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Logitech International SA (LOGI)

Q1 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Chris and I will be your conference operator today. At this time, I would like to welcome everyone to the Logitech First Quarter 2018 Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

Ben Lu, you may begin your conference.

Benjamin Lu, CFA

Vice President-Investor Relations, Logitech International SA

Thank you, Chris. Welcome to the Logitech conference call to discuss the company's financial results for the first quarter of fiscal year 2018. The press release, our prepared remarks and slides, as well as a live webcast of this call are available online at the Investor Relations page of our website, logitech.com. As noted in our press release, we publish our prepared remarks on our website in advance of this call.

During the course of this call, we may make forward-looking statements, including forward-looking statements with respect to future operating results that are being made under the Safe Harbor of the Securities Litigation Reform Act of 1995. The forward-looking statements involve risks and uncertainties and actual results could differ materially as noted in our quarterly and other filings with the SEC. The company undertakes no obligation to update or revise any forward-looking statements as a result of new developments or otherwise.

Please note that today's call will include results reported on both a GAAP and a non-GAAP basis. Non-GAAP reporting is provided to help you better understand our business. However, non-GAAP financial results are not meant to be considered in isolation from or as a substitute for or superior to GAAP results. Non-GAAP measures have inherent limitations and should be used only in conjunction with Logitech's consolidated financial statements prepared in accordance with GAAP. Our press release and slides provide a reconciliation between GAAP and non-GAAP numbers and are posted on our Investor Relations website. We encourage listeners to review these items.

Unless noted otherwise, comparisons between periods are year-over-year and in constant currency, and all reported results and updated outlook are focused on continuing operations. This call is being recorded and will be available for replay on the Investor Relations page of the Logitech website. Joining us today from Lausanne are Bracken Darrell, President and Chief Executive Officer; and Vincent Pilette, Chief Financial Officer.

I'll now turn the call over to Bracken.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Thanks, Ben. And thanks to all of you for joining us. We started the year strong. Net sales grew 13% and profit grew 14%. All three regions grew double digits for the second consecutive quarter and the second time since I've been at Logitech in five years. We expanded gross margins by 1.4 points and invested that back into growing the capabilities that will enable long-term growth. By now I think all of you know, our underlying vision is to create a multi-category, multi-brand company, so investing and excelling in those five capabilities, operations, design, engineering, go-to-market and marketing, are absolutely key to realizing this vision.

From a product launch perspective, it was a really exciting quarter. Let's start with Gaming. Here's an insight about competitive gamers. Even though productivity users of mice prefer wireless mice, gamers prefer wired mice for two reasons. First, the battery in the wireless mouse could die in the middle of a game, while a wired mouse obviously is always plugged in. Second, a wireless mouse has greater latency than a wired mouse.

Latency, in this case, is that delay you see when you move the mouse and there's a slight lag between your hand movement and the movement on the screen, especially at high speeds. These two problems are enormous for competitive gamers. The possibility of a dead battery is a potential catastrophic issue mid-game. And the latency problems in some ways are even worse because they're an ongoing drag on competitiveness, and it's not just an insight applicable to eSports athletes who make their money gaming.

This is Nike's best basketball shoes are worn by casual players. Competitive equipment is not just demanded by the pros, but also by serious gamers and even casual gamers. We've been working for a few years to solve both problems. We've made progress but that is an understatement. We've solved both problems and actually made wireless gaming mice superior to wired gaming mice.

At E3 in Los Angeles last month, we announced a breakthrough. Continuous charging wirelessly. That's never been done before by anyone. Now you have a mouse pad, which most gamers use anyway, that wirelessly charges your gaming mouse as you play. So you have the untethered freedom of a wireless mouse but with infinite battery life. As for the latency, well we also fixed that with superb engineering creativity. We unlocked that with our light speed technology, and now our light speed wireless gaming mice are faster in latency than many of our competitors' most popular wired gaming mice. So there is no reason not to go wireless in gaming.

For the next innovation, we told you we're working on enhancing our software capability and we're doing it broadly. As an example, we're even bringing that to the mouse. Logitech Flow is a new free download that allows you to not only seamlessly control up to three computers with a single mouse, but you can even cut and paste text, images and documents among those three computers. You no longer have to mail them to yourself or go reopen them in the cloud program. Yes, you can drop and drag across computers. Imagine simply copying a file from a PC and then pasting it into a Mac on the fly, instantly, only with the cursor moving from screen to screen seamlessly. This is another first of its kind.

In Video Collaboration, we launched a special new conference cam, Logitech MeetUp. MeetUp is designed specifically for small conference rooms and huddle rooms. Huddle rooms are the fastest growing segment of the Video Collaboration market. Traditional conference cameras are terrible for huddle rooms. The screen and the camera are so close that if you have two or three people in the room with normal cameras with their limited viewing range, you actually lose one or two people or they're leaning in just to appear on the screen. MeetUp has a really wide field of view, which captures everybody in the room. Its all-in-one design also puts super high quality video and super high quality audio in one unit, eliminating annoying cables from the table. At a small fraction of the cost of normal video conference camera in a system, it's an amazing way to expand video anywhere.

Now I'm not going to stop talking about products without mentioning the latest version of our security camera, Circle 2. We took our original Circle camera and made it tremendously better and even more versatile. Not only does Circle 2 now offer the widest field of view, a stunning 180 degrees, but we're also offering mounts and accessories that make it multi-purpose. They can take the same camera, the exact same camera, and now you can go indoors or outdoors in the rain, wired, battery powered, plugged directly into a socket, attached to a window and even more. It's simply awesome and we just started selling this, this past weekend. These are just a few of the products we announced in the past few weeks and trust me, we have a lot more to come. I'm super excited about our pipeline.

Now let's take a look at the progress in each category. Let me start with Gaming again. Sales in our Gaming category grew a very strong 40%. All three regions posted healthy double-digit momentum in the quarter, and of course the latest news is the recent announcement that we've agreed to acquire ASTRO Gaming. We've demonstrated our ability to execute a leadership position in the PC gaming peripherals industry, and we still have so much more opportunity there. Now with the acquisition of ASTRO expected to close in early August, we're excited to be able to expand our leadership into an adjacent category, console gaming, the console gaming headsets in particular.

ASTRO leads the high-end of the console headset market and it's a powerful brand built by a powerful team. I'm excited to have them join Logitech. We see significant opportunities to leverage our global go-to-market and operations capabilities, with ASTRO's award-winning headsets to further deepen our presence in the PC and console gaming markets.

Video Collaboration sales increased 51%. The opportunities in this nascent but growing market are simply tremendous as we partner with leading cloud-based Video Collaboration solutions providers with our low cost hardware products to video enable thousands of huddle rooms and conference rooms.

Our Mobile Speaker sales grew 10% with particular strength from Asia Pacific. The newest addition to our Ultimate Ears family, the \$99 WONDERBOOM, was a powerful contributor to the growth. Audio-PC & Wearable sales fell 10% in the quarter. We're in the early days of the wireless earphone market and we are crafting the right distribution product portfolio for the years ahead. You'll see some very interesting things soon as we make changes to play in one of our hottest markets today. Stay tuned.

We continue to have renewed growth from our Smart Home business with sales up 49%. The interest in the Harmony Hub has been strong as it's really the premiere way to use voice to control the full range of devices in an entertainment room. Our decade-long track record of connecting new and old devices via [indiscernible] (09:24) source database of almost 300,000 devices makes using a personal voice assistant in a TV room easy.

Our PC Peripheral category continued to grow with sales up 3% this quarter. A stable PC installed base along with our strong innovation has enabled this category to remain healthy. Pointing Devices grew 6% while Keyboards & Combos were flat. And our new baby, Spotlight Presentation Remote, had a strong performance in the quarter, but our mice products were also up. PC webcams grew 3% in Q1, the sixth consecutive quarter of growth. You'll recall that webcams have been driven by the growth of personal broadcasting, from gaming to social media to video blogging.

Sales in our Tablet & Other Accessories category rose a powerful 71%. Even with a weak compare, the business fell 26% last year. This was a strong performance. It's too early to call that a growth of trend, but I do think you can see that our approach to innovation in tablets is working. Our newest slim combo for the iPad Pro is off to a great start, and we're also seeing strong sales to educational institutions for the first time with our new rugged combo case and keyboard for the 9.7-inch iPad. Looking ahead, we continue to expect sales in this category to attract the overall performance of the broader tablet market.

Now I'll pass the call over to Vincent for some financial performance info.

Vincent Pilette

Chief Financial Officer, Logitech International SA

Thanks, Bracken. With sales up 13%, all regions growing double digit, a few categories being well ahead of our expectations, and operating profits up by 14%, we delivered another strong quarter. As I tell our teams, a strong start is very important, but this is only the first quarter of the year. We will stay very focused on execution ahead of a heavy investment quarter so that we can deliver a great holiday season and another great year.

Our Q1 non-GAAP gross margin increased 140 basis points to 37%. We continue to be very diligent in managing our cost structure and the contribution margin of every product line so that we can reinvest our gross profit dollars into targeted investments, both for the short term and for the long term.

And as you can see, we are investing in sales and marketing and R&D, which increased 22% and 8% respectively. As examples of our investments, we are adding sales capacity in Video Collaborations around the world, we are expanding our online marketing capabilities, and we are increasing funds for more seed projects.

G&A spending has remained flat in dollars, absorbing our growth through productivity gains. Overall, our non-GAAP operating expense rose 15% to a \$153 million in the quarter. Our cash flow from operations was roughly breakeven in the quarter as working capital increases ahead of the holidays. This is similar to the seasonal patterns we saw in fiscal year 2016 when working capital was consumed in the first half, to support our growth and the product roadmap with cash flows from operations queued towards the second half. Similar to prior year, we still continue to expect our full-year cash flow from operations to be approximately one time our non-GAAP operating income.

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

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Thank you, Vincent. Our momentum from fiscal year 2017 continues into fiscal year 2018. We launched a strong tranche of new products in the first quarter, and we have even more exciting products to come throughout the year across our product categories.

Our strong first quarter and the pending acquisition of ASTRO put us in a position to raise our fiscal year 2018 guidance, the sales growth of 10% to 12% in constant currency, and a non-GAAP operating income of \$260 million to \$270 million.

Vincent and I are now ready to take your questions. Operator, please queue up the questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And your first question comes from [ph] Ananda Baruah with Loop Capital (13:37). Please go ahead.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Hi, [ph] Ananda (13:41).

A

Vincent Pilette

Chief Financial Officer, Logitech International SA

Hey, [ph] Ananda (13:42).

A

Q

Hey, Bracken, Hey guys, Vincent and Ben.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Hey, hey.

A

Q

Hey, congrats and thanks for taking the question.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Absolutely.

A

Q

Just a question one – yeah, a quick one for me. In the raised guidance for 2018, can you confirm that ASTRO is still expected to be about 200 basis points of contribution to that? And then if that's accurate it sort of suggests – I think your prior guidance is high-single digit, so it sort of suggests there's, I don't know, order of magnitude 100 to 200 basis points of incremental rates in that guidance rates. And you spoke broadly to the momentum, Bracken, but is there anything, I guess, on a more specific level you could speak to that's having you raise sort of the non-ASTRO portion of the portfolio. And then it's pretty early in the year for you guys to be raising guidance relative to how you typically like to provide us visibility. So is it a stretch to think that the momentum that you're seeing that's giving you sort of satisfaction to do that feels greater at this point than it has in prior fiscal years? Thanks a lot. That's it for me.

Bracken P. Darrell*President, Chief Executive Officer & Director, Logitech International SA*

A

Let me take the second two and I'll let Vincent to take the first question on ASTRO. Yeah, in terms of the momentum one specifically, I would say it's been a while since we've seen such strong growth from some of our most profitable categories and really across the board, Gaming, Video Collaboration, Harmony. We just across the board had very strong growth rates. I don't necessarily expect all those to continue quarter after quarter, but between that and the strong gross margins, it gave us a lot of confidence to go ahead and raise at this point.

In terms of the timing of the raise, you asked how would I compare this with past years. I would say, yeah, I mean it's a little hard to remember back to how we felt a year ago and the year before that and the year before that, but I would say I feel really, really good about where we are at this point after the first quarter. We came into the year saying if we have a good strong start, it usually dictates a strong finish. And I think we had a good strong start so it's up to us to finish.

Vincent Pilette*Chief Financial Officer, Logitech International SA*

A

So [ph] Ananda (16:03), this is Vincent. So yes, ASTRO is included, it's about 2 points on the top line slightly dilutive on the bottom line as we invest to build out that business internationally. Normally, after Q1 we wouldn't raise. But as you know, our guidance did it from [ph] AID (16:19) in March and then we fully digested Q4, look at the momentum in Q1, got better confidence in our roadmap moving forward.

And since we integrated ASTRO, we took again a full look at the bottom up and felt that we were in a position to raise where we are. I wouldn't expect every Q1 every year to be a raise, of course, but that's where we stand today. Much more confident to the year than we were four, five months ago.

Q

That's great. And then just one quick follow-up for me in that regard. You reminded me, Vincent, so ASTRO is dilutive next 12 months. You raised the op profit guidance, and as well despite dilution. So Bracken, to your point about gross margins. Just what's specific about the portfolio as having sort of the gross margin, number one, beat for the June Q, but the number two, having enough momentum such that you feel like you can raise the op profit guide even though you're absorbing dilution from ASTRO?

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Well, I don't think there's really a specific – I mean, we've made really strong cost savings that we started last year that is carrying over into this year, and we're executing our cost savings programs this year and we expect to do that throughout the year. And then on top of that, we're having really strong growth in a lot of categories and we do have mixture of gross margins across those and that it shouldn't hurt from a mix standpoint, let's just say that. So overall, we look to Q1, it felt like we're really in a strong position to go ahead and raise.

Q

That's great. Thanks a lot guys, congrats.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Thanks, [ph] Ananda (17:51).

Operator: Your next question comes from Asiya Merchant of Citigroup. Your line is open.

Asiya Merchant

Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Hi, everyone. And again congratulations on the quarter, strong results.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Thank you.

Asiya Merchant

Analyst, Citigroup Global Markets, Inc. (Broker)

Q

I just wanted to talk a little bit about your Audio-PC & Wearables that you talked about realigning your portfolio. [ph] They (18:15) were underwhelmed a little bit. So can you – maybe you can provide some more insight into that and how we should be looking at this category. And overall, just along with your music speakers, any competitive dynamics you can talk about in that category and what your expectations are if that's still aligned with what you had at your Analyst Day for the music category growing this year.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Sure. Let me take both those. So let me start with the category for Bluetooth earphones. The category for Bluetooth earphones is really strong. I mean, it's really taking off and we expect that to be the beginning of a very long term trend. So we got into this category because we were excited about being able to carve out a niche within that and have a really strong performance in it.

Now we would love to be able to just bring it in and turn that on and immediately have the same kind of growth rates or better growth rates in the category. But realistically, as we've gotten into this, like every category we've got to learn it. And we're learning that we need to really adjust our portfolio to be in the right position within the category for a long-term sustainable growth, and we've got to do same thing in our go-to-market. I have been

doing this now for over five years, and Vince and I have an – Alastair and the whole team. And every time we entered new category, we have to learn it, we have to iterate in it, and then we have to execute. And I'd say we've been iterating our way through the first year of the business and I think you're going to see some really cool things come out from us over the next quarter two and three and I'm really optimistic about where we are.

In terms of Bluetooth speakers, I think, it's very much in line with – the category itself is very much in line with what we expected. It's a great category, it's a big category, it's super global and we're playing it all over the world, and we still have opportunities everywhere. It's always going to be competitive. It's one of the most competitive categories we're in and we're – we've really competed well there from a pure innovation standpoint and we've leveraged a global go-to-market. And that's the way we're planning on going forward. And yeah I'm optimistic we can continue to do well in that very competitive market.

Asiya Merchant

Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Okay. And then one about your sales and marketing investments that had gone up. I mean, is there something that you can point to, is there a different distribution format, store fronts that you're going into, is there anything there that we can look for and see how that materializes in improving your operating income as the year progresses?

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Yeah. I'll give you a couple of examples, and Vincent, you can jump in, too. There's a series of things within that. As we expand into more categories, we have different kind of plays we need to make. One example of that, I think Vincent mentioned in the opening we just had with – in Video Collaboration, for example, one of the thing – just like in Jaybird where we're iterating [indiscernible] (20:54) to make sure we have the formula correct for sustainable growth, one of the pieces of the formula that we've discovered we needed, and we've discovered this couple of years ago, was direct enterprise sales in some cases. And so we're adding direct enterprise sales people to support the rest of the distribution chain, and that is highly effective. And so that's one of the places we're obviously adding. It's not the only place, we're adding it in other places, too, but that's one of the key ones.

And in terms of looking at how it sustains our profitability, all these marketing investments, our marketing sales investments are really – one of our principles is, and I've said this probably on every call since I've been here, I'm not here for the short-term so I am not interested in stuff that's only going to drive a quarter or two or a year. So everything we're doing is really to set us up for a long-term sustainable growth path, and that's exactly what we're doing in each piece of what we're investing here.

Asiya Merchant

Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Okay. Thank you.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Thank you.

Operator: Your next question comes from Joern Iffert of UBS. Your line is open.

Bracken P. Darrell*President, Chief Executive Officer & Director, Logitech International SA*

A

Hey, Joern.

Vincent Pilette*Chief Financial Officer, Logitech International SA*

A

Hey, Joern.

Joern Iffert*Analyst, UBS AG*

Q

Thanks for taking my question. The first one would be for Bracken, please. And Bracken, you stated a couple of times in the last conference calls, Logitech is just at the beginning. Can you please give us some more clarity here and what is really happening maybe in the next 12 months, how many new designers you are hiring, how many direct sales guys you are hiring in Video Collaboration, what are the new areas you are working on, on the product portfolio? What is the new product introduce rate in 2018 versus 2017? So some more clarity would be appreciated.

Second question then please to Vincent, also the third one. On the FX hedging, can you please provide us with some clarity on what rates you are roughly hedged right now and when the euro benefit should come through to the P&L. And then the third question on gross profit margin, if you split the improvement on the 140 basis points into the design to cost, mix and scale, this would be appreciated.

And the last question is just to double check, is momentum running into Q2? Is it similar to Q1 or are you observing any mild changes in the end markets? Thanks very much.

Bracken P. Darrell*President, Chief Executive Officer & Director, Logitech International SA*

A

Okay. Let me take the first one and let Vincent take the two. So my reference to just the beginning, our references at the beginning is a very long term reference. I'd really think it less of being in a position to be a company, one of the companies that creates a multi-category, multi-brand format that leveraging today's technology. So I think there will probably be more than us, but we're very fixated on doing that. And there are lots and lots of opportunities to do that. You mentioned a couple of categories that we're in that – or the tools that go into a couple of the categories we're in, the people in one case, so Video Collaboration, but it's a much, much longer point than that. I mean, we're constantly looking at – we have a whole portfolio of what are the new categories we should be entering and what timeframe should we, do we – to your point on designers, we're building small teams to do sprints and then sees to figure out how to enter them and where to enter them, and sometimes we're shutting those down and keeping others going so it's a very dynamic process.

In terms of specificity on exactly how many people we're adding over the next year or are we adding, we don't disclose that. What I would say is, and you asked about number of products we might be selling this year versus next, this is – the whole principle here, Joern, is really we're building a long-term growth platform of multi-brand, multi-category. So it's not about any quarter or 12-month period. And so you'll see us building this capability and systematically entering new categories and I hope, generally being successful in each category we enter, so that's really our game plan. As we do that, we'll unfold what those categories are and how we're supporting them, just as we are in Video Collaboration.

Vincent Pilette*Chief Financial Officer, Logitech International SA*

A

So I will take the currency hedging question. Just let me focus for illustration on the euro-USD exchange rate, which is the major driver in our P&L. In the last quarter, that rate moved from \$1.06 in April to on an average \$1.08 in May and \$1.12 in June. The average for the quarter is \$1.10 and FY 2017 average rate is also \$1.10. As you know, from a hedging perspective, we hedged three months on the four months rolling forecast kind of view, so even though today there's a little bit of an uptick, we would be hedged at around \$1.10 average for the next quarter. And our guidance also assume average rate of FY 2017 within a few points. So those are the assumptions used and how we drive the business from a currency perspective.

Gross margin improvement, your third question, 140 basis points, 37%. The 37% is somewhat in line to how we moved into the high end of the gross margin target as you know through last year. As we explained last year, most of that improvement is coming from cost savings, very little impact of mix, and then partially offset by increased of promotion. As we see, we reinvest the portion of the gross profit generated into short-term demand.

From a cost saving perspective, it comes from both design from cost and scale, both of them playing into the overall bucket of cost savings. Momentum, we don't guide by quarter, but I would say if you're modeling by quarter, Q3 is different. It's our big quarter and what we are shooting for. As I mentioned in my script, Q2 is an investment all the way. We really prepare for a great holiday season.

Joern Iffert*Analyst, UBS AG*

Q

Okay. Thanks very much. And maybe the last question if I may to follow-up on the financials. I mean, with marketing and selling spends going up 22%, was this all or are you recycling cash outflow, or is it something billed via provisions in the cash outflow and marketing campaigns that you only had in Q2, Q3?

Vincent Pilette*Chief Financial Officer, Logitech International SA*

A

No. Most of it is somewhat on the cash outflow. This is what happened in June, maybe outflow in July, but it is part of the cash flow of the quarter generally speaking.

Bracken P. Darrell*President, Chief Executive Officer & Director, Logitech International SA*

A

Yeah. There's nothing extraordinary.

Vincent Pilette*Chief Financial Officer, Logitech International SA*

A

No. There is no extraordinary accrual if that's your question, Joern.

Joern Iffert*Analyst, UBS AG*

Q

Thanks very much.

Bracken P. Darrell*President, Chief Executive Officer & Director, Logitech International SA*

A

Thanks, Joern.

Operator: Your next question comes from Chris Gretler of Credit Suisse. Your line is open.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Hello, Chris.

A

Vincent Pilette

Chief Financial Officer, Logitech International SA

Hey, Chris.

A

Christoph Gretler

Analyst, Credit Suisse Securities Europe Ltd (Switzerland)

Yes. Hi. Thank you. Hi, Bracken. Hi, Vincent. I have two question. The first relates to the bonus effect on your cash flow. Could you speak about how substantial that impact was? And the second relates to your gross margin. I mean, you're now tracking already the top end of your longer term guidance in Q1, which is seasonally typically a smaller quarter. What actually would trigger you to review this longer term guidance and kind of given maybe some structural change in your product portfolio?

Q

Vincent Pilette

Chief Financial Officer, Logitech International SA

Yeah. Let me answer the first question quickly. So on the bonus side, what we put in our prepared remark is that the Q1 cash flow from operations were impacted by a change in our bonus structure, up to FY 2017, we were paying out bonus semi-annually. So the first half of the year, bonus was paid within the year. Last year, we changed that and make it an annual bonus. So in FY 2017, there was no mid-year payment and all of the payment on a full year basis happened here in Q1 2018. That effect was compounded by the fact that FY 2017, I don't know if you remember, was an extraordinary year in term of beating our own expectation and our plans, so we paid above the 100% level of bonus.

A

If you go into the accrued liabilities of the balance sheet, you will see that that decreased by over \$20 million. The impact on the cash flow is over \$20 million on a year-over-year basis [indiscernible] (29:08) compare. On the gross margin side, Bracken will also answer, we're definitely trying to drive gross margin as high as possible structurally, both by creating great value and to price premium, but great value for the consumer. But also by tying up our operations and that goes from efficiency of our promotion all the way to product cost savings, as you know. And the reason we're doing that is because we definitely want to invest in all of our capabilities and create the capacity to invest in our five key capabilities.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Yeah. And you asked what would trigger us to relook at that top-end or the range on the gross margin, and I would say if we didn't think we had the kind of growth opportunities ahead that we do today, we would rethink it. But I think our job is to make sure that we have so many opportunities ahead of us that investors would think we were crazy to try to eke out more profit at the expense of stronger growth. And so our whole mission here is to have strong profitable growth options ahead of us that are substantial, and we just keep going even if we did have our gross margin rise above 37%.

A

Christoph Gretler

Analyst, Credit Suisse Securities Europe Ltd (Switzerland)

Q

Okay. Thanks. Keep it up. Great results.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Thanks, Chris.

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Thank you.

Operator: Your next question comes from Andrew Humphrey of Moran Stanley. Your line is open.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Hi, Andrew.

Andrew E. Humphrey

Analyst, Morgan Stanley & Co. International Plc

Q

Hi, there. Thanks for taking my question. Firstly, maybe on Jaybird, it would be useful to understand how much do you think there is down to you learning the business, as you say, and getting to know the channels and maybe specific channel partners, and how much is, I guess, the kind of conscious decision to move around the product portfolio. And I guess how long do you expect that transition to take?

And Vincent, I think you mentioned in the comments that the coming quarter is going to be an investment quarter ahead of stronger performance in Q3, as you would normally expect from a seasonal point of view. Would you expect profitability this year to be more heavily weighted to Q3 than usual or is that what we should read into that remark, or am I reading too much into it?

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Okay. I'll jump in and take the first one. I would say it's hard for me to parse out which is which, but I would say we've always – every time, we've entered a new category, we've had things to learn and we've adjusted both the go-to-market, the distribution emphasis and the product portfolio for that. And it's really hard for me to say how much of this is us learning and how much of this is us adjusting because we're doing it at the same time. In terms of how long it'll take, I feel like we're really where we need to be. I think it's probably a few quarters. I feel very good about where we are and I'm super excited about the portfolio that we are developing. So I'd just say stay tuned. I think you'll see some good things.

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

And then with regard to the seasonality, as you know, as we drive growth rate, we do always have investment in inventory, in OpEx to prepare in the field and marketing plan. And then of course in margin as we transition products from old to new, I would say that this year, like other years, but not like FY 2017, we are a lot more

frontloaded from an investment perspective, and of course it will become more apparent, as you know, and see the years unfold and we continue to launch new product. But yes, investment will be more frontloaded in Q2 than FY 2017.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Yeah.

A

Andrew E. Humphrey

Analyst, Morgan Stanley & Co. International Plc

Okay. Very helpful. Thank you.

Q

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Thanks, Andrew.

A

Operator: Your next question comes from Paul Coster of JPMorgan. Your line is open.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Hello, Paul.

A

Q

Hi. This is – hey, Bracken. Hi. This is [indiscernible] (33:04) on for Coster. Thanks for taking my question.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Great.

A

Q

So, to start...

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

You're consistent. We can always say Paul, and we know it'll be one or the other.

A

Q

Yeah, it'll be one of us. That's right. So on Gaming, it may now become your most important category and may even become your biggest segment by fiscal year 2019 with ASTRO. Do you see other opportunistic acquisitions or any product introductions, possibly a VR headset? And then on ASTRO, can you give us some insight into the

thinking behind the buy versus make decision? And then finally, Vincent, how does the margin profile in Gaming stand relative to keyboards and desktops and does that change over time? Thank you.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Great. In terms of opportunistic acquisitions, actually I'm probably mincing words a little bit but I would say that we would never do an opportunistic acquisition; it would always be a strategic one. And this was very strategic for us because we felt like we really had an opportunity to play in the bigger part of the headset business for Gaming, and we really didn't have any real play in it at all, and that leads right into your question of make versus buy in ASTRO. And obviously, we could've taken our existing brand and brought it over. What we saw was a wonderful opportunity to buy the top premium brand in the category. You had 80% of the top of the category, and that just doesn't come around very often. And they had already established a very strong brand in the console eSports space, which was important to us because we're really dedicated to being a key player in the eSports peripheral space.

So this, really super opportunity, I mean, we didn't – this acquisition we worked on for quite a while because we were really dedicated to getting it done. In terms of other spaces within Gaming that we think there might be, VR and AR and other things, we absolutely think they are out there. It's been no secret that we've been working on it. We have a [ph] seed (35:08) we call VR and AR, it's not just Gaming. But I don't know exactly when that will come. We'll have to wait and see. And in the meantime, we have so much opportunity in the places we're in now in Gaming that we're super excited about where we are.

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

And then your last question on gross margin, as you know, as we shared at [ph] AID (35:27), Gaming is sitting at around the corporate average gross margin and ASTRO is fairly in line to that overall business, being in that old business structure.

Q

Okay. Thank you.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

By the way I would come back and just – [ph] Paul (35:40), I would reply to or respond to one thing you said. I'm not taking issue with it. I think Gaming is a really important business to us. It has been almost from the beginning and it's been a great growth driver and will be a great growth driver for us, but we have so many that I wouldn't say that it's going to be the most or even one of – I think we've got a very distributive portfolio of growth opportunities now, one at a level this company's really never had before. And I suspect that we'll give richer and richer over time. So we're super excited about Gaming, but we have lots of other opportunities out there too, and we're excited about them as well.

Q

Thank you very much.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Thanks. Thank you, [ph] Paul (36:17). Say hi to Paul.

Operator: Your next question comes from Tavis McCourt of Raymond James. Your line is open.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Hey, Tavis.

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Hey, Tavis.

Tavis C. McCourt

Analyst, Raymond James & Associates, Inc.

Q

Hey. Thanks for squeezing me in.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Absolutely.

Tavis C. McCourt

Analyst, Raymond James & Associates, Inc.

Q

A couple of details here and a nice start for the year.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Sure.

Tavis C. McCourt

Analyst, Raymond James & Associates, Inc.

Q

So, I had in my notes previously that the minimal Circle revenues previously had been in video, but I'm imagining from your commentary, those are going to be in the home segment, is that right?

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Yeah. That's correct. It was very minimum and material, as we had shared. Then as we re-launch now or launch the Circle 2 that will ship in July, we will put it in the smart home category.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

No, it's just – yeah, exactly. It's just started shipping in July. Yeah.

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Yeah.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Yeah.

Tavis C. McCourt

Analyst, Raymond James & Associates, Inc.

Q

Got you. And then as I look through your slide show on your slides on gross margin, it has a footnote that in Q4 there was a \$14 million benefit or so from a change to a breakage model in EMEA. I don't recall that from last quarter, can you remind us what that was and is that non-recurring?

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Yes. I would invite you to go and read our 10-K that was filed at the end of May, and there we've [indiscernible] (37:34) the implementation from an accounting perspective of a breakage model on our promotion in Europe, which first time implementation of that breakage create a \$14 million adjustment.

Tavis C. McCourt

Analyst, Raymond James & Associates, Inc.

Q

Got it. And then, Vincent, you've mentioned kind of Q2 being an investment quarter a couple of times. If I look at kind of at the full year guidance at this point from an operating margin basis, it looked like it's reasonably flattish. Would you expect your operating margins in Q2 to be slightly down and then some operating leverage for the back half of the year, is that how we should think about the – how you expect the year to play out at this point?

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Yeah. Correct. As we said, every year is unique and last year was a lot more smoother through the year. FY 2016 was the reverse, first half investment, second half return on operating leverage. We would be closer to 2016, although every year is unique, of course.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

But I will say, I mean, I think our ideal year would be to be a little more frontloaded in our new product launches and investment activities because that's the stuff for Q3.

Tavis C. McCourt

Analyst, Raymond James & Associates, Inc.

Q

Yeah.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

[ph] We used to try (38:42) a better model than we've had in the past but we never got to deliver it.

Vincent Pilette*Chief Financial Officer, Logitech International SA*

A

Correct.

Tavis C. McCourt*Analyst, Raymond James & Associates, Inc.*

Q

Got it. And then one product question for you, Bracken, on the video conferencing segment, the MeetUp launch. So I think that's a higher price point than the conference cam. Well, there may be some kind of bundled offering in conference cams. But I guess what is your sense on what's the right price point for that category? When do you get kind of too much into the higher end, Cisco, Polycom competitive dynamic versus really designing specifically for the huddle rooms?

Bracken P. Darrell*President, Chief Executive Officer & Director, Logitech International SA*

A

It's interesting because we already have a pretty wide range of price points. This one actually, we have – our price points run well over \$1,000 up into the \$1,500 range where you can buy a whole array of things for almost a board room-sized room now, actually a board room-sized room. This one is actually targeted at about \$899 in the U.S. or \$799 in the U.S. so it really is for a huddle room. I think that's a completely reasonable price so we always say it's the cost of two or three chairs in your office and you can video enable a room. And you can save that in one flight or one of your teams' flight somewhere they didn't have to go to.

So it's absolutely a good value. And I think from a competitive standpoint, it's in a really, really good spot. So I don't know, I think we've got a lot of room on the portfolio for conference cams. I don't think we've really filled it out completely yet and I'm – but this one's a terrific product. It's an all-in-one product and it really is a – you can attach it to the wall or attach it to a TV and you don't need to have the cords running on the table. I'm using it in the huddle room right behind me now and it's – and the acoustics are amazing.

Tavis C. McCourt*Analyst, Raymond James & Associates, Inc.*

Q

Yeah. It looks very well conceived. A follow-up on that on the distribution model there. Can you remind us, so historically have you sold through traditional enterprise channels and distributors and resellers or is this kind of the growing of an enterprise sales force from the beginnings of that? Kind of how along that journey are you?

Bracken P. Darrell*President, Chief Executive Officer & Director, Logitech International SA*

A

Well, we have always sold through that since we started this business up three and a half years ago, and we still are. We're just augmenting it with direct selling to some of the larger enterprises so that we can get the story right directly to them because a lot of these distributors we're working with are carrying big bags. They've got a lot of other things to sell. So this is a way for us to supplement. And I don't want to preempt anything. I would say this is a very smart complement to what's – for the way we're going to market in this category and it seems to really work.

Tavis C. McCourt*Analyst, Raymond James & Associates, Inc.*

Q

Great. Thanks. And a great start to the year.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Thanks.

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Thank you.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Thanks a lot. Thanks, Tavis.

Operator: Your next question comes from Michael Foeth of Bank Vontobel. Your line is open.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Hi, Michael.

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Michael, hey.

Michael Foeth

Analyst, Bank Vontobel AG

Q

Yes. Hi Hi, Bracken. Hi, Vincent. I would like to come back to the FX situation. At the time when FX went in the other direction, obviously it was a big topic and it put a drag on your margins. Now my question is can you update us on the sensitivity of your operating margin to the FX rate? And if you're guiding or if you're basically planning with \$1.10 and we're now, I think, at \$1.16 or so, that alone should be enough to get your operating profit up by \$10 million, so is that part of the confidence you mentioned when increasing your guidance so early in the year? I mean, that's basically already [ph] teased (42:29) just with the FX. That would be my first question if you can elaborate on that.

And then the second question would be regarding China, if you can explain the dynamics you're seeing in China and what sort of specifically is driving the strong growth there? I think it was a record quarter again. If you can go into more detail there. Thank you.

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Yes, Michael. I will quickly do FX and Bracken will take China. So on FX, if you remember FY 2015, right, when the euro-USD depreciated 15%, 20% we lost about 3 points of margin. We see it would take about 18 months to recover through price action and pricing, et cetera, and we did recover it as you know. When we planned the year we initially assumed average currency rate to be on average equal to FY 2017, right? We don't try to forecast currency. We plan on that level, and within a few points, we know how to manage the different levers in our P&L.

It goes without saying it started the year at \$1.06, three months later we are at \$1.12, when we finished June \$1.16 today. It does give us confidence that FY 2017 average is still at play, I would say. We're not counting per se on currency just to raise the guidance. I think, it's a true operational strength, but of course it plays in our mind that currency has not collapsed and therefore I would [indiscernible] (43:51). If we see upside from currency, frankly we have plenty of investment plan as well and we'll always balance profit growth with investment for the long-term.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Yeah. To answer your China question, we've had a string of quarters now where China's had very strong growth. It's driven – it's actually very broad based, broad in almost every conceivable way in China including the fact that a lot of this growth – we're seeing very strong growth in Gaming, very strong growth in Video Collaboration. Good start even in Jaybird and some of it. So really it's a very broad based story. We've got a good team executing very well in China and I'm super optimistic. In fact, we're now building – we're building a group to do products in China for China. We started this about a year and a half ago, we continue down that path.

So we're big optimists about China. We're definitely not one of the companies that said well, we think we'll pull out, it's not worth it. We're pouring in and we're going after a lot more. We think there's more opportunity there than probably anywhere else in the world.

Michael Foeth

Analyst, Bank Vontobel AG

Q

Excellent. Thank you.

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Thank you.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Thanks, Michael.

Operator: [Operator Instructions] Your next question comes from Andreas Mueller of ZKB. Your [Operator Instructions] Your next question comes from Andreas Mueller of ZKB. Your line is open.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Hi, Andreas.

Vincent Pilette

Chief Financial Officer, Logitech International SA

A

Hey, Andreas.

Andreas Mueller

Analyst, Zürcher Kantonalbank

Q

Hello. Hello, everybody. Thanks for taking my question. I've got a question on the – also on ASTRO Gaming and then the cross-selling of G products into the console market and of course, vice versa, ASTRO Gaming products into the PC market. I mean, is that a real difference in terms of go-to-market channels and so forth and what do you need to do to do that, to cross-sell here effectively between the two kind of categories or end markets in a way?

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Okay. Yeah, I wouldn't – no, I don't think – the go-to-market is quite similar. I mean I think ASTRO has a stronger direct selling operation than we did, mostly online or all online. But besides that, I would say the go-to-markets are very similar. This is really about the brand and the portfolio and they had a very strong brand, very strong brand in console Gaming. They started years ago with really in the eSports of – they were console Gaming related and they were the first ones in and gained quite a reputation there. And then they built a portfolio at the very, very top end of that category. They established price points that didn't exist before. So they positioned themselves as a premium player in the console market and so it's really not as much about cross-selling into one channel or another. This isn't that kind of synergy. This is about really taking advantage of the fact that we're a global player. We can take those products very efficiently into markets all over the world. And we can continue to build that brand in the places that make sense, and we also have a lot of technology in earphones and headphones to complement theirs, and so it's really a great marriage of just two companies with strength that are quite complementary.

Andreas Mueller

Analyst, Zürcher Kantonalbank

Q

Okay. Got that. And then on the sustainability of tablets and the accessories, and also the [indiscernible] (47:05) keyboard for these educational purposes. I mean, can you elaborate there a bit, is that the one timer for example for the education market for after the holidays, or would you see there really kind of another kind of market popping up? And also on the tablet side, what's currently – I mean, of course you mentioned that the year before it was pretty low, so it was easy to have this growth, but going forward what do you kind of think?

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Well, you probably know me well enough now to know that I'm a little bit conservative on the way I think about things. So my general view is it's a great American expression, one robin, which is the bird becomes out once in the spring. One robin doesn't make a spring. So I'd say this strong quarter in tablet keyboards doesn't make me think that we might be having suddenly a resurgence in our tablet keyboard business. But I do think it's a very strategic category for us. As you point out, our path into the education market has not been available to us before, this is new. It's early days. We love the potential there. We're selling there now and it looks really good so far, but I'm too conservative to tell you that I think you can expect that for the long-term.

I'm hopeful that you'll see a good story there, but I certainly wouldn't want to set the expectation that you could expect anything like we saw this quarter, in the next quarter or quarter after that. What I can guarantee you is that we'll keep innovating very effectively there, and we'll get everything there is to get there. And if there is a big market there, we'll get it.

Andreas Mueller

Analyst, Zürcher Kantonalbank

Q

Okay. Thank you very much.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

All right. Thank you, Andreas.

A

Operator: Your next question is from Joern Iffert of UBS. Your line is open.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Hi, Joern.

A

Joern Iffert

Analyst, UBS AG

Yeah. Hi again. And sorry for a follow-up question. And I apologize, my ignorance, it's on Jaybird. I'm not getting this 100%. Is Jaybird at the moment declining in revenues year-over-year, and is this something which can take or which can happen also in the next couple of quarters, this would be the first one. The second one also on Jaybird, I mean, what is the update on the expansion into Europe and Asia? I mean, where do we stand here? When do you expect that you have penetrated your classic distribution channels in these regions? Thanks very much.

Q

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Yeah. Yeah. To be clear Jaybird is a small business but it is – it declined this quarter year-over-year. And could that go on in the next quarter, too? Maybe. But I mean, it's a little hard for us to say because we're now – as you pointed out, we're now on the – we're also in the early phases of expanding this into distribution all over the world. So I think you'll see – as I said, I don't want to say anything about the next quarter or the quarter after that. We're not going to guide to quarters. But what I can say is I feel really good about the plan we have both from a go-to-market standpoint and from a portfolio standpoint, and I think you'll see some really cool things coming. And I don't want to go too much further than that expect to say it's a cool category. And I think we've created a strategy that goes after a part of it where we can really sustain good strong growth.

A

Joern Iffert

Analyst, UBS AG

But what is the incremental challenge? I mean, remember when you acquired Jaybird, I think you were quite positive on growth which can materialize immediately. What is for you the incremental challenge here? What is something where you said, okay, look this was really something we have not foreseen in Jaybird.

Q

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Yeah. No, I think the key here is that as we've gotten into this, we decided we don't want to be playing a broad game where we're just selling an earphone to anybody for anything. And we bought a great brand that's positioned in sports. So without being too specific because I don't want to kind of unleash our entire strategy that we haven't let out the bag yet, we're trying to narrow this much more so we can create a really sustainable play here and become the leader of one segment as opposed to number three or four of a very large segment. You know me by now, you know that I'm not a believer in being number – being 2% of a really big category is not nearly as good as being 50% of a smaller one. And that's the game we're really after and I think after we – by the time we bought the business we really integrated. We saw that – we continued to see the category unfold and develop. And now we can see this opportunity much better for what it is. And I think it's a great opportunity, we

A

just got to make sure we had the right portfolio, the right focus on the channels and then execute, and that's our game plan.

Joern Iffert

Analyst, UBS AG

Q

Okay. Thanks.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

A

Thank you. Please feel free to jump back on if you have another question there, Joern. Okay.

Operator: There are no further questions at this time. I return the call to our presenters.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Okay. Well, thank you very much. It was a strong start to the year. We're super optimistic or we wouldn't have raised. And we can't wait to see you guys in about three months.

Vincent Pilette

Chief Financial Officer, Logitech International SA

Thank you.

Bracken P. Darrell

President, Chief Executive Officer & Director, Logitech International SA

Thank you, now.

Operator: This concludes today's conference call. You may now disconnect.

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