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SPM.MI - Saipem SpA New 2013 Guidance Driven by Escalating Commercial Difficulties in Algeria Conference Call

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PRESENTATION

Umberto Vergine - *Saipem - CEO*

Good evening, ladies and gentlemen. I am here with Stefano Goberti and Giuseppe Caselli, our CFO and our CO of the new E&C business unit. This is clearly an announcement no management team wants to have to make. But we find ourselves in different circumstances to those prevailing when we changed the 2013 guidance back in January. You will have read the announcement and I will go over its main point before taking your questions.

The change in 2013 guidance results from a series of unconnected factors that have occurred and emerged over the past month and a half and which have had such a major impact on our results for the year. We have obviously disclosed these at the earliest moment possible and the evaluation of the issues and discussions with the client remain ongoing.

The first and biggest factor behind this announcement is the dramatic deterioration in our relationship with Sonatrach. At our Q1 results on April 23, I spoke extensively about the problems we were already facing in Algeria. Just to remind you what I said at the time was that our discussions with Sonatrach were becoming more difficult and that we believed that this was related to the escalating intensity of the investigation in Algeria.

I warned that it was possible that the discussions would not continue in a constructive manner, although I hoped, based on the longevity of our relationship with Sonatrach that our core request could still be achieved. Since that Q1 result presentation, we have been trying hard to engage with Sonatrach to maintain a constructive dialogue but these efforts have proven to be fruitless.

In recent weeks the Algerian authority's investigation has broadened in scope and intensity and the commercial effects of this have been felt immediately. Sonatrach has effectively stopped any constructive dialogue which leaves us with significant costs on projects completed or near to completion. On top of which we have been served with a claim for liquidated damages. We have no choice but to take a charge for this and carry on doing everything in our power to do the best possible job for the client on the work outstanding, and ultimately in time work to repair our relationship.

I will add that as of today we have no knowledge or evidence of any wrongdoings by Saipem in the case under investigation, and of course we continue to cooperate in any way we can with the authorities carrying out the investigation, both in Algeria and Italy.



The second factor in today's announcement is the escalation of operational issues present in two contracts in Mexico and Canada. In the past month, the vastly greater consequences of these has come to light upon new management taking over, as part of the introduction of the new operating structure in April.

Mexico and Canada are part of one organizational unit under a single manager who has now left us. A series of inadequate assessments and the lack of corrective action consequently accumulated. These have come to light and the price is a high one. Our difficulties in Mexico have coincided with wholesale management change on the client board and understandably the new team there do not look kindly on our performances.

This kind of shortcoming is unacceptable in any organization and especially in one that prides itself in its technical and operational ability and excellence; it is a rude awakening. On both projects we are now working with the clients to re-scope the subcontractor works and to get the job done properly with more direct involvement of Saipem also in the activity on site.

The third element has been engineering and technical problems in two contracts within the offshore E&C business and these have landed at the same moment. We have found a technical solution to the challenges but the amounts we will be able to recover against the suppliers who delivered to us incorrectly built parts are dwarfed by the losses we have incurred on the overall delays to the contracts and the extra work required.

As a Board we are highly conscious of the pain this has imposed on our shareholders. The problems in Algeria and offshore have been recent real-time occurrences. In Mexico and Canada, quantification of the problems has been possible only in the last few weeks, as we have engaged with clients to solve developing problems.

We have taken a very close look at the other contracts in particular in this region and we can say that there are no major causes of concern. I remain totally focused on the clean-up of major legacy issues which have proved to be of greater magnitude than I envisaged when I became CEO seven months ago. We have to manage the business much more tightly and prevent any recurrence of these shortcomings.

However, in overall terms, I am confident in Saipem's future and the strength of its business model, because firstly the drilling business continues to perform strongly in line with our expectations. In addition, the new way of running the organization with 30 changes in management position is starting to have a positive impact. This is true in terms of accountability and from a commercial point of view.

In terms of accountability, while we are disappointed with the impacts we have announced today we are comfortable with the process by which they have been assessed. From a commercial point of view we are winning contracts for 2014 and beyond on terms that are commercially sensible and if the quality and quantity of the order intake in the second half of the year will continue to reflect the trend achieved year to date ensuring a return to the historical Saipem margins we will restore value to the shareholders. Saipem remains a first-level player with a worldwide activity.

I want to emphasize that 2013, however unwelcome, represents a huge trough in profit and performances of a business that is fundamentally robust, and that has attractive opportunities before it.

Thank you and we are now available to take your questions.

QUESTIONS AND ANSWERS

Operator

Thank you, sir. (Operator Instructions). We'll now take our first question from Jaideep Pandya with Berenberg. Please go ahead.



Jaideep Pandya - *Berenberg - Analyst*

Yes, thank you. A couple of questions. First, could you give us some sense of what was the underlying margin in the two contracts in Mexico and Canada which you are booking the loss for, to start with? And also, if you can tell us what contracts and what revenues are we talking about for the two contracts?

And then the second question is referring to your statement on the new contracts that you have won this year. How should we think about -- what is the change in approach that you can highlight to -- which you have taken for, for the new contracts that you have won compared to the old way Saipem was sort of bidding and executing the contracts? Thank you.

Umberto Vergine - *Saipem - CEO*

Thank you. Well, I cannot give you the information on the specific contracts that you are asking, both in terms of margin and also mentioning exactly the contracts and the terms of these contracts, for the right of reason not least the fact that we are still negotiating with the client in respect to the possible best recovery of the situation.

For what relates to your second question, as I indicated in the previous communication, we are applying a much stricter commercial discipline on the selection of our tender and on the desire of revenue compared to margins. Margins is our priority and we are ready to leave contracts behind if they don't fit in our risk management system that indicates to us where the level of margin should not go any lower.

Jaideep Pandya - *Berenberg - Analyst*

Okay, thanks.

Operator

We'll now move to our next question which comes from David Phillips with HSBC. Please go ahead, sir.

David Phillips - *HSBC - Analyst*

Thanks, afternoon, everyone. Of course I'm sure like everyone we're not particularly impressed with the timing or content of this, but we do have some questions. There are a few things here really. Firstly, can you just give us a bit more information about your confidence about the recovery in 2014, in particular we all know this is the in-between year, but can you give us some form of guidance as to where you think you'll get to in 2014 given what you've won so far this year and in terms -- and also what you think you might win in the second half? That's the first question or first theme.

The second one, after all this change, what else changes in terms of your net debt and working capital outlook for your performance over 2013?

And the very last one, backlog. As you become more selective what sort of growth or lack of growth do you expect to see by the end of this year? Thank you.

Umberto Vergine - *Saipem - CEO*

Okay, thank you, David, but first of all I apologize for the timing. I think that I need to give an explanation to everybody, besides the fact that the urgency of having everything organized for the communication was the main driver during this week and today was the day that we have been able to meet with our Board. The discussion with the Board, as you can imagine, has taken much longer than expected, that's why we end up at this very unusual time and again I do apologize for that.



About the term of confidence for 2014, I think that besides the fact that the guidance is normally provided much later on the next year, I can reaffirm that the order intake that we have so far is -- I expect to be supplemented during the second half of the year by similar good value contracts that we are discussing or monitoring in the conclusion of their tenders.

And we have a portfolio of offers presented to clients that if, in terms of success and in terms of timing, materialize as we expect will create the required level to get not only the margin that we want, because that's what we are working on, but also the necessary work to provide a level of revenue sufficient to drive the company into a scenario, into a region that in a matter of maybe two years will look much more similar to what Saipem were used to provide.

On -- in terms of talking about the net debt I will ask Stefano to give you some explanation.

Stefano Goberti - *Saipem - CFO*

Yes, David, the projection at the moment of course is preliminary because we didn't run the full exercise of the repercussions. But what we are estimating now for the net debt at year-end is something in the region of EUR4.9b, EUR5.1b.

And regarding your question on the backlog, as usual we will be more precise when we produce the numbers for the second quarter 2013, at the end of July this year.

David Phillips - *HSBC - Analyst*

Okay, and just one quick follow-up, you obviously talked about picking up problems in Mexico and so on as you look through the backlog. Have you been through your entire backlog to the same extent, and that you're confident that these issues you've found are really the main issues that exist and the rest of the backlog is in line with what you said to us in the last few months?

Umberto Vergine - *Saipem - CEO*

Yes, we have done a thorough review of all our contracts following the implementation of the new organization and with the new managers and the new local managing director in the different countries. We have in comparison to what was done in January, we had extensive review also with our clients [determine] better direct measures on how the situation of the contract is. And we have, I believe, give also to the client of the contract where certain difficulties were present, the confidence on our ability to recover the situation. And in fact we have agreed with them a recovery plan like in Canada and in Mexico or in other contracts where extra efforts were required.

David Phillips - *HSBC - Analyst*

Okay, thank you.

Umberto Vergine - *Saipem - CEO*

Thank you.

Operator

Our next question will come from Mick Pickup with Barclays. Please go ahead.



Mick Pickup - Barclays - Analyst

Good evening, gents. It's Mick here. Just two quick ones for me, just on the liquidated damage, is that the total amount of liquidated damages you could get in maximum in Algeria? Or is that your estimation of what you might be liable to? So is that 100% of the likely liquidated damages?

And secondly, you mentioned briefly the corruption charges and you said you still found no evidence of anything there. Have you still been unable to speak to anybody who's been involved in that? So that's just your view that there's nothing wrong?

Umberto Vergine - Saipem - CEO

On the liquidated damages what we are considering in projecting our result of the year is what we estimate that we could be liable of. In the sense that we are considering the netting of what we believe that in a way or another we will be able to recover from the client, even though today there is disclosure to continue the commercial discussion that we had before.

On your second question, if you don't mind to repeat it, it was in relation to?

Mick Pickup - Barclays - Analyst

Just on the corruption, the illegal practices; when you said you still found no evidence, is that just a status quo from where we were at 1Q in that you said you've not been allowed to speak to anybody involved, this is just your view.

Umberto Vergine - Saipem - CEO

Okay, yes, it's again only our view in the sense that this is the result of the deep analysis that we are continuing to carry out. So compared to the Q1 this is the result of much more work that has been done in our internal assessment, in the different ways that we are coming out of this assessment. So it is not to the status quo of three months ago, but having done much more in-depth analysis, this is where we remain in terms of what we have found.

Mick Pickup - Barclays - Analyst

Okay, and just sorry, just going back to that first question, on the liquidated damages, could you give us an idea of what the maximum is if you get no recovery from Sonatrach?

Umberto Vergine - Saipem - CEO

No, I can't give you any other number, because besides the fact that what we are assessing today is the status quo on a project that is not yet fully completed, but for which we are actively working to close in a reasonable number of months. The estimation is our complete assessment. The terms of the liquidated damages is exactly what -- if I put it in this way, this is the amount of money that we will try to recover commercially that we know that the closure of the commercial relationship we don't have ground for recovery in other ways.

Mick Pickup - Barclays - Analyst

Okay, okay, thank you very much. A difficult night, but very clear, thank you.

Umberto Vergine - Saipem - CEO

Thank you very much.



Operator

We'll now take a question from Andrew Dobbing with JP Morgan. Please go ahead.

Andrew Dobbing - *JP Morgan - Analyst*

Yes, good evening, a couple of questions. Can you clarify in the guidance downgrade in Algeria, is that being driven by cost overruns or is it being driven by the fact you don't think you're going to be able to recuperate some of the cash you're owed by Sonatrach?

And the second question is, you talk about your -- or the strength of Saipem's business model. I guess one of the strengths historically, at least in some markets, has been the fact that you don't have to rely on subcontractors, because you've got quite a horizontally-integrated business model and you've got your own yard, etc, etc. Obviously that hasn't been the case in Mexico; you've come a little bit unstuck because of problems with subcontractors.

Is this whole episode going to change the way you do business? Is this going to make you become much more cautious about doing -- relying on subcontractors and hence perhaps concentrate your business in those markets where you do have the benefit of having -- the benefit of this horizontally-integrated business model where you can do everything yourself? Thank you.

Umberto Vergine - *Saipem - CEO*

Thank you. Referring to Algeria, very simply no, we are not talking about payment we are talking about costs incurred in relation to delays and extra work done. So this has to do with what we were discussing with Sonatrach that relates to delays in the completion of the project for a variety of reasons that we believe gave us a lot of commercial ground for discussion, including and not last the evolution in the country during the last year's spring. And is not in relation to what I presented as a more complicated system of getting our current work paid.

About the business model and your comment on the use of subcontractors, you are correct to point that out, because this is typically the case that we'd identified as a weakness in the strategy, that the area manager followed in managing this contract at the tar for Canada in a relatively new area, where to be so depending on our subcontractors and demanding all the responsibility has proved to be a very wrong decision.

Today, we are not thinking about leaving these countries; we're thinking about doing what we normally do and what we're doing today. We have put a lot of Saipem direct people in the business to retake control of the situation.

In Mexico the problem was also linked to a selection of a contractor that was not of the right size, it was not strong enough for the type of business that was given to him. And today we are again taking control of our operation there. This is what is in our golden rules. This was a risk that was wrongly taken at the time of contract signature. So as I said we are not putting any more commercial in front of engineering and construction and I believe that this will rectify the situation rapidly, also in Mexico and in Canada.

Andrew Dobbing - *JP Morgan - Analyst*

Okay, I think that's quite clear. Thanks very much.

Umberto Vergine - *Saipem - CEO*

Thank you.

Operator

We'll now take our next question from Marco Baccaglio with Kepler Cheuvreux. Please go ahead.

Marco Baccaglio - Kepler Cheuvreux - Analyst

Yes, (technical difficulty), two questions from me. The first one is about 2014 and this -- not asking about the guidance but the question is, these issues with these contracts are likely to imply that your 2014 performance will be any different from what you could have expected before? So are there orders which will be let's say of low profitability or loss making which will impact also in 2014?

And the second question is about Algeria, you have put some capital employed in the region and now it feels that your relation with the local company is quite difficult. Are you thinking about changing your strategy in the country? Are you going to, let's say, to exit or to leave the capital employed there? What is your view about the future of the Company beyond this problem in Algeria?

Umberto Vergine - Saipem - CEO

Okay, thank you for the question. About 2014 there is no doubt that the fact that some of this contract will last longer than expected before, their duration throughout 2014 will be somehow longer, and therefore adding a different weight on the year, also considering the fact that with this present loss the low marginality will be impacting the average marginality of the existing contract throughout 2014. We have not yet exactly quantified the impact of that. We don't expect to be significant, but there will be an impact.

For what relates Algeria, in Algeria we have -- the most valuable assets that we have there are the six drilling rigs that are currently operating in the country. And we are, as anticipated, in a previous conversation, they are going to be relocated to other clients in other contracts. So we don't see any risk about that.

Of course, this -- the issue about our other assets, like the operating base and the offices and some of the equipment -- the fixed equipment that we have there will be partially impacted if this hold up with Sonatrach will be lasting a long time. Anyway this is not something very material and we believe that as we have seen in the past as we finish the project, the past five have been recently completed; we demobilize people and equipment without any problem.

We are anyway continuing to try to maintain the best possible relation with Sonatrach, because we don't want to escalate any negative situations, particularly while we still have business and people in the country and activities still ongoing.

Operator

We'll now take our next question, a follow-up question from Jaideep Pandya from Berenberg. Please go ahead.

Jaideep Pandya - Berenberg - Analyst

Yes, it's sort of a follow-up to the previous question actually. Could you tell us, if on schedule when were the Mexican and the Canadian contracts supposed to have finished? Was it 2013, 2014? That's the first question.

And the second question really is a little bit more fundamental, which is, you obviously have changed the way you bid and you think about contracts, and you are going for margin. At the same time you are having some operational issues. Is it having impact on your reputation and putting you in a weaker position in terms of bargaining compared to your previous positions with oil companies? And, if so, why are you so confident that the future contracts that you will win would be better margin contracts? Thank you.



Umberto Vergine - *Saipem - CEO*

Okay, about the timing of this contract, for what relates Canada, we are expecting completion of the facilities towards the middle of 2014. There are certain gaps in between the two units and this is the timing that we have recently agreed with our clients. In the case of Mexico we expect also to have the work completed by the end of 2014, maximum beginning of 2015.

We are having -- in general we continue to have very positive discussion with the oil companies which are our clients, both in the preparation of submission of offers, both in review of offers that we have already submitted, and also through formal and informal meetings where we discuss the business opportunity and the scenario for the business. So I don't -- I'm not really recording any change or any new criticalities that we will have to manage from our commercial strategy. I hope that this was the sense of your question.

Jaideep Pandya - *Berenberg - Analyst*

Yes, I'm just trying to gather, so is this basically mispricing and lack of assessing risk on your part that you are having operational issues on contracts that you won in 2009-10? Or was it because the competitive environment was very difficult in 2009-10 and the competitive environment's much more, let's say, easier now why you are so confident? I'm just trying to gather that whilst you're going for margin, how is it that you're still bullish on the fact that you will win business as well, given that you're having operational issues right now. So that's what I'm trying to assess. Thank you.

Umberto Vergine - *Saipem - CEO*

Okay, all right, let's be clear, the problems that we are presenting today, particularly the Mexican and the Canadian ones are related not even to two countries, but only to two contracts, one in one country, one in the other country. While if we look at the type of contracts won as you said under competitive pressure just after the explosion of the crisis in 2009, 2010 and partially 2011, yes, the difficult terms and conditions that we took at the time were the mirroring basically the commercial situation that was generally available at the time.

Today the market has a different profile. Today we are seeing tenders for contracts where we believe that we are able to extract better margin and therefore to make offers without the same type of competitive pressure that was typical of the time and that did impact not only Saipem but also other construction companies.

Today we are still invited to tender because of the quality and the specialized ability that we have in managing particularly complex and difficult contracts both onshore and offshore. And this is what we are recognized for.

Jaideep Pandya - *Berenberg - Analyst*

Thank you.

Umberto Vergine - *Saipem - CEO*

Thank you.

Operator

We'll now take our next question from Roberto Bogoni with Libra. Please go ahead.



Roberto Bogoni - *Libra Equity - Analyst*

Yes, hi, good evening to everyone. I wonder if you can clarify, given the new guidance and about EUR5b of debt which you referred to earlier, are you at risk of breaching covenants or incurring in higher financial charges in any way?

Umberto Vergine - *Saipem - CEO*

No, we are not. I ask Stefano to give you a little bit more.

Stefano Goberti - *Saipem - CFO*

Roberto, no, we are not breaching any covenants on our loan facilities taken on board. And of course simply because of the fact that we have a higher average amount of net debt, we are increasing the cost of the interest for the debt. But no, we are not paying a higher tax rate compared with before, because we still benefit of the fact that we draw a major part of our debt from the Eni Group.

Roberto Bogoni - *Libra Equity - Analyst*

I understand, okay, thank you.

Umberto Vergine - *Saipem - CEO*

Thank you.

Operator

we will now take a question from Alejandro Demichelis with BNP Paribas. Please go ahead.

Alejandro Demichelis - *Exane BNP Paribas - Analyst*

Yes, good afternoon, gentlemen, Alejandro Demichelis with Exane BNP Paribas. A couple of questions here. In terms of the assessment of your overall backlog, let's say prior to when you joined, Umberto, how many more projects do you think that you still need to assess, because what you're telling us today from the 16 contracts that you highlighted back at the beginning of the year and also at the April strategic update?

Umberto Vergine - *Saipem - CEO*

Well, we have completed our assessment. We have looked at all the issues possibly emerging after our guidance in January in the past month with the new management team. And if -- I know that today is another huge blow, but if we look at the component of that, really we have something that is really technical and operational and are the issues in relation to the two vessels, to the two ships that I've announced.

On the issue of Algeria is something that in many respects we are very sorry to see that all the efforts which we were doing on the ground to complete the contract and commercially to have the best possible commercial outcome in discussions with Sonatrach now so badly impacted we believe from the growing emphasis that in the country the investigation is taking, and therefore obliging the officer of our counterpart to become more rigid towards us.

The issue of Mexico and Canada are issues that are related to assessments that have been developed only recently on processes that were in relation to the two contracts, indicating criticalities which -- of which the assessment maybe was done too late by the previous management, or not fully



measuring their consequences. So I cannot -- I don't see the point, even though I understand the concern that this could generate, to consider this an example that could be somehow moved across all our situation of contracts ongoing.

Alejandro Demichelis - *Exane BNP Paribas - Analyst*

Okay, and then I have two follow-ups here. The first one is how can you give us confidence that the EDINA project or let's say the contract that you have been recently awarded that were actually negotiated by the previous management, you're comfortable that the execution and the pricing and the terms and conditions are the ones that will allow you to recover margins?

Umberto Vergine - *Saipem - CEO*

Well, I can give you this as a meter of comparison. Other contracts that were being -- that had been negotiated by the previous manager we took a very critical review of them, to the point to engage with the client and even risking to be kicked out from the contract because we were not any more pleased with the terms that had been negotiated. The ones that I'm signing are the ones that I'm very pleased of.

Alejandro Demichelis - *Exane BNP Paribas - Analyst*

Okay, so in terms of getting to the efficiency in the Cutter 1 vessel, when is it that you think that you're going to reach kind of full efficiency there?

Umberto Vergine - *Saipem - CEO*

Well, we have indicated that is a matter of a few weeks and I confirm that. Of course for a vessel so prestigious and so expensive when we are able to place it in the market, now to start working with a few weeks of delay will not change its life performance, but of course will have a direct impact on 2013 revenue and results. So the impact is big because the contingency that we had for the sea trials that are actually designed to do the full efficiency test before you start to work for a client, proved that some extra problems were present. And now we have the double impact, the extra money needed to fix it and the delay in being operational.

Alejandro Demichelis - *Exane BNP Paribas - Analyst*

And could you please remind us how much the Cutter 1 has cost you and it's going to cost you with the repairs and upgrades you have to do there?

Umberto Vergine - *Saipem - CEO*

Well, we are talking about the cost of building it of many hundreds of millions and the cost of very few tens of millions to fix it now. I mean, we are not talking about a major rework on the ship; is our operational costs to put a few components up to specification.

Alejandro Demichelis - *Exane BNP Paribas - Analyst*

Okay, that's great. Thank you.

Umberto Vergine - *Saipem - CEO*

Thank you.

Operator

We now move onto our next question from Jaideep Pandya with Berenberg. Please go ahead.

Jaideep Pandya - Berenberg - Analyst

Sorry to keep coming back, but can you just tell us what kind of management compensation changes have you made since the previous management team, and for the new management team, especially on the operational level please? Thanks.

Umberto Vergine - Saipem - CEO

Well, our remuneration policies are basically the same in the structure of short-term and mid-term and long-term merit reward. What we are changing is specifically in yearly objective by having identified not only the number of contracts or the volume of revenues that we are creating by taking new contracts, but we have added as a cut-off the marginality associated with the new contracts. So the commercial discipline is clearly specified in the objectives that we give to our people.

Other important element, of course, is the performance and the measuring of performance on a yearly basis on the people that are directly responsible for the execution of the project.

Jaideep Pandya - Berenberg - Analyst

Thank you.

Operator

Ladies and gentlemen, that will now conclude today's question and answer session. I would now like to hand the call back to Mr. Vergine for final remarks.

Umberto Vergine - Saipem - CEO

I thank you for the patience, considering the time of the day and the day of the week. And of course will remain available for any follow-up that you will require. Thank you very much.

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