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Stride, Inc. (LRN)

Q2 2022 Earnings Call

CORPORATE PARTICIPANTS

Tim Casey

Vice President-Investor Relations, Stride, Inc.

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

Timothy J. Medina

Chief Financial Officer, Stride, Inc.

OTHER PARTICIPANTS

Jeffrey M. Silber

Analyst, BMO Capital Markets Corp.

Stephen Sheldon

Analyst, William Blair & Co. LLC

Thomas A. Singlehurst

Analyst, Citigroup Global Markets Ltd.

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to Stride, Inc.'s Second Quarter Fiscal 2022 Earnings 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.

Tim Casey, Vice President of Investor Relations, you may begin your conference.

Tim Casey

Vice President-Investor Relations, Stride, Inc.

Thank you and good afternoon. Welcome to Stride's second quarter earnings call for fiscal year 2022. With me on today's call are James Rhyu, Chief Executive Officer; and Tim Medina, Chief Financial Officer. As a reminder, today's conference call and webcast are accompanied by a presentation that can be found on the Stride Investor Relations website.

Please be advised that today's discussion of our financial results may include certain non-GAAP financial measures. A reconciliation of these measures is provided in the earnings release issued this afternoon and can also be found on the Investors section of our website. In addition to historical information, this call may also involve forward-looking statements. The company's actual results could differ materially from any forward-looking statements due to several important factors as described in the company's latest SEC filings. These statements are made on the basis of our views and assumptions regarding future events and business performance at the time we make them and the company assumes no obligation to update any forward-looking statements made during this call.

Following our prepared remarks, we'll answer any questions you may have. I will now turn the call over to James. James?

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

Thank you and good afternoon, everyone. As I enter my second year as CEO, I wanted to reflect on this past year and provide some insight into what I see for our future. Environmentally, here are some observations.

Unfortunately, the COVID pandemic continues to wreak havoc even as vaccines have become widely available and there continues to be significant disruptions and uncertainty to K-12 learning. American workers are quitting their jobs at record high levels, with more than 4.3 million public sector workers quitting in November 2021 alone. The national teacher shortage continues to be acute and issues within school districts across the country make getting back to normal that much more difficult. As a nation, we continue to politicize issues that should not be political and education, unfortunately, continues to be one of those areas.

And employers and employees are settling into the work-from-home trend, with estimates showing that almost one-third of all workers were remote at the end of 2021. This environment will continue to cause uncertainty across many sectors of our economy. We already see rising inflation and interest rates and continued disruption in the supply chain. I believe Stride is well-positioned in this environment to continue to thrive by providing solutions that meet the various demands of our times. People of all ages are searching out more educational choice and flexibility, and they are seeking training options to prepare them for economically sustainable careers. Meanwhile, employers are looking for well-trained workers to fill the nearly 11 million job openings in the US.

Now, last April, I said that I believe Stride would grow through the pandemic and that I believe the pandemic has created a longer term structural opportunity for us and my belief is stronger now than it has ever been. One aspect of our culture that helps us is our continued focus on outcomes. Regardless of what area or discipline, we need to ensure that our students and company are achieving the outcomes we expect.

We recently sent out a survey to our alumni to hear what they think. The results demonstrated that what we are doing can have an incredibly positive impact on their lives. 94% of those surveyed believe their online school experience was a success. 92% believe that they benefited academically from their online school experience, and 82% feel that they are on the path towards their desired career. And I believe we are just getting started.

Another area I've been focused on is innovation. More than 20 years ago, Stride was one of the first education technology companies to enable students to learn online. Now, millions of students later, we must continue to innovate to drive outcomes and reach more learners. To that end, we're continuing to develop new products that will expand our market opportunity and ensure we remain at the forefront of education technology. We are investing behind our digital-first curriculum, our career platform, enrichment programs like eSports, and our professional development platform, among other initiatives.

This fall, we should have some additional exciting news on how we are progressing. We have an amazing team with an incredible amount of experience in education and technology. And I want to ensure we are leveraging that for bigger, more mainstream opportunities.

We published our first ESG report in June, outlining the four cornerstones of our approach: expanding lifelong learning options; supporting racial and socioeconomic equity and inclusion; fostering transparent leadership, governance and professional development; and contributing to a more sustainable world. We've done some great work already in these areas and are going to continue our focus. I encourage all our investors to read the report and a supplemental update we published in November. And looking forward, we anticipate publishing yearly updates on the great progress we will be making.

It's also been just over a year since we acquired MedCerts and Tech Elevator. Tech Elevator is growing at over 30% and continues to be on pace to hit both its financial and strategic goals. Similarly, MedCerts' revenue has grown over 50%, and is far exceeding our business case assumptions.

Strategically, we have been able to leverage these businesses to grow our overall career initiatives. This year, we introduced to much success a pilot enabling high school students to take MedCerts' certificate programs. These businesses are run by innovative leaders and remain well-positioned in their respective markets to continue to grow and the macro environment remains very positive for continued demand for software development and Allied Healthcare training.

In November 2020, we outlined our five-year financial targets which we continue to believe we are well on pace to achieve. Underlying all these assumptions is our strong belief that the COVID pandemic has structurally changed the demand for Stride's offerings. We continue to see positive demand characteristics across our offerings. Over the past several months since our [ph] count date (07:16), applications to our managed programs have trended up almost 30% from last year and today, we sit at enrollment levels higher year-over-year across our managed programs after starting the year down 3%.

Many have predicted since the inception of the pandemic that the increased demand for our programs would be temporary. Well, after almost two years and demand remaining strong, I'm not convinced the opposite isn't true, and that demand will continue to swell. The pandemic also demonstrated that the US needs to be more open to educational options for families and we're now having conversations with states and school districts that even two years ago would not have been possible. So with increased demand from families and a more receptive educational system, both of which we believe put us on a trajectory to achieve our fiscal 2025 targets.

In our General Education business, we were targeting fiscal year 2025 revenue of \$1.25 billion to \$1.4 billion. A few themes will drive this growth. First and foremost, overall demand characteristics that I just mentioned. While we used to believe the penetration curve for our programs flattened out around 2% to 3% of the student population, there's growing evidence that we have hit an inflection point up the S- curve and penetration may begin to climb to upwards of 10% to 15%.

Second, increasing the number of programs in states that offer our Stride-powered solutions. While our recent focus has been on growing Career Learning programs in states, the pandemic and resulting demand for educational options has led many schools in states to be more open to full-time virtual programs. In fact, we know today that there – we will be opening a program in at least three new states this fall.

And third, the economic and political landscape for the pandemic has produced recognizes the need for our programs. One easy macro trend we know is putting the wind at our backs is the work-from-home trend. The ability for families to logistically manage virtual learning for their children because they're at home creates significant long-term upside for our business.

In our Career Learning business, many of these same characteristics will allow us to achieve \$650 million to \$800 million in revenue by fiscal 2025. This is a market that is still in its early stages, and we believe there is significant growth ahead. We continue to hone our messaging to ensure that parents and students understand the value proposition of our career programs so we can tap into the incremental audience for Career Learning.

We also have our Adult Learning businesses, which we anticipate will reach at least \$140 million to \$150 million in revenue by fiscal 2025. These businesses are well-positioned to train the workforce of today and tomorrow while helping current workers get the training they need to achieve their career goals. These two businesses should

drive our ability to achieve close to \$2 billion-plus in revenue and to \$250 million to \$350 million in adjusted operating income within the next four years.

And we believe there's potential upside to that with a new product revenue that is not in these goals. As I mentioned earlier, this is an area where I think we can innovate and make some serious inroads. We have an incredible core of assets from which we can launch innovative and mainstream products. One easy example, in March of this year, we will be introducing our professional development to a broader audience through an inaugural Stride Promising Practices conference that will be open to everyone. The theme for the conference is career readiness education. It will be held virtually and will be free for all teachers, administrators, counselors, and families. Our professional development experts will share best practices and teacher effectiveness, student socialization, leadership, and special programs. We'll also have an exhibitor hall that will feature our education partners and we will share demonstrations of Stride's platform and content. We hope that this conference can help improve the education of students across the country.

And finally, as we turn the calendar to 2022, I am grateful for the dedicated teachers and employees who remain focused on students in the midst of many distractions. Thank you all for what you do. I hope everyone remains safe and thank you for the time today.

Now, I'll pass the call over to Tim. Tim?

Timothy J. Medina

Chief Financial Officer, Stride, Inc.

Thank you, James, and good afternoon, everyone. First, let me recap our reported results. Revenue for the quarter was \$409.5 million, an increase of 9% from the same period last year. Adjusted operating income was \$60.7 million, up \$10.6 million or 21% from last year's second quarter and capital expenditures were \$14.2 million, an increase of \$3.4 million over last year.

We exceeded the revenue and profitability guidance we provided last quarter. We continue to see strong demand for our General Education and Career Learning programs. We believe this demonstrates that families value our virtual programs and are choosing us even when other options are available. And as I will outline later, we are increasing our revenue and profitability guidance because of this strong demand.

Returning to our results for the second quarter in more detail, revenue from our General Education business was down just slightly to \$313.2 million. This is due primarily to the expected decline in enrollments, offset by an increase in revenue per enrollment.

General Ed enrollments were 145,600, down from last year's COVID-impacted results of more than 161,000 enrollments. Revenue per enrollment in General Ed increased 11% from the second quarter last year. We continue to see favorable funding and for the full-year, we expect to see revenue per enrollment that is substantially higher than our fiscal 2021 results.

Career Learning revenue was \$96.3 million, up 55% from the second quarter of last year. This was driven by growth in Stride Career Prep enrollments and growth in our Adult Learning business. Middle and high school Career Learning revenue was \$75.3 million, up 47% from last year. This was driven by a 38% increase in enrollments and a 7% increase in revenue per enrollment. Like our General Education business, we expect our revenue per enrollment in our Stride Career Prep programs to improve significantly over last year.

Adult Learning revenue was \$21 million. We acquired MedCerts and Tech Elevator mid-second quarter last year so our results next quarter should give a better year-over-year comparison for organic growth. Gross margins for the quarter were 36%, an increase of 160 basis points compared to last year. As we said last quarter, we've returned to a more seasonal pattern for our cost of revenue.

Selling, general and administrative expenses were \$90.6 million, essentially flat from the prior year period. We expect that SG&A expense for the year will be in line with last year as we've continued to focus on efficiencies and automation in our business.

Stock-based compensation was \$0.6 million for the quarter. This was well below our expectations, and we now expect that we will finish the year with stock-based compensation in the range of \$20 million to \$22 million.

Adjusted operating income for the quarter was \$60.7 million, above the top end of our guidance from last quarter. Adjusted EBITDA was \$82.7 million. As expected, we're beginning to see increases in our profitability in line with the return to a more normal seasonal pattern of expenses than we had in last fiscal year's quarterly trends.

Our effective tax rate for the quarter was 28%. We now think that we will finish the year with a tax rate in the 27% to 30% range. Capital expenditures in the quarter totaled \$14.2 million, up \$3.4 million from the second quarter last year. We continue to invest in new products which we believe will expand our addressable market, allow us to become a more mainstream, consumer-focused company and generate higher margins.

Free cash flow was \$105.7 million, up from \$23.8 million last year. This increase is tied to revenue growth and the timing of our receipts. We expect to see positive cash flow for the rest of the fiscal year. We finished the quarter with cash and cash equivalents of \$257 million.

Now, turning to our guidance, for the third quarter of fiscal year 2022, we are guiding to revenue in the range of \$405 million to \$415 million, adjusted operating income between \$60 million and \$65 million, and capital expenditures between \$15 million and \$18 million.

For the full year, we are raising revenue and profitability guidance. We expect revenue in the range of \$1.62 billion to \$1.64 billion, up from \$1.56 billion to \$1.60 billion previously; adjusted operating income between \$175 million and \$185 million, up from \$165 million to \$180 million previously; capital expenditures between \$65 million and 75 million; and an effective tax rate between 27% and 30%.

Thank you for your time today. I'll turn the call back to the operator. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And your first question comes from Jeff Silber with BMO Capital Markets. Your line is open.

Jeffrey M. Silber

Analyst, BMO Capital Markets Corp.

Q

Thank you so much. You kind of opened up talking about next year when you talked about the potential three new states for Gen Ed, so let me focus on that. I know it's probably too early for any enrollment indicators, but if you can give us a little bit more color on those three new states, if you're willing to give us enrollment indicators, that'll be great. And then also, I'm just wondering what you're thinking for the funding environment for next year. Thanks.

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

A

Yeah. Thanks for the question, Jeff. I think – so, we've got three – I think we've got at least three new states, for sure: Georgia, which is sort of in the public domain already; New Hampshire, I think which is also in the public domain; and West Virginia, also in the public domain also, I think, set up for the fall.

I think the enrollment – we know for sure, long-term, Georgia has incredible enrollment demand. In the short-term, our arrangement there will be under a cap so we will not be able to meet all the demand in that state. But I think long-term, it presents a tremendous opportunity for us. The other states obviously are a little bit smaller, but I think they're states that we've worked hard to get and are really good, important states for us. And I think they represent also just an increase in the openness of states that previously may not have been open to us to really have meaningful conversations. And I think the road map [ph] past that (19:59) into the years past that also look good. So I think without giving specific numbers, but I think that just the trajectory looks pretty strong and the ability for us to continue to open new states in the coming years looks pretty good.

Jeffrey M. Silber

Analyst, BMO Capital Markets Corp.

Q

That's great and I'm sorry. Did you address the general funding environment for next year?

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

A

Oh, I'm sorry, Jeff.

Jeffrey M. Silber

Analyst, BMO Capital Markets Corp.

Q

No worries.

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

A

The general funding environment continues to be, I think, strong. We don't see at the state level a lot of headwinds. I think you'll see – you'll continue to see tailwinds around funding, I think.

The thing that I would – not even a caution. You'll see tailwinds but there is – I think there's pockets in the education sector in grades K-12 where districts are really sort of awash in money and that's flowing to some of our education maybe peers. That sort of flood of money that's gone from the federal government down, that probably is not going to give us a huge lift next year in funding, but I think the general environment remains very strong.

Jeffrey M. Silber

Analyst, BMO Capital Markets Corp.

Okay. Great. And I think last quarter, you talked about some issues in terms of finding teachers. I'm just wondering if we can get an update on that, how that's going and what you see going into next year. Thanks.

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

Yeah. So the national teacher shortage remains an issue across the country. It's not just us. We see this across the entire landscape of the US. It is – I think this year, we found – so I'd say an equilibrium now in here now that we're in January, I think we work hard all year-round to get teachers. I think we've got a good process now or approach now to accelerate hiring going into next fall so that hopefully we will actually get ahead of it more than we did this past year.

So I think we won't experience the type of restriction that the shortage imposed upon us this year next year. So I think that will be alleviated somewhat, but I do think the shortage will continue into next year. We see a lot of teachers that are actually leaving the profession altogether. We see that, I think, less so in our programs because I think there's less controversy surrounding sort of the teacher environment within programs like ours. But certainly across the nation, we see actually teachers leaving the profession altogether.

I think the long-term macro trend, though, for teachers works in our favor because the landscape of educators are going into the profession are – they're more now in tune with and skewing more towards digital – being digital natives and being, I think, more aligned with online education. That works in our favor. I think as teachers in school districts [indiscernible] (22:48) school districts increasingly become, I think, disenchanted with their school districts. That also gives us opportunity.

Our teacher satisfaction remains very high so I don't think it works the other way around. So I think the general trend for our teacher shortage as a nation remains intact. But I think the trends for us specifically will improve here going into next year.

Jeffrey M. Silber

Analyst, BMO Capital Markets Corp.

Okay. That's great to hear. I'll jump back in the queue. Thanks so much.

Operator: Your next question comes from Stephen Sheldon with William Blair. Your line is open.

Stephen Sheldon

Analyst, William Blair & Co. LLC

Hey. Thanks for taking my questions. On the – the enrollment numbers here look really, really solid so would love to just get some more color on what you saw, especially in the last few weeks in terms of retention rates for the start of the new semester and whether you saw any notable benefit from new students maybe signing up for the

first time this semester. So maybe just high level commentary on retention rates and new enrollment trends for the second half of this fiscal year.

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

A

Yeah. So retention rates, we saw last year, I think unexpectedly to a lot of us, retention rates that were better than prior years, and I think there was an assumption last year that retention would actually get worse once schools, brick-and-mortar schools, reopen and kids would go back – kids would leave our programs and go there. And we've seen this year that our retention rates remain improved against pre-pandemic levels, similar to last year. So they're not – there's not another step function change improvement from last year, but they remain improved to pre-pandemic levels. So I think retention is a good news story for us and continues into this year to be a strong story for us.

I think for new enrollments, the trend that we're seeing, and it's – I mentioned a little bit in my comments, but since we announced our [ph] count date (24:53) back in October, enrollment for – enrollment demand for our programs is up. Actually, this morning, I was looking. It's up. It's actually a little north of 30%. The applications are up a little north of 30% and it just remains very strong.

We continue to see strength in the demand side of this equation. We see customers really looking for alternatives, and I think they see that we're a very viable alternative, in many cases. And as we stand today here on January 25, actually year-over-year, our enrollments now have surpassed last year.

So again, just from all fronts, we see the demand side of the equation continuing to improve.

Now, the reported numbers you see are obviously from last quarter and are blended across the quarter. And we started out the year down 3% so the reported numbers look different. But as we stand here today, year-over-year, we have surpassed last year's numbers. So, I think the new enrollment trends and the retention trends, they continue to remain strong. The demand side of the equation continues to remain robust. We see no abating of that, at least as far as we can see from the data we see for our product and services.

Stephen Sheldon

Analyst, William Blair & Co. LLC

Q

Got it. That's great to hear and really helpful. And then I guess as a follow-up, I know it's a small business, but what can you share about what you're seeing in the institutional business? How has that been performing relative to your expectations and how are you thinking about the growth potential there as we think about the next few years?

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

A

So I think the institutional business over the next few years is really going to surprise a lot of people on the upside. We struggle with that business. We had fits and starts. We've had issues around our sales teams and things like that. I think now, we see that with – I think we have the smallest sales team we've had pretty much in the history of this company and we see order of magnitude, the largest pipeline we've ever built.

So I think the demand side of this equation is strong, and I think you're going to see that our offerings in the market are just going to get stronger. We're going to put some new products into the market in the fall over the

next couple years. That's going to be to really capture some digital trends in education in K-12 and I think we're really going to make some inroads on our institutional business. I think it's going to be a winner for us long-term.

Stephen Sheldon

Analyst, William Blair & Co. LLC

Great to hear. Thanks for taking my questions.

Q

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

Yeah.

A

Operator: [Operator Instructions] And your next question comes from Tom Singlehurst with Citi. Please go ahead.

Thomas A. Singlehurst

Analyst, Citigroup Global Markets Ltd.

Yes. Good evening. It's Tom here from Citi. Thanks for taking the question and congrats on the results. A couple of, I suppose, sort of [indiscernible] (27:56) questions. First one, revenue per enrollment, I just wanted to understand and this is just portraying a slight lack of knowledge on my part but just understand whether there's a sort of seasonality to those figures. And can you go over again what your expectations are for the full year? I missed that in Tim's commentary, so that would be the first question.

Q

And the second one, I'm interested, once again, this is a point on disclosure. I think you mentioned that's still a bit of a sort of an M&A sort of anniversary impact on the growth rate for the pure Adult Learning revenue. Can you just give us the pure underlying revenue growth? I know you mentioned the impact of M&A, but just whether there's a proper underlying number that we could focus on. That would be a great [ph] two (28:47) questions to start off with, if that's okay.

Timothy J. Medina

Chief Financial Officer, Stride, Inc.

Great. Sure, Tom. Well, I'll start with the second question. This is Tim Medina. What we said in our prior call that I would still repeat here that we expect the Adult Learning business overall to approach \$100 million for the year. We would still say that, and so rather than giving you a year-over-year comp, I would just say that if you take that into account, that that would suggest the Q3 and the Q4, that's going to have very strong, completely organic growth year-over-year.

A

On the first question on the revenue per enrollment, what we also have said is that we expect revenue per enrollment this year to not just be higher than FY 2021, but actually go all the way back to FY 2021, in fact, surpass FY 2020 levels, so to surpass the pre-pandemic levels that we saw in FY 2020, Tom. So, we will continue to say that, that we expect a full rebound back to even above FY 2020 for both Career Kearning and General enrollment.

No particular seasonality, the way our numbers come in really. We may have some – when we do have any adjustments in our estimates, Tom, there is sort of a year-to-date effect. Sometimes, that'll cause some quarter-to-quarter anomalies, but there really is no particular seasonality that I would highlight at this time.

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

A

One thing I would add is our most recent acquisitions, Tech Elevator and MedCerts, I think as Tim mentioned, they continue to perform very well against our acquisition plan. They're both organically growing north of 25% year-over-year. So I mean it's very strong growth. We've got great leaders in those businesses. They're doing a fantastic job about continuing to grow those businesses, finding opportunities to expand and they've been tremendous strategic assets as leaders across Stride. And so we continue to be very, very bullish on those acquisitions and we think they're going to just pay off our shareholders in spades.

Thomas A. Singlehurst

Analyst, Citigroup Global Markets Ltd.

Q

Perfect and that leads on to the next question, which is on – well, actually going to be two questions on cash flow. But I'll start with the second part of that which is given you mentioned M&A, then I'm surprised you guys haven't done more transactions of a bolt-on nature. I mean I'm just interested in whether that's just where it is and the pipeline [ph] going to lead (31:20) forward. Is that sort of delayed since the last deal? Is that a sort of conscious delay that is there for a reason?

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

A

Yeah. So I think...

Thomas A. Singlehurst

Analyst, Citigroup Global Markets Ltd.

Q

M&A is [ph] more likely to come through (31:32).

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

A

Yeah.

Thomas A. Singlehurst

Analyst, Citigroup Global Markets Ltd.

Q

Yeah. Sorry [indiscernible] (31:34).

James Jeaho Rhyu

Chief Executive Officer & Director, Stride, Inc.

A

No, no. I think there's no delay. We have a very active pipeline of deals that we look at. I think valuations within our sector, in the public markets, they've really trended down. In the private markets where a lot of the deals that we would look at, I don't think they've trended down as much. I mean, in fact, I think there's a recent deal in sort of a public company in the education space, Adtalem, they announced recently a deal to sell a piece of their business. That, I think, was sort of indicative of some of the private market valuations that you'll still see.

And I think we want to be responsible deployers of our capital and when we do, we want to do it at valuations that we feel like warrant that deployment of capital. And so while there are some strategically interesting assets in the space right now, particularly on the career side that we might otherwise think about, I think we'll only do it when the valuation equation makes right for us and our shareholders, and we just haven't found that equation.

MedCerts and Tech Elevator, I think that equation made a lot of sense. We got strategic value out of it. We got great leadership out of it. They continue to perform well and if we can find more deals like that, we'll continue to pursue them.

Thomas A. Singlehurst

Analyst, Citigroup Global Markets Ltd.

Q

Very clear. One very final one for Tim on working capital, I mean obviously in the first quarter, relatively big working capital outflows, I think, is normal. Should we expect a fairly big working capital inflow across the balance of the year?

Timothy J. Medina

Chief Financial Officer, Stride, Inc.

A

Yes, that is correct. We expect to have strong free cash flow in Q3 and Q4 driven by good inflows of working capital.

Thomas A. Singlehurst

Analyst, Citigroup Global Markets Ltd.

Q

[indiscernible] (33:19). Thanks very much.

Operator: [Operator Instructions] There are no further questions at this time. This concludes today's conference call and thank you for your participation. You may now disconnect.

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