the extent we've got some folks less familiar with L3, Ralph, I wondered if we might start off kind of high level, state of the union question. 2016 was a year -- I think end of 2015 and end of 2016 was a year where we saw a good bit of change at L3.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Sure.

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**Carter Copeland - Barclays - Analyst**

And maybe -- I thought you could give us a kind of high level overview about where the company saw itself and where you see it going and kind of what else we can expect from a change standpoint, I think high level for those that don't know you.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Sure. And good morning, Carter. Thanks for having us here today.

So, I think it's best if I start with a quick overview of L3 --.

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**Carter Copeland - Barclays - Analyst**

Please.



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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

For those of you who are not very familiar with L3. We're predominantly an aerospace and defense contractor. This year our sales will be just under \$11 billion, and about 70% of our sales are to the US military.

We're both a prime contractor and a supplier, a prime in about two-thirds of our business. And we're not a platform OEM. So, we're a non-platform OE prime contractor with a very diversified and broad exposure to the US military budget.

So, the good news is that, after having gone through a cyclical downturn in the US defense budget for the last five or six years, 2016 marked what we believe is the beginning of a new up cycle. And that had a lot to do with the improvement in our business last year, coupled with the fact that we were able to capitalize on several opportunities that we'd been working on for the last few years.

And we actually outperformed the DoD budget growth in 2016, where the budget grew about 4% and our Department of Defense business grew 5% organically. So, we did a little better than the budget, and that's something that we aim to continue doing.

Last year we also refined our strategy, if you want to say that. We had gone through a period in the downturn where we reshaped the portfolio, did some divestitures to strengthen the company competitively, and to position us for the new upturn. And so, that phase is behind us.

And now we believe that we're in a phase that we call disciplined growth, and that's we want to grow the business both organically and then supplement that organic growth with M&A growth. And disciplined, meaning that we're going to be prudent about how we grow the business and not take on any outsized risks, especially when it comes to purchase price and valuations for acquisitions.

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**Carter Copeland** - *Barclays - Analyst*

Does that apply to bid and proposal activity, new business sort of opportunities organically as well?

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

Absolutely. So, we have a very disciplined bid and proposal review process in the company, including at corporate. And that allows us to see eyes wide open, if you will, what we're bidding on and what's likely going to be entering the company in terms of new business and new contracts. And that enables us to manage the growth and the risks effectively and appropriately.

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**Carter Copeland** - *Barclays - Analyst*

Okay. You've done some -- additionally some restructuring. I know you've had a couple of consolidations within the portfolio. And for those who don't know the portfolio, I think you've got 60 BUs or something.

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

55.

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**Carter Copeland** - *Barclays - Analyst*

55. So, you've had a couple of those consolidations where it made sense. But I think 12, 15 months ago it sort of sounded like maybe we would see more of that.

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

So, let me give you a little background on that, because I think that's a misperception about L3, this notion that we do not integrate the businesses that we've acquired.



So, to give you a bit of history, if you go back to our beginnings -- and we will have our 20th anniversary in a couple of months, and it's a nice milestone to achieve. But since the beginning, I would say that we had acquired about 130 businesses. And I just explained that we presently have 55 business units or P&Ls that comprise our sectors and our reportable segments.

And so, over the years, systematically and quietly, we've been consolidating our businesses. And that is an activity that will continue at L3 over the next several years. I think our 55 business units will probably consolidate to about 35 units over the next few years.

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**Carter Copeland - Barclays - Analyst**

That's probably a more rapid -- it's safe to say that that's a bit more accelerated --.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Yes.

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**Carter Copeland - Barclays - Analyst**

Than what you've been over the last several years.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Yes.

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**Carter Copeland - Barclays - Analyst**

How much of this is different from -- I guess from a high level, what L3's sort of always been, right? I mean, there's a different feel in the last year or so than -- I mean, yes, you've done consolidations, yes, you've done M&A, yes, you've done portfolio shaping. But there's almost sort of a slightly different angle. How much of that is there right now? I mean, I know you've been with the company a long time.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

What's different now is that we're more focused on growing the business organically and through acquisitions, and it makes sense for where we are in the cycle.

So, we're more inclined to make M&A investments when we're in an up cycle, because when you're in a down cycle mistakes become amplified and there's more risk. So, we're more comfortable investing, especially in M&A, when we're in a up cycle.

And following the portfolio reshaping that we did, the company is more focused. And we aim to grow within our business areas with the new focus that we have.

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**Carter Copeland - Barclays - Analyst**

And obviously a topic that's come up a lot among the other defense companies we've seen here is the budget. Clearly you don't have a lot of visibility on what the administration's budget request is going to look like, but there's clearly a lot of anticipation that those numbers will be higher. When you look through your portfolio, clearly L3 has a reputation of being a little bit more shorter cycle focused than the peer averages. Where would you expect higher budget numbers and the dollars associated with that to flow through to your portfolio more quickly?

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**



Okay. So, you asked a few questions there.

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**Carter Copeland - Barclays - Analyst**

Yes.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Let me try to take one at a time.

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**Carter Copeland - Barclays - Analyst**

Pick them apart.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

So, yes, the consensus is that defense budgets the next several years will be higher under the Trump administration compared to what was projected by the Obama administration. And we agree with that sentiment.

However, not a lot of details yet, a lot of speculation, but the new administration has outlined objectives, if you will, of how they want to strengthen the US military. And we think those objectives align well with what we do at L3.

So, the main ones are including the -- increasing the size of the force structure, particularly the Army, where they want to go from about 475,000 troops to about 540,000. So, that's a positive for L3, because our business is highly levered to the size of the force structure if you look at what we supply and provide to the military.

So, for a couple examples, we're one of the leading suppliers of night vision and image intensification equipment. And the more active servicemen and women you have, the more requirement there is for night vision equipment. We also supply tactical communications that are used across the force structure. So, there's another positive there.

And then we also do a lot of work in terms of training the force, to include simulation devices and related training support activities. And then also, we do a lot of work to maintain and sustain training aircraft across the services. So, we think we're highly levered to any increase in the force structure.

In terms of our business nature, you'd mentioned the short cycle. So, we are shorter cycle than most of the large defense contractors in that we derive about 60% of our US military sales from the operations and maintenance accounts, with the other 40% coming from procurement and RDT&E.

So, the O&M, or operations account -- operations and maintenance account budget dollars, they flow quickly. That's typically one-year money. And a lot of it goes towards dealing with the readiness of the military. And that's a second objective that's been outlined, the need to improve the readiness of the force structure.

So, to the extent that we see incremental budget dollars in those two areas, we think that's going to benefit L3 quickly, I would say over the six to 12 month period. So, we're encouraged by what we see happening. We're just waiting for the details, which will be forthcoming over the next couple of months.

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**Carter Copeland - Barclays - Analyst**

Yes. I think another thing that's been pretty topical in the industry is, I guess from a high level, this focus on cost and reducing costs for the taxpayer --.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Sure.



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**Carter Copeland - Barclays - Analyst**

The war fighter getting more for the taxpayer dollar. We've never seen a president take to Twitter to kind of put this and this sort of debate or topic into the public eye. But do you think that that's something else that we should watch with respect to the budget and spending, the outlook for companies like yours and some of the competing companies, for what it could mean for requirements or profit policies? Is there really an impact here, or is it just bringing that debate more to the center stage?

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

So, I think there will be an impact. President Trump has definitely talked about the virtues of genuine competition in a variety of areas, most recently, as you'd mentioned, on a couple of defense programs.

So, the good news for L3 is that most of our business has been competitive all along.

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**Carter Copeland - Barclays - Analyst**

Yes.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

We don't have a lot of sole source positions. So, what that means is that we have to actively compete for our business. And whenever you're competing, price is always, always, always a significant factor.

So, I think L3 is very adept at dealing with competition and price competition across our business areas, and we'll just continue to do that.

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**Carter Copeland - Barclays - Analyst**

Yes.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

So, I think we're well equipped to deal with any change in terms of procurement that comes along those competitive lines.

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**Carter Copeland - Barclays - Analyst**

Great. I want to ask another question of the audience just to help shape the next questions. And that's question number six, which is what do you see as the most significant investment issue for L3, core growth, margin performance, capital deployment, execution, and strategy?

All right, so core growth clearly on everyone's mind. I think when you look at L3's portfolio, as you highlighted -- and maybe this isn't a fair question, given that your DoD business did outgrow the outlays last year. When you look at the top line guidance for L3 versus the rest of the peer group for this year, it's a little bit below the averages despite this short cycle, the budget's going up. Maybe speak to that and whether that's, you think, a 2017 anomaly, or is there something in the portfolio that is holding you back, if you will, relative to the peer group average?

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**



Sure. So, our top line growth outlook, which is 2% for 2017, is below some of the larger defense contractors. And what we explained when we updated our guidance at the end of January is that our 2017 guide is based upon what's presently projected in the defense budget -- or for the defense budget for FY 2017, which is the Obama administration's request, which called for 0% growth over FY 2017.

And then we also explained, to the extent there is upside from this widely expected supplemental that's supposed to happen sometime next month, there should be better budget growth, and we think that should benefit L3. But we were very clear about where our -- what's underlying our guidance assumptions.

And then I would say, compared to most of the other defense companies, we do have more margin expansion in 2017 where we're looking for 70 basis points of improvement versus 2016, whereas most others are flat or contracting.

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**Carter Copeland - Barclays - Analyst**

Down, yes.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

So, I think when you take the combination of our slightly lower sales growth coupled with the better margin performance --.

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**Carter Copeland - Barclays - Analyst**

Kind of higher (multiple speakers).

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

We're generally in line, I would say, at the operating income level in terms of growth, where we expect to have about 10% growth in operating income over 2016.

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**Carter Copeland - Barclays - Analyst**

Do you think longer term -- I mean, this has historically been a very growth focused company, right? Do you think longer term you'll see that top line growth exceed the peer averages? Is there the hope for that, or we'll have to wait and see?

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

The answer is yes. So, I explained that we're highly correlated to the US defense budget. So, number one, we want to grow organically at at least the same rate as the defense budget.

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**Carter Copeland - Barclays - Analyst**

Yes.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

And then secondly and more importantly, we want to exceed that growth rate both organically and then supplementing it modestly with good, reasonably priced acquisitions.

So, the answer is we want to outgrow the defense budget and have accelerating growth over the next several years. And if you look at what happened in 2016, where -- our actual final sales for the year compared to what we initially guided where about \$450 million higher, or about 4 percentage points.



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**Carter Copeland - Barclays - Analyst**

Yes.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

So, I think we have some opportunity to do better in 2017 in the top line as well. I don't know if it's going to be 4 percentage points, but we should have some upside. And we'll see how it unfolds.

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**Carter Copeland - Barclays - Analyst**

When you look out through the end of the decade and across the business units, which ones do you see being the biggest growth engines, both organically and inorganically?

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

I think it's going to be electronic systems, communication systems segment, and also our new sensor systems segment. And within aerospace systems we do have some large growth opportunities, but they're more binary in nature.

Either we're going to achieve them or we're not, whereas in the other three reportable segments the business base and contract mix is more diversified, less concentrated in any singularly large single programs. So, that's the difference in the dynamic across those, aerospace versus the other three segments.

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**Carter Copeland - Barclays - Analyst**

Looking specifically at the margins, you highlighted recently that you expected both electronic systems and sensor systems could reach a kind of 13% to 14% target long term --.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Yes.

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**Carter Copeland - Barclays - Analyst**

Margin range. Clearly, that looks like a very achievable number, a number you've already hit in electronics, but it's a bit more of stretch in sensor systems.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

A small stretch.

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**Carter Copeland - Barclays - Analyst**

Yes. I know you've had some drags in the past in things like EOTech.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**





So, if you look at our guidance for 2017, we're in the 13% to 14% range for electronic systems.

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**Carter Copeland - Barclays - Analyst**

Yes.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

We're at 12.7% in sensor systems. So, we're in striking distance of that 13% to 14% range in 2017.

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**Carter Copeland - Barclays - Analyst**

So, the 80 basis points that would get you to, say, the midpoint, right, what takes you there? Is it just mix?

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

It's a combination. It's mostly returning the business to an organic growth situation, because we expect that we're going to have some leverage, operating leverage, as we grow organically because we don't expect that we're going to grow costs at the same rate as sales, especially overhead costs. There's natural leverage that comes from an improving top line.

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**Carter Copeland - Barclays - Analyst**

Okay.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

So, that's the main driver, plus we're going to continue to be focused on cost takeouts and becoming more efficient and productive. And we talked about the ongoing consolidation activity that we have at the company.

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**Carter Copeland - Barclays - Analyst**

Additionally, the margin bridge to your long term targets in AS, the 7% to 9%, maybe give us some more color on the moving pieces there. Clearly between Vertex and ISR, you've got several re-competes. You've got several moving parts. Ideally, what's the path to get to those?

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Okay. Very simply the path is more top line in all of our end markets. To the extent that we can begin to grow the international sales there again. And they've declined for the last couple years. And we see that happening within a year or two. The margins are better on the international side.

So, the key to getting the margins from 7%, where they are today, to the high end of our target range of 9% is growing, expanding the top line, especially overseas.

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**Carter Copeland - Barclays - Analyst**

Yes.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**



That's how we do it.

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**Carter Copeland - Barclays - Analyst**

So, growing high margin business. But clearly there's some lower margin business in there as well that you said --.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Yes.

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**Carter Copeland - Barclays - Analyst**

You want to improve.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

So, the lower margins are mostly in the Vertex aerospace sector. And the margins there are low, but they're improving. So, they're increasing in 2017 as well. So, that's going to help the overall margin situation for the segment.

And we do have some large opportunities there for organic growth. We've talked about one in particular, which is the worldwide or global logistics support contract for the Special Operation Forces.

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**Carter Copeland - Barclays - Analyst**

SOF GLSS.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

That's a competition that should be decided no later than the second half of this year. So, that's a big opportunity where it could be \$500 million plus in annual sales, which would increase Vertex by more than 35%. So, it'll be --.

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**Carter Copeland - Barclays - Analyst**

You'll get a lot of leverage there.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

It would be good leverage there.

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**Carter Copeland - Barclays - Analyst**

A big binary opportunity. I want to ask one more question of the audience before -- for the audience response, and then see if we have any out there, but ask number three. In your opinion, through-cycle EPS growth for L3 will be above, in line, or below peers. I can remember the days where it was very solidly above by a wide margin.

All right, so actually a pretty reasonably spread distribution. I know we have a couple of questions in the audience. Maybe go ahead and do those.



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**Unidentified Participant**

Sure. Well, one question from the audience. In the past couple of years, while defense spending was in a downturn, L3 encountered a few contract issues. In the past, that was attributed to poor performance rather than mismanaging costs. Could you give a little bit more color on this?

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Sure. So, we did have a couple of challenging years in 2014 and 2015. In 2014, it was the Army C-12 fixed price contract. And then in the first half of 2015, it was the head-of-state aircraft modification contracts.

So, those were significant isolated operating performance issues which, while we don't like them, many companies in our industry occasionally have cost growth issues on large programs. It's not specific to L3.

And Carter, you know this. There are many examples of that happening --.

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**Carter Copeland - Barclays - Analyst**

It's so current.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Elsewhere presently at other defense companies. So, that's not an unusual specific item to L3. It's more endemic of being a large aerospace and defense contractor.

And in any event, those were significant problems then. And I think as a result, a lot of people misperceived that the company was somehow systematically broken --.

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**Carter Copeland - Barclays - Analyst**

Yes.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

Which was false.

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**Carter Copeland - Barclays - Analyst**

Right.

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**Ralph D'Ambrosio - L3 Technologies, Inc. - SVP, CFO**

And you see that in our improved results in 2016 and what we expect to do in 2017. So, I think we've overcome those issues.

Our performance on the Army C-12 contract is very good right now. That's also up for re-competition this year, and we expect we're going to win that re-competition. And we've stabilized our performance on those three head-of-state modification jobs.

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**Carter Copeland - Barclays - Analyst**



You've delivered one, right?

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

We delivered one last October, and we expect to deliver the next two over the next year or so.

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**Carter Copeland** - *Barclays - Analyst*

Okay.

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

And we did change some things around, how we look at bids and proposals, to ensure that we don't get in a situation like that again at the company.

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**Carter Copeland** - *Barclays - Analyst*

And what types of changes are those?

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

Well, just adding another level of --.

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**Carter Copeland** - *Barclays - Analyst*

Layer of oversight.

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

Review when it comes to bid and proposal reviews, where we do incremental at Corporate across the disciplines where there's contracts that have opportunity to have increased risk escalation, if you will. And in many cases, as a result of those bid and proposal reviews, we'll change the terms and how we're going to bid a contract, or not bid the contract at all. So, that's a key --.

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**Carter Copeland** - *Barclays - Analyst*

A big difference.

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

Element to making sure we avoid having any large problems like the ones we did in 2014 and 2015.

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**Carter Copeland** - *Barclays - Analyst*

Great. I'll ask one more on cash, question number four. In your opinion, what should L3 do with excess cash? Clearly, we've seen a lot of the first two over the years.

Okay, so bolt-on M&A. Clearly we saw a lot of it last year. L3 has always been a very acquisitive company, but 2016 was a big shift in that respect. You did several transactions. Has the velocity of your M&A process changed at all? It sort of feels that way outside.



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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

So, we actually also did several transactions in 2015.

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**Carter Copeland** - *Barclays - Analyst*

Yes.

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

But we had more divestures in 2015. So, the M&A pace was slightly higher 2016 versus 2015, but even in 2015 we started doing more bolt-on acquisitions.

And those are the ones that we like best because they create the most value for the company and for our shareholders in that they're smaller. So, we're generally going to be assuming less risk, which is very important when it comes to acquisitions.

Most of the transactions are private. And we're able to negotiate and pay more reasonable prices as well as structure many of the transactions with favorable tax shields that improve the economics, the economic return, on the investment.

And what we've been doing all along with the bolt-on acquisitions, since Mike has been CEO, which is 10 years now, we've been continuing to build out our core business areas. And you saw more of that last year, particularly in the aviation security space and the commercial simulation and training business area. So, that's what we want to continue to do, make small acquisitions that build and strengthen our existing core businesses.

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**Carter Copeland** - *Barclays - Analyst*

Okay. So, more of the same is what you're saying, or is there --?

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

I would say for now more of the same.

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**Carter Copeland** - *Barclays - Analyst*

Okay. Okay. I know we're running low on time here. I do, for the benefit of the data, want to ask the last question of the audience, question five. In your opinion, what multiple of 2017 earnings should L3 trade? Ralph, I'm sure you remember the days where number six was where it stood for a long time. Still got some of those out there.

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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

And that's where we are today.

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**Carter Copeland** - *Barclays - Analyst*

Yes, so trading where you're trading today. So, it looks like people are maybe suggesting there's a little bit of upside but close to fairly valued. I don't know. Maybe we'll prove them wrong.

Anyway, thank you so much for joining us. I know we've got to give the room to somebody else, but it was a pleasure to have you.



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**Ralph D'Ambrosio** - *L3 Technologies, Inc. - SVP, CFO*

Same here. Thank you, Carter.

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**Carter Copeland** - *Barclays - Analyst*

Yes. And thank you all.

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