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Aritzia, Inc. (ATZ.CA)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by. This is the conference operator. Welcome to Aritzia's Second Quarter 2021 Earnings Call. As a reminder, all participants are in listen-only mode, and the conference is being recorded. After the presentation, there will be an opportunity to ask questions. [Operator Instructions]

I will now turn the conference over to Helen Kelly, Vice President of Investor Relations. Please go ahead.

Helen Kelly

Vice President-Investor Relations, Aritzia, Inc.

Thank you, Anastasia, and thank you, all for joining Aritzia's second quarter 2021 earnings conference call. Apologies for the brief delay. On the call today, I'm joined by Brian Hill, our Founder, Chief Executive Officer and Chairman; Jennifer Wong, President and Chief Operating Officer; and Todd Ingledew, our Chief Financial Officer.

Following management's discussion, we'll host a question-and-answer period open to analysts and investors. Please note that remarks on this conference call may include our expectations, future plans and intentions that may constitute forward-looking statements. The uncertain and dynamic nature of COVID-19 and its ongoing impact could continue to materially alter our performance. We would refer you to our most recently filed management's discussion and analysis, and annual information form, which include a summary of the material assumptions, as well as certain material risks and factors that could affect our future performance and our ability to deliver on these forward-looking statements. Our earnings release, the related financial statements, and MD&A are available on SEDAR, as well as the Investor Relations section of our website at aritzia.com.

I'll now turn the call over to Brian.

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

Thank you, Helen, and thank you, everyone for joining us this afternoon. I'm pleased to report, alongside Jennifer and Todd, our Q2 results, which reflect the encouraging recovery of our business. Notwithstanding the ongoing impact of COVID-19, and the evolving social, economic and political climate, we're pleased with our performance, and excited about the outlook for the future. And I could not be more grateful for our incredible team, with whom I have had the privilege of working alongside every day.

All of our boutiques are now open, and have been performing better than our expectations. Our eCommerce business has maintained its exceptional growth, albeit not at the same rate as when our boutiques were closed, at far higher projections than previous to COVID. Our world-class talent and infrastructure, in which we continue to invest, remained strong, and we have capitalized, and will continue to capitalize on the many opportunities made available in this unprecedented time.

Net revenue was CAD 200 million in Q2, down 17% from CAD 241 million last year. As you will recall, our net revenue was down 43% in Q1. The significant improvement in our quarter-over-quarter results is an encouraging sign of our business's ongoing recovery.

Despite shutting our retail operations in March, we were thrilled by the response of our people and our clients. As we reopened and began the recovery of our retail operations early May, this enthusiasm carried forward into Q2. Our multi-channel client relationship continued, upholding the momentum of our eCommerce business, which delivered 82% growth compared to last year despite the reopening of our boutiques throughout the quarter. Importantly, our increasing revenue combined with highly effective inventory and cost management allowed us to maintain our strong cash position.

As a result of keeping all our people employed during the shutdown, and starting to plan our reopening the moment we closed our doors, we were able to reopen our boutiques quickly, efficiently, and above all, remain vigilant with our health and safety precautions for our people, our clients, and our communities.

At the start of the quarter, 31% of our boutiques were reopened, and by the end of it, 96% were. As of September 9, all our boutiques were reopened. Notwithstanding lower traffic and social distancing limiting our in-store capacity, as we reopened our boutiques in the second quarter, our clients enthusiastically returned. While it is too early to tell what our new normal boutique performance would be, we were encouraged by the persistent improvement in our boutique productivity during the quarter with reopened boutiques performing on average at 70% of last year's productivity.

With geographical variation in performance depending on the past and present impacts of COVID-19, this is clearly a regional recovery for us. Suburban boutiques outperform downtown boutiques, and Canada unsurprisingly recovered in Q2 at a quicker pace than the United States. During the quarter, we began a number of initiatives, and launched new enhancements to our eCommerce website, enriching our clients' shopping experience, which Jennifer will share with you shortly.

In addition, our site navigation and content on the breadth of offerings were optimized, allowing our clients to more easily shop various attributes such as fabric, rise, length and color. This meaningful extension of our site navigation supports our expanding product offering, and will continue to scale with the growth of our assortment.

And while we have typically largely foregone paid advertising, the online environment offers compelling opportunities to test. As such, we recently launched a paid media pilot to evaluate the potential return on a formal paid media program. We will share more details if this becomes a meaningful ongoing initiative.

As noted, we see unlimited potential in our online growth, complementing the strategic advantage of a strong boutique network. Our clients continue to demonstrate their desire for an omni experience, and this multi-channel relationship presents boundless opportunities.

Since the beginning of COVID-19, as we have discussed, our product team pivoted flawlessly. Immediately upon closing our boutiques in the first quarter, we focused on moving our Spring/Summer inventory. This put us in great inventory position to start the second quarter, and allowed us to maintain markdown levels consistent with the same time last year.

This meant that at the beginning of August, we were in a remarkably clean inventory position, which allowed us to launch Fall with new exciting product that has been incredibly well-received, and notably, has facilitated full price selling.

Second, we effectively pivoted our inventory to reflect our clients' lifestyles and activities with less professional and event product to more of a casual and lifestyle product. As we recently saw in our clients' response to the launch of our Fall 2020 product lines, we're still chasing the overwhelming demand that we have experienced since the start of COVID.

And thirdly, we began our exciting new initiative to significantly expand our product assortment. The expansion of breadth, including new style development, depth including sizes, length, and colors, and new categories such as swim, intimate, bags, shoes and beauty, many of which are targeting our eCommerce channel began with our Fall 2020 collection, and we will have an even larger impact on Spring 2021, and thereafter.

As Jennifer will elaborate in a minute, we're exceedingly pleased with the launch of our product lifestyle management system this week, which will support the ongoing expansion of our product strategy. As we move forward with our expansion, attracting top creative talent remains an utmost importance. In the second quarter, we expanded our design team with talent acquired from world-renowned fashion brands who're already making a significant contribution to our product expansion strategy. And to complement our design team, we further invested in our manufacturing talent, securing senior leaders whose global experience is invaluable.

In marketing, we presented our clients with captivating campaigns that both reflected their stay-at-home reality, and resonated with their adjusted lifestyles. Our product catalog continues to successfully feature models shooting from home, and our compelling product campaigns continued with the Fall launch of each of our major brands.

During the quarter, we wrapped up our Aritzia Community Care Program, which we launched to show our heartfelt gratitude and support from those fighting on the virus frontlines. Through the program, we gifted 100,000 frontline healthcare workers in Canada and the United States with custom clothing packages, a total retail value of CAD 10 million. It was our honor to do our part to support the selfless healthcare heroes.

Last but not least, sustainability has always been a priority for us. We're proud to have completed our first CDP climate assessment in August, and officially became a company with carbon-neutral operations within our offices, stores and managed DCs as of the second quarter, covering our 2019 Scope 1 and 2 emissions. We achieved all

this through all of our efforts to minimize our footprint complemented by purchasing renewable energy credits and VCS-certified carbon offsets.

While this is an important first step, we know there is more we can do as an industry leader to make a difference. We're committed to this important work, and we will continue on our journey to do the right thing for our people and the planet.

As we progressed into our new normal, we were encouraged by our results, and embracing our opportunities. We're proud of how much we have accomplished as a team in the second quarter. Our results are a testament to the everyday lifestyle – Everyday Luxury experience that continues to resonate with our loyal clients, our engaging service, beautiful product, aspirational environments, and the unwavering commitment of our people.

Looking at Q3 to-date, we're pleased with the positive client response to our Fall/Winter product launch. This has manifested itself into sustained momentum of our eCommerce business, and continued improvement in boutique productivity in the first six weeks of the third quarter. As we now prepare for the holiday season, which represents our busiest time of the year, we're cautiously optimistic about our potential. Given our clients' enthusiastic response to our Fall launch, we're prepared as always to respond to the demand with flexibility.

As we move forward through the fall season and enter winter, we're already experiencing sellouts, and are quickly chasing reorders on these highly-productive styles. And while occupancy restrictions, recent increases in COVID-19-positive case rates, and new corresponding government restrictions in some markets will continue to impact our retail performance, our eCommerce business is well-positioned to continue to offset these measures.

I will now turn the call over to Jennifer to give you an update on some of the key areas of our operations. Jen?

Jennifer Wong

President, Chief Operating Officer, Corporate Secretary & Director, Aritzia, Inc.

Thanks, Brian, and good afternoon, everyone. The past six months have stretched us a new, and in many cases previously unimaginable ways. As a team, we've come up with creative and agile measures to pivot our business as we faced unprecedented challenges head on. And we've achieved this while continuing to delight our clients with the Everyday Luxury experience they have come to love, and expect from us.

Although the pandemic is not yet behind us, from an operations perspective, the second quarter was about resuming our long-term strategy and building for future growth. I'd like to give you a progress update in four key areas: first, continually improving our distribution and logistics; second, supporting our product expansion strategy; third, driving top line growth by empowering our clients to shop seamlessly between our physical and digital channels; and finally, fulfilling our commitment to cultivate and celebrate diversity and inclusion at Aritzia.

With the sustained momentum in our eCommerce channel carrying through the second quarter, we continue to refine all processes and activities across our distribution and logistics operations to accommodate the doubling of our eCommerce units. I'm pleased we've been able to keep our people safe while maintaining delivery times that meet or exceed our clients' expectations.

Starting with our Layer It On sale this past weekend, we have recently ramped up hiring and training of additional DC associates in preparation for our upcoming holiday season. While the retail environment in the near term remains uncertain, our infrastructure is well-positioned to continue to meet growing demand. As you may recall, one of the infrastructure projects we've been working on for the past few years is our Product Lifecycle Management system or PLM. We reached an important milestone just yesterday with the official launch of the

platform. This is the culmination of years of hard work and dedication of our team, who along the way mapped over 129 processes, gathered over 600 business requirements, executed over 20,000 steps in the system, developed training materials for over 245 processes, and consolidated thousands of data records.

Completing this launch was a marathon, and while we have additional phases to come, I'm proud of our team for this major accomplishment. PLM enhances our efficiency in bringing a product to market, and provides the scalability to support the expansion of our product offering well into the future. The adoption of PLM will follow the normal cadence of our product lifecycle, with multiple seasons cycling through at their respective checkpoints. Fall 2021 will be the first collection to see its product cycle through PLM from initial concept right through to delivery.

Next, with personalized experiences and enduring relationships as an ongoing priority, we continue to invest in an exceptional omni-channel experience. Earlier this year, we launched and have gradually expanded the use of digital selling tools. Our results so far show a meaning increase in both version rates and average order values. We are excited about the potential of digital selling tools, and we'll continue to expand the usage across our boutiques in the coming months.

With our eCommerce business steadily growing, we also continue to invest in our digital capabilities. As Brian noted, during the quarter, we implemented a number of initiatives on aritzia.com to enhance our client's shopping experience. As a larger portion of our business shifts to eCommerce, it is increasingly important to accurately convey size and fit information with our clients online. We are excited to be rolling out an AI tool later this month for size and fit optimization. This technology allows us to provide highly personalized size recommendations to our clients on aritzia.com. Based on the measurement data and preferences that our client provides, this tool leverages machine learning algorithms to generate precise fit guidance based on past purchases and its exceptional knowledge of our products.

Given the strong client engagement and positive feedback on our fit enhancements to-date, we expect these added features will increase client satisfaction and boost conversion. In the coming weeks, we're also launching a Buy Now, Pay Later payment option that allows for seamless checkout, while decreasing the barrier to purchase. We expect this deferred payment method to be an effective tool to augment our omni initiative by increasing brand awareness, attracting new clientele, and driving traffic. It also has the potential to meaningfully contribute to our top line growth by enhancing our conversion rate, and average order value.

Turning now to people. As Brian has noted, we continue to add world-class talent to support our growth. As we do, we're intent on ensuring for both our current and future employees that we are an inclusive culture that inspires high levels of engagement and performance.

Since our last call, we've made encouraging progress towards our commitment to cultivate and celebrate diversity and inclusion at all levels of our organization. We took our first ever company-wide D&I survey in August, and we shared the top line results with all of our employees in September along with an action plan. We learned that we have a strong foundation to build on. We also learned that there is room to improve our diversity in certain markets, and in positions of leadership. We're already using this data to inform our D&I strategy.

Going forward, our top three actions are: number one, laying the foundation by embedding D&I into everything we do company-wide, this includes more diversity in key areas, such as hiring, career growth and leadership; two, increasing learning and development through D&I training in our workplaces, which is already underway; and last but not least, we are evolving our brand by more clearly defining and expressing our diversity and inclusiveness.

To that end, we launched our first D&I campaign titled With Love, Aritzia at the end of September. This campaign shines the spotlight on six inspiring individuals from around the globe, who articulate and embody our diverse Aritzia community. Through a series of letters featured in captivating videos, images, and editorials broadly shared across our various platforms, we're highlighting the diversity that inspires us.

We've recently received highly positive feedback on the campaign's authenticity, and it's a powerful and timely way to connect with our clients on a unique new level. We will continue to seek out further opportunities to share our values and our commitment to authenticity, diversity and inclusion with our loyal clientele.

In conclusion, I share Brian's cautious optimism. We are not immune from the impacts of the COVID virus, literally, quite literally and figuratively. However, our powerful business model, combined with our adaptability to the evolving retail landscape, continues to serve us well in these extraordinary times.

I'll now turn the call over to Todd to discuss our financial results.

Todd Ingledew

Chief Financial Officer, Aritzia, Inc.

Thank you, Jennifer, and good afternoon, everyone. We are pleased with the momentum we saw in the second quarter that drove meaningful improvement in both our top and bottom line results, as strength in our eCommerce business continued and we reopened our boutiques. The ongoing recovery in our performance demonstrates the resilience of our business as we adapt and navigate the uncertain environment.

Net revenue for the second quarter was CAD 200 million, a decline of 17%. This compares to a decline of 43% in the first quarter. At the beginning of June, the start of our second quarter, 30 of our boutiques were reopened. At the time of our last call on July 9, 89 boutiques had reopened and we're trending on average at 55% to 65% of last year's sales productivity. The sales momentum increased through the remainder of the quarter, driving overall boutique sales productivity of 70% for the full second quarter. By the end of the quarter, we had 93 of our 97 boutiques reopened.

As sales ramped in our boutiques, the strength in our e-commerce business continued, delivering 82% growth in the quarter. The exceptional growth in eCommerce revenue year-over-year was driven by the positive response to our product, which manifested a meaningful increases to both traffic and conversion with similarly strong performance in both Canada and the United States.

Gross profit in the second quarter was CAD 70 million or 35.2% of revenue compared to 39.6% last year. The decrease in gross profit margins was largely driven by occupancy, warehousing and distribution center cost deleverage from the reduced retail revenue. This was partially offset by improved merchandise margin from the cancellation of the warehouse sale this year, as well as mostly lower markdowns in the quarter, compared to last year.

Gross margin also benefited from rent abatements and government payroll subsidies recognized during the second quarter. While the overall landlord response has been mixed, we appreciate the support in the form of abatements that we have received to-date from many of our landlords.

We are continuing to work with each of them for further relief as we evaluate ongoing boutique performance and future traffic impacts in this uncertain environment.

SG&A expenses in the second quarter were CAD 60 million, effectively flat compared to last year. SG&A expenses during the second quarter included additional costs related to the implementation of health and safety measures and other COVID-related costs, as well as investments in talent year-over-year. These were both offset by government payroll subsidies and savings and operating expenses.

Adjusted EBITDA returned to positive in the second quarter at CAD 12 million, compared to CAD 36 million last year. We maintained our solid liquidity position through the end of the second quarter with cash balance of CAD 207 million. Excluding the cash drawn down from our revolving credit facility, cash increased CAD 77 million from the same period last year. Despite the significant revenue decline associated with boutique closures, we have maintained our liquidity since the start of the pandemic through strong eCommerce revenue as well as prudent inventory and expense management.

Given our strong cash position subsequent to the end of the second quarter, we made the decision to repay in full the CAD 100 million drawn on our revolving credit facility. Inventory at the end of the second quarter was CAD 141 million, a 3% increase compared to last year. Our swift action to calibrate inventory and immediately drive eCommerce revenue enabled us to enter the fall season in a clean inventory position with an on-point product assortment and a return to full price selling.

Turning to our third quarter. We are pleased with the enthusiastic client response to the launch of our Fall product, which manifested itself into sustained momentum in our eCommerce business and ongoing improvement in our boutique productivity in the first six weeks of the third quarter. While we were pleased with the trajectory of our business and believe we are well-positioned for holiday, we are only halfway through our third quarter. We have recently seen a return to tighter government imposed COVID-19 restrictions in two of our Canadian markets, and saw an immediate impact to sales in our boutiques.

In addition, occupancy restrictions and reduced hours remain in place across our boutique network. Therefore, we're tempering our enthusiasm for the short-term and anticipate our retail performance to moderate in the back half of the third quarter. We expect the momentum in our eCommerce business will remain strong and continue to partially offset the potential impact of reduced boutique traffic.

To ensure the health and safety of our people and clients, we're maintaining stringent protocols for our boutiques, distribution center and support offices. These incremental measures are expected to add additional labor and operating expenses of approximately CAD 4 million per quarter for the foreseeable future. Based on the level of our current performance, we expect government subsidies will be immaterial going forward.

We continue to expect capital expenditures for fiscal 2021 in the range of CAD 30 million to CAD 35 million. Including the three new boutiques already opened in this fiscal year, we plan to open an additional two to three new boutiques and two exclusive pop-up locations. We have also repositioned three of our existing locations already this year.

In conclusion, we are pleased with the momentum in our business, the ongoing recovery in our financial performance, and our healthy liquidity position. And we remain confident in our ability to successfully navigate the crisis. As we look ahead, we will continue to strategically invest in our business to drive long-term growth and enhance shareholder value.

With that, I'll now turn it back to Brian.

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

Thanks, Todd. As I look forward, while the near-term remains somewhat uncertain, I could not be more excited about our long-term opportunities, fueled by our four strategic growth drivers. Geographical footprint expansion, product expansion, brand awareness and customer loyalty, and channel capabilities – omni-channel capabilities and digital enablement.

We've been building our digital capabilities for several years and we are well-positioned to capitalize on our accelerating eCommerce business. Over and above the digital enhancement of our website and our expanding footprint of profitable retail boutiques, our most effective marketing tool, fiscal 2022, we'll see our full attention directed to our omni-channel capabilities which will seamlessly connect our eCommerce and retail sales channels.

Through a handful of services such as store inventory visibility, ship from store, and buy online pickup in store, we will elevate our clients' experience, fueling sales in both our boutiques and our website. Speaking to our geographical footprint, already in the third quarter, we have expanded two boutiques and open two new boutiques, one in the new market for us, Philadelphia.

For the remainder of the fiscal year, we plan to open three more boutiques, one in the new market, Honolulu, which I'm confident we will have no problem finding teams to support the opening up. In addition, we're looking forward to the expansion of our signature Super Puff brand and vastly expanded product line this season. With the opening of two exclusive Super Puff pop-ups in iconic locations at the former Dean & DeLuca locate – Dean & DeLuca in Soho, New York City and the former Fred Siegel location in Los Angeles.

With many shuttering their doors, premier real estate locations across North America are plenty with corresponding financial terms that are unheard of. While our boutiques have always been highly productive, with opportunities coming available, we are in exciting position to strategically expand our boutique network in world-class, highly profitable locations.

As mentioned earlier in the call, we have begun to implement our product expansion. This initiative and its potential to grow eCommerce business is compelling. Our product calendar has us expanding our breadth and depth each season, doubling our product selection by fiscal 2025. We're confident in the tremendous growth potential of our business as we continue to enhance our eCommerce capabilities and omni-channel experience. Expand our exclusive product offering and capitalize on unprecedented real estate opportunities, increasing our geographical footprint, all supported by investing in world-class talent and infrastructure.

Our results over the past several months have proven the viability of our powerful business model. Our people's commitment to excellence and teamwork, and our clients' enduring loyalty during this time of crisis. Although, the retail landscape is shifting for many, our long-term future is rich with potential and we are well-positioned to capitalize on the boundless opportunities that lie ahead. Thank you.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] The first question comes from Mark Altschwager with Baird. Please go ahead.

Mark R. Altschwager

Analyst, Robert W. Baird & Co., Inc.

Q

Good afternoon. Thank you for all the detail and congrats on the progress and the recovery so far. I'm wondering if you could share any more perspective on what the store productivity recovery looked like in August. Sounds like maybe it was in the 80% range based on the quarterly average that you shared. Also digital, sounds like that has remained pretty steady relative to when you gave the update in July. So, I guess this is a fair take away here that digital has not materially changed quarter-to-date relative to the Q1 average even as the boutiques have ramped back up?

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

A

I'll take part of this and I'll pass it to Todd here. Thanks for the questions and welcome. We have found our boutiques getting increasingly better every month or every period. P6 is better than P5 and P7 has been better than P6. We have of late with some of the shutdowns in key markets like Ontario and Québec and uptick in COVID numbers throughout the North America, but we have seen sort of flattening and some pressure on those retail sales just of late. We'll see what manifest themselves. It's too early and too recent to be able to figure that out.

But I do – I'm really optimistic – but I am a little cautious of what's going to happen during peak periods running into November and specifically Black Friday in those weeks. Those are big important weeks for us and I'm a little concerned with store capacity issues and things around then. I mean, typically, it doesn't really affect us much on a Tuesday afternoon with capacity issues because we probably weren't at capacity anyway but when we get to these peak periods and we start getting lineups at our boutiques and things like that and particularly with spikes up in COVID, we're getting a lean on a little bit concerned what's going to happen. We haven't seen it manifest itself too much, but I'm a little bit concerned.

Todd, do you want to take the eCommerce question then?

Todd Ingledew

Chief Financial Officer, Aritzia, Inc.

A

Yeah. We've continued to see strength in our eCommerce business, so as we said, and are expecting that that strength will almost offset or potentially offset the shortfall that we're expecting to continue in the boutiques. But the answer to your question is no, we're not running at 150% like we were when the stores are closed in eCommerce. So, that is a – has subsided a little bit, but it's still our eCommerce business is far, far better than it was pre-COVID. The growth is far, far better than it was in pre-COVID. So, we're super excited with eCommerce.

And I think a little bit or a lot of it might have to do with COVID. I think we've done a [ph] look (00:34:31) great job on our product and anticipating trends and things. I think the fact that we've – we got out our inventory and we've had these great new collections that I don't think all other competitors have had into the marketplace this fall, and enhancements to our eCommerce sites and things have all contributed to that. And certainly, people shifting to

more digital is having effect, but I wouldn't suggest it's accounted for all of it. I'd like to give shout out to my teams here and our teams here who've done an exceptional job, product teams, eCommerce teams, marketing teams, and the fluency of our distribution centers and our [ph] share (00:35:10) retail teams reacting well and making customers feel really super, super comfortable in our stores.

So, everybody's banded together and done a great job. And I know I'm missing some teams here but we're just super excited about the business and what's been going on and are really happy with our performance throughout this period.

Mark R. Altschwager

Analyst, Robert W. Baird & Co., Inc.

Q

That's really helpful. Maybe just a quick follow-up there. I guess, it makes sense that store productivity may get more difficult to sustain as we approach the higher volume periods in the coming weeks here. We have seen efforts from some other brands and retailers to pull forward events to smooth out demand. Now I know you haven't historically been a promotional retailer, so tougher to do that. But just curious if you're making any changes on this front for this holiday, any different approach to the Black Friday period, for instance, given the capacity constraints you mentioned in the stores?

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

A

Yeah. I mean, there's probably mixed reasons why people are pulling forward events or maybe they have too much inventory which we don't have a problem. Maybe they have cash flow challenges. I mean, we're super excited to see that we were in the midst of this pandemic. Q2, we made money and a lot of people didn't. They're still losing money. So, we don't have a [ph] presently touchwood (00:36:27) cash flow issues. Business remains strong. And we think that we have our promotional calendar and everything sort of aligned to where we want to be, and we're kind of going about this as normalcy as much as we can. And it seems our customers are responding.

There is some concerns during these peak periods around store capacities and things. So we've been looking at maybe stretching some of these opportunities out, both from a sales perspective but also health and safety for our clients and our people. So, we're adjust – we're making adjustments in everything that we're doing, but we're not abandoning what's made us successful in the past and what our customers have appreciated in the past, and we're still committed to that Everyday Luxury experience.

And so, it's not really promotional calendars and things like that. That's not how we operate. We've never operated by having promotions in sales to generate sales. We've always used it to clear out inventory when the inventory that is a little bit more – a little bit slower selling. But we haven't ever used it to smooth things out in sales. So, we're not going to lose sight of that. We're going to stay true to who we are and it seems to be working right now. So, we're super thrilled.

Mark R. Altschwager

Analyst, Robert W. Baird & Co., Inc.

Q

Great. Thanks again. And best of luck over holiday.

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

A

Thank you.

Operator: The next question comes from Mark Petrie with CIBC. Please go ahead.

Mark Petrie

Analyst, CIBC World Markets, Inc.

Q

Hi. Good afternoon. Brian, given the unprecedented real estate opportunities that you mentioned and the compelling store economics that you're seeing, does this open a window to accelerate the store opening pace specifically in the US?

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

A

We've discussed that. I think one – somebody might be suggesting you should be accelerating and opening a ton of new stores and more so than we have in the past. Others are suggesting that it could get – things could get – the opportunities could get even better. And in some cases, some of the landlords not recognized or – this sort of new reality. So – but realistically, we do have logistics challenges with building them right now. We can't cross the border and a lot of our teams up here in Canada. And that hasn't really impeded us, but it certainly hasn't made it easier.

And then, obviously, all the COVID restrictions on site, and things like that. And we haven't really been able to go look at sites, although we do have a senior real estate executive down in the US. But – so and then – and so we kind of approached it as, look, it's the same as anything. We have our pipeline, we wait for the right deals both from a location and shape and store perspective, as well as financial terms. And we're going to continue to do that. So we're not really in a position that we're thinking let's push the pedal down but we're also not letting it out. The opportunities are too good to pass.

I would say we're probably going to start getting more aggressive. We don't think these opportunities are going to go away in the next week or month or anything else. And but at the same time, we're driving a lot more of our business through eCommerce. So we think we can grow our business at a very, very good clip with continuing to promote and invest in eCommerce and continuing to open stores and continue to invest in our product and we're pretty comfortable with the mix that we have right now and have had in the past and as the opportunities come up though, we're not hesitating doing deals, I can tell you that. But are we doing more, and going to push the pedal down more? Not necessarily. We have our pipeline. And if those opportunities come up, we're going to hit them. But the pipeline is a pipeline, and the opportunities are the opportunities, and we can't really force them if they're not there.

Operator: The next question comes from Irene Nattel with RBC Capital Markets. Please go ahead.

Irene Nattel

Analyst, RBC Capital Markets

Q

Thanks, and good afternoon. If I might, just a shorter-term question. Can you talk a little bit about sort of the cadence of demands in terms of the mix of products that you're selling versus what you would normally sell? And then, as we move through the balance of the year, what you're kind of thinking in terms of holiday, and I guess, sort of more formal wear, and what have you – I guess, how you ordered it given the new reality?

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

A

Yeah. Thanks, Irene, and welcome. We've shifted. People are spending more time at home. They're buying more comfortable clothing, they're buying more casual clothing. I sat with our [indiscernible] (00:41:10) designer here last night, I think it was 10:00 or something, chatting with her about the demand that she's had. And we've seen some of the demand for some professional wear, and event wear go down. But it's going to come back.

I mean, people – a lot of people are changing their lifestyles to working-from-home and everything else. But I can't find a single person who likes being shut in every day. I mean, everybody wants to get out, just clambering to get out, and quite frankly, I think we're all going a little stir-crazy, so. And once people start going out again, they're going to want different types of clothes than when they're hanging at home.

So, what's so beautiful about our brand is that and our product mix is we have brand, we have products, and we have as you know as well as anybody, Irene, we have our lines that cater to professional and event, but also have casual, lifestyle and active lines and practical lines. And we have a balance between coats and sweaters and pants and shorts and dresses and everything. And I think that's one of the things we've always been the most proud of is our product mix and everything else.

So, we just pivoted quite fluently to our new product mix, and it's certainly different than it was a year ago, for sure. But I'm pretty confident that it's going to go back and look at a lot more. Hopefully, if we get this behind us a year or two from now, it's going to look a lot more like it did a year ago than it's looked in the last six months, and we're going to be ready for that too. And so, we're ready for everything. I mean, as I just mentioned we're profitable for the quarter. We had a great start to our Q3. And so, we're super excited, and whatever the situation is we're ready for it, and we'll adapt accordingly.

Irene Nattel

Analyst, RBC Capital Markets

Q

That's great. Thank you. I really appreciate that. And yes, please, God, I'd love to get out of the house. Just thinking a little bit further ahead. How should we expect to see the evolution of the extended offering happen over time, you said – and how are we as consumers and as analysts going to really see it as it happens?

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

A

I think part of the whole impetus of this is the fact, and I've mentioned on the last call the fact, that we're not constrained by the four walls of our retail stores anymore. And although retail drives still a majority of our sales, eCommerce has hit a critical mass now that we can explore and develop product that could come out as eCommerce-only product. So, we're going to continue to do that. We have a list of 18 initiatives, and we have them all jammed into the next year-and-a-half, two years, and we had a board meeting the other day, and they all looked at me, and said, come on, Brian, you've got to just get a little bit more realistic.

So, my big takeaways from the board was – at our board meeting was prioritize these initiatives, and obviously hit the ones that are the easiest to do, and certainly going to generate the most profit, and maybe put some of the other ones secondary and tertiary. But there's some super-easy ones, just adding colors that we couldn't do before because the stores have limitations in size – and sizes and lengths and things like that, so these are no-brainers. We're already executing on most of these right now. As we started this fall season, we've had most of these, we've had extended sizing since last spring. We've added colors, more colors this fall. We're going to see a lot more next spring and summer.

So, we're going to see a lot of that more online. There might be a bit more variability in the stores, but the stores have their limited capacities, we're going to start seeing our warm weather collections, be a little bit more robust,

particularly since we're opening in Texas, we have three stores open in Texas now. We're in San Diego. We're just in – the store we just mentioned in Ala Moana in Hawaii and places. So, we're going to continue to pursue that warm weather initiative, and then we're going to start looking into other categories. And we actually already started building the teams to explore other categories, expand on our denim, and just really facilitate the breadth of offering.

As I mentioned, I think over the last call, if you look at a lot of the pure-play e-commerce people out there, who have no limitation that, their merchandise breadth is multiples of ours. And so, for us to compete and to execute well, and continue to capture our customers' imaginations, and give her luxury, Everyday Luxury, we need to strengthen and broaden the appeal of all our products. And so, we're going to continue to explore that, and we're really excited about it. Our whole product team's energized.

And it's going to cost money. It's going to cost capital. We need more space and more people and more heads and more expertise, and some of these people don't come inexpensively because we're bringing them in; some are Canadians, and some of the support people are Canadians, but we're bringing some of these experts in from all over the world. But, we're pretty excited about what we've assembled so far, and what we're going to assemble. So, we're looking forward to it, and we're going to see – you're going to start seeing things hopefully already with the sizing and things, but you're going to start seeing a lot more colors and start seeing a lot more breadth of styles in some of these categories as soon as next year.

Irene Nattel

Analyst, RBC Capital Markets

Q

That's great. Thank you. Looking forward to it.

Operator: The next question comes from Derek Dley with Canaccord. Please go ahead.

Derek Dley

Analyst, Canaccord Genuity Corp.

Q

Yeah. Hi, there, and congrats on a strong quarter and outlook. Just wondering, just in terms of gross margin, it came in quite strong this quarter, and I get you're not expecting the CAD 2.5 million in subsidies going forward, but likely some of the rent abatement may continue. So, when we think about gross margin, do you feel you're getting closer to that sort of normalized range, call it 38%, 39% over the balance of the year, especially given your healthy inventory position?

Todd Ingledew

Chief Financial Officer, Aritzia, Inc.

A

Yeah. Well, listen, there's obviously a number of factors impacting gross margin. One that Brian discussed is that we have returned to full price selling. So, from a merch margin perspective, we expect to be flat with the prior year. But we still continue to expect deleverage from occupancy and warehousing costs because we do have all the boutiques open now. So, the pressure from deleverage is lessened, but we are still expecting to have lower boutique sales. And so, that will drive some deleverage.

And we did receive significant rent abatements that we negotiated in the second quarter. We do expect abatements similar to that in the third quarter. However, we currently aren't planning for any of that material for the fourth quarter. So, there is a difference between the two quarters. And to maybe put a finer point on it, we expect the gross margin will be below last year in Q3, but potentially the gap will be smaller than the 440 basis points that we saw in Q2.

And if I could add to that, you may or may not recall, 9 months ago, 12 months ago, I was discussing increased raw material prices, wool, silks, all those things had gone up. So, we were actually buying all the products we've received in this season is with those higher inventory costs, so raw material costs. So, our starting margin isn't quite as high as it was. That said, going forward, Derek, we're seeing far, and we're seeing a lot of actually downward pressure on these prices due to the demand, the worldwide demand.

And so, we're going to start seeing some better margins due to raw material costs, probably not spring so much. We're going to see a little bit in the spring, but next fall, we're booking in wools and downs and things like at far less prices than we are now. So, we're going to pass some of those on to our consumers who we think are going to have some financial challenges due to the economy. But some of them will help us retain or regain some of the margin that we lost this year from – get back up to previous years.

Derek Dley

Analyst, Canaccord Genuity Corp.

Q

Thanks. Okay. That's really, really helpful. Appreciate the color. Maybe just one more quick one. Just regionally, I think last quarter, you commented that Vancouver, the Pacific Northwest was performing a little bit better than some of the other regions. Were there any big sort of disparities this quarter on a regional basis?

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

A

Yeah. I think – Todd, should I take this one?

Todd Ingledew

Chief Financial Officer, Aritzia, Inc.

A

Sure.

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

A

Yeah. I mean, we're seeing – we saw some of the same trends we saw. As I mentioned in my discussion earlier that it's not just present COVID situations. We've all – we've seen previous COVID, so regions that were affected dramatically by COVID. They just – they were hit hard, and they haven't recovered quite as well as regions that weren't.

But now with the sort of so-called second wave, we're seeing a whole another new pattern develop, and with Ontario shutting down – I was in Ontario and in market, in our stores on Saturday, and I noticed a definitive decrease in traffic once the Premier shut down the province on Friday night. So, we'll see. I believe it's a 28-day shutdown, but we've already seen effects at retail.

Now, whether those get made up from an e-commerce perspective, I don't know. But once again, when things like that happen, it rocks the consumer, it rocks people, they don't go out as much, they don't go out not just shopping in the stores, but they don't have events and things they're going out to. So, whether it'd just be controlled dinner parties or whatever, I think it rocks everybody. So, we're seeing these patterns, we've seen these patterns evolve, but now we're seeing new patterns take place as falls reopen, and we've seen different regions get affected a little bit heavier.

I mean, we're getting affected probably at the worst case we've had out here in British Columbia, Ontario re-shutting down again. All of a sudden there're numbers from the US, which was harder hit before are almost flat with numbers in Canada are now as far as percentage soft. So, it's ever-evolving. It's really organic. And it's unfortunate we're all going through this, but we're just going to roll with the punches and do the best we can, and so far the team's done a remarkable job.

Derek Dley

Analyst, Canaccord Genuity Corp.

Terrific. Appreciate the color. Thank you.

Q

Operator: The next question comes from Stephen MacLeod with BMO Capital Markets. Please go ahead.

Stephen MacLeod

Analyst, BMO Capital Markets Corp. (Canada)

Thank you. Good evening, good afternoon. I just wanted to follow up specifically on your comments, Brian, around the online category expansion. You gave some good color in the Q&A. But I think in your prepared remarks, you sort of suggested that you actually have introduced some new products or new category expansions online. Just wondering if you could give a little bit of color around what we have seen so far, and what the customer reaction has been to that?

Q

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

Yeah. No, I hope I didn't mislead in that. I think what I'm trying to communicate is we're grouping sort of three different groupings of product expansion. We're grouping colors, lengths, sizes, that sort of in existing styles. We're grouping – and then the second group is with new styles and existing product lines, and the third is new categories.

A

I didn't mean to mislead, and I apologize if I did. What we're already seeing is the first category. We have new sizes. We have new lengths now hitting the stores. And we have new colors, and just more selection of colors hitting the stores. And we've just seen a positive response to it. I mean, it's hard to predict exactly because you can't really tell with new items whether you would have sold, what the rate of sale would have been nor what the percentage of black would have been versus yellow versus green versus if now you have black, yellow, green, purple, and blue, are those sales in the purple and blue incremental or are some of them incremental, and then taking away from.

So, it's hard to figure that out. We do know though that by just offering different lengths and things like that, we're going to appeal to a broader range of customers. So, my daughter is always complaining, and she's 5'9", and she's always complaining that her pants are too short to wear at Aritzia, and now she's thrilled because she can buy pants that fit her now.

So, and buy is the operative word here for her. So, yeah, she's out buying those sorts of things now, and she can buy and fit in her pants quite well. So, there's just an opportunity for us to be a lot more things to a lot more people here from a color and that perspective. Even sort of more body conscious items that have skin tone, looks different on different skin tones, and enable to offer a wider variety that looks better on different people in their different skin tones. So, we're excited about that, and that's what we've seen so far.

We haven't really introduced a broader range. And quite frankly, last spring when COVID hit, one of the first things we did was have a really good hard look at our breadth of our existing lines. And we kind of called some of the items that we didn't think we needed. So, we quickly have pivoted though on that as our business picked up, and our – we got cleaned out our inventory, we quickly pivoted, and been adding new styles, and our customers have responded very much, so. But we've added new styles in existing programs and things like that. And we've seen it perform extremely well, which is probably something I just left out. But there really isn't – the quantity of new styles, we've just been focusing on our core strengths, and our business is good. We're super-pleased with it, so, at this point in time. But we're not going to see any of these things that I mentioned to Irene for a little bit here. So, I apologize if I misled you there.

Stephen MacLeod

Analyst, BMO Capital Markets Corp. (Canada)

Q

No, no. That's great. Well, that's good incremental color, so, thank you. And then, I just wanted to just maybe along those lines, Jennifer, you talked about the Product Lifecycle Management, which was officially launched. Can you just give us a little bit of color around kind of what benefits you're expected to realize from this new product? I think you said that fall of 2021 will be the first collection with product cycle into this new tool. So, I just want to get a little color there.

Jennifer Wong

President, Chief Operating Officer, Corporate Secretary & Director, Aritzia, Inc.

A

Sure. The strategic benefit ultimately is to enable the product expansion strategy that Brian has just [indiscernible] (00:56:47). So, in my group, we build infrastructure to enable growth, and essentially everything we do generally ties to a growth initiative or a growth driver or optimizing our current business in some way.

So ultimately, if we're going to scale our product assortment and create more skews essentially as what it translates to right down to the lowest level, we need a system to help manage the data, and manage the processes to make sure we do it efficiently, and can manage it essentially cost effectively.

So, some of the side benefits apart from strategically enabling us to expand our product mix is more than a greater efficiency, greater control and management over design quality, construction quality, possibly fit quality. So all of the aspects that go into the development of a product will now be managed through a system rather through manual processes and spreadsheets and basically documents. So, it's kind of critical in order for us to expand our product.

Stephen MacLeod

Analyst, BMO Capital Markets Corp. (Canada)

Q

Right. Okay. That's helpful as well. Thank you. That's it from me.

Operator: The next question comes from Meaghen Annett with TD Securities. Please go ahead.

Meaghen Annett

Analyst, TD Securities, Inc.

Q

Thank you. Good afternoon. Just sort of more of a follow-up question on the Buy Now, Pay Later option that you discussed. Was that about more of a regional initiative, and how meaningfully do you see that impacting conversions and basket size? And do you think that there's any maybe potential offsets to those benefits?

Jennifer Wong

President, Chief Operating Officer, Corporate Secretary & Director, Aritzia, Inc.

A

The product? Hi, Meaghen, welcome back. It's Jen. We chose a product that has great prominence, I guess I would say in Canada and the US. And so for us, we'll be starting with the product online. I think they have it. I think they do have a presence with US in actual bricks and mortar. But, we're going to use it for our online business first and foremost in the US and in Canada.

And essentially, I'm not sure if you know how these payment solutions work, but it's – at the end of the day, it's a deferred payment solution. And so, what it allows is it allows greater accessibility for purchasing power to our clients. There's also tremendous marketing synergies between the company that we chose and ourselves, and that can drive client acquisition. But essentially, at the end of the day, when I say a drive conversion and possibly average order value, that's because it allows our client to make their purchases. They essentially have credit and it allows them to make their purchases now rather – right now, and defer the payment over a period of time.

Meaghen Annett

Analyst, TD Securities, Inc.

Q

Okay. So does that impact returns at all or?

Jennifer Wong

President, Chief Operating Officer, Corporate Secretary & Director, Aritzia, Inc.

A

I don't think it will impact it one way or the other. I don't – like that – it's just – it's actually just making our products more accessible. What I would say is as it relates to returns, that's where the size and fit optimization product that I spoke about actually will impact positively in that we would hope to see that if a client is purchasing items more accurately, there'll be fewer returns. So, that's what we've done to address return metric.

Meaghen Annett

Analyst, TD Securities, Inc.

Q

Okay. That's it from me. Thank you.

Jennifer Wong

President, Chief Operating Officer, Corporate Secretary & Director, Aritzia, Inc.

A

Did that make sense? Great.

Operator: The next question comes from Lorraine Hutchinson with Bank of America. Please go ahead.

Lorraine Hutchinson

Analyst, BofA Securities, Inc.

Q

Thanks. Good afternoon. Your comments about evaluating paid media is really leading to my question about the long-term implications of higher online penetration to your margin structure. Can you just talk a little bit about the puts and takes there, please?

Brian Hill

Founder, Chief Executive Officer & Chairman, Aritzia, Inc.

A

Yeah. It really is a test, and we don't really have – we're not going to – that's the whole purpose of it. And we're not going to have any numbers until we actually come up with that. Our team is a lot more versed team that's –

that we have presently is a lot more versed in this area than previous teams we had in the past. And I think our – their perspective is pretty balanced. There is – some people would tell you that paid digital is something that at the end of the day, you don't eventually make money on, and others would tell you it's a windfall and client acquisition and everything else. So, we're going to explore and see what that means for Aritzia.

Our biggest client acquisition, and I've always said this to this call and our teams is our retail stores, our retail footprint, and we've seen that in the past when we've had these – our stores open, and our sales, and eCommerce sales in those regions go up. But at the end of the day, this is – there's been this major shift. There already was a shift. But as you know, there's more of an exponential shift to digital, and we need to become more famous in the United States. And with our sales and our eCommerce sales accelerating and everything else, we still have a huge opportunity in the US.

And really at the end of the day, hopefully five years from now, we'll be doing more business in the US market in eCommerce than we will in Canada, and that's just the nature of the people and the size of the market, and presently we're not. So, we're exploring everything here. And they're going to get back to see if it's profitable, if it makes sense, are we driving incremental sales, are we trading dollars or whatever it is that we're doing here.

From a marketing perspective, I historically thought that we're better off treating our people and our existing customers, and spending the money on them rather than acquiring new customers. But the digital landscape is different. And unlike real estate, everybody's website is treated equally as far as searches and everything else goes to some degree. But – so, we're going to – well, actually not treated equally based on that. So, we're going to have to explore that.

It was simple before, you go by, get a good location in retail, and a better location in retail. And now, you need to have that equivalent. You need to do – spend money on digital and everything else, and pay digital. So, that's what the exploration is. It's not – we're not going to see a meaningful increase of our business in the short term because we're quite frankly we're out testing all sorts of different paid digital vehicles, and then report back, we're doing some A/B testing around that and things like that.

So, we see this as something that is going to be evolving. And as I mentioned in the call, we'll – if it becomes something more meaningful, we're going to do a change in strategy, we'll – everybody here on the call will be the first to know. But right now, we're still in the test phases. And quite frankly, I just don't know the answers on all the puts and takes. Obviously, it's investment and less expenses, and revenues less expenses are return. But I just don't know what that equation is going to look like, and what buttons within the digital landscape are going to work for us and prove to be incremental versus ones that are not.

Lorraine Hutchinson

Analyst, BofA Securities, Inc.

Q

Thank you.

Operator: This concludes the question-and-answer session. I would like to turn the conference back over to Helen Kelly for any closing remarks.

Helen Kelly

Vice President-Investor Relations, Aritzia, Inc.

Thank you, Anastasia, and thanks again to everyone for joining us this afternoon. We will be available after the call to answer any questions you may have. Take care, and we look forward to speaking with you again soon. Thank you.

Operator: This concludes today's conference call. You may disconnect your lines. Thank you for participating, and have a pleasant day.

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