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WithSecure Corp. (FSC1V.FI)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Laura Viitala

Director-Investor Relations, WithSecure Corp.

Right. Very good afternoon and welcome to WithSecure. My name is Laura Viitala, I'm the Investor Relations Director, and wishing you welcome to this Quarter Three 2022 Result Release. Welcome to the brave people in the room on this busy results day, and all the people online, especially our newest analyst, [ph] Erik, (00:00:33) very happy to have you all on board.

So today, we have our CEO, Juhani Hintikka, presenting the business, a couple of events from the company during the quarter. After him, our CFO, Tom Jansson, presents the numbers and the results of the quarter. And after that, at the end, we will have questions and answers. You can send questions through the webcast all the time, we will take them up in the end.

With this, I'm handing the floor to our CEO, Juhani Hintikka.

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

Thank you, Laura. Good afternoon from me as well. Growth of cloud revenue continues 33% growth year-on-year, that was the theme for our Q3. And that, of course, tells the story of steady growth. We had said 33% year-on-year growth at the level of €17.9 million. And this, of course, was specific to cloud-native corporate security products, which we report as one important growth driver for our company.

Regarding our annual revenue ARR, another important metric, we saw growth of 29%, taking us to a level of €71.7 million. So we're well on our way of becoming a growth – SaaS growth company. The Elements products are performing well, especially the EDR, Endpoint Detection and Response. You may recall that we launched this Elements portfolio into the market now already a little over a year ago, maybe a year and a half ago we started talking about it and market has received this well. And now, of course, we're very happy to see the traction with

the Endpoint Detection and Response, and clearly signaling that the market has moved towards that direction from classic endpoint protection and response alone.

And then in Managed Detection and Response and Cloud Protection for Salesforce, two of our faster growing areas within that cloud solution area, we saw growth as well during the Q3. The on-premise corporate security products, which we call the Business Suite, there we saw, as expected, a decrease. So we are seeing customers migrating to cloud native solutions. And then overall, of course, reflecting also the focus we have put on cloud native part of the portfolio.

Our cybersecurity consulting revenue on a comparable basis decreased by 6% to the level of €8.9 million in the quarter. As reported earlier, we have been busy doing recruitment activities and also building an environment where we can retain talent as this high attrition situation has been something that we and others in the business have been experiencing. And finally, we saw our profitability improving. The adjusted EBITDA was at the level of minus €4 million improving, therefore, from the first half of 2022.

A few comments about the market. So first of all, there continues to be strong demand for cybersecurity products and services overall. Now, that is partly, we believe, due to the fact that there have been highly publicized breaches and events, that tends to then drive more interest in demand towards cybersecurity companies. And then, of course, the current geopolitical situation is contributing too, partly to this demand as well. So, we think this is a relatively defensive sector.

Of course, we are not isolated from cuts in IT budget. But overall, I think increasingly companies are seeing this as something which is existential. They need to protect their company and their business in order to be in the business also tomorrow.

We have then launched a number of solutions to the market. So, our cloud collaboration suite, we see that increasing. We just recently launched the OneDrive Collaboration Protection solution into the market in the Microsoft environment. And the other factor, which has been quite prominent this year, has been the discussion around Europe based cybersecurity, so having solutions that have data residency within the European community. And for those customers, we have actually launched the Europe-only Countercept solution and Countercept being our Managed Detection and Response solution.

And then we have continued our efforts on developing an easy customer interface where you can basically, in the future, access all of our products and services. And that – this we have the next iteration we have launched into the market with some supporting material and videos.

Another thing to mention in Q3 was the employee share savings plan. So an important part of our overall employee value proposition. We have now about 25% of the company as a shareholders and of course we're very happy about this. And with it, it kind of takes us all together, and brings us all together in executing this plan going forward. And also then we had another plan, a performance matching share plan for leadership team members who have invested now €1.6 million to with secure shares. And of course, that is a strong show of commitment to the company and our future plans, we believe.

A major decision that we took was to introduce a new operating model that is planned to be operational by the 1st of January. So we are clearly now coming out of the demerger of becoming an independent company focused on corporate and business segment. At the same time, there was a recognition of the fact that we need to adjust the way we address the market and how we operate as one company.

And a key theme in this reorganization is unification. So we're talking about one unified sales organization. Why is that important? We clearly see that those over 100,000 customers that we have out there, many of them are using only one solution from our portfolio of product or service. And clearly, we have a significant opportunity in terms of up and cross-selling across that portfolio. So we want to make – take that to the market by a one common organization that will manage both the direct sales, indirect sales and everybody being able to articulate the whole portfolio at least on a high level. And this, we believe, is quite an important step forward.

On the product and R&D side, we're also bringing together and consolidating all the product development and product management activities. This has been previously or still is today residing three different operational units, and we believe that we will gain certain efficiencies here and also target to increase the R&D velocity and take us even faster through certain key areas such as cloud in the portfolio.

The customer responsibility will reside in the countries where we have offices around the world. That is where we kind of bring ourselves to the market. And then we have also the capability of tailoring our approach flexibly dependent on local situation, whether we need more direct sales, whether we need more partner activities, and also having the entire portfolio at our disposal everywhere.

We will continue to consolidate the solutions, which will be largely a services organization. Of course, still packaging together, for example, Managed Detection and Response, which is a combination of our SaaS platform combined with our threat hunting services capabilities. And we believe that this is a key differentiator for us as a company and also consulting being an important part, not only in terms of bringing in revenue and more customers, but also as a way for us to really understand what's going on in the cybersecurity market and benefit from the research we are doing there and driving our thought leadership also as a player in the global space.

And finally, Cloud Protection for Salesforce. That will be organized into an independent start-up-like venture, so that unit will be slightly separate from the rest of the organization, and it will report directly to myself. Here, the aim is simply to maximize the time to market, maximize the speed for us on capturing as much of the market as we can because we believe that we are enjoying certain uniqueness in the marketplace at the moment.

This is the leadership team. We have basically same people in the leadership team as in the previous iteration, but there are some role changes, and I will just quickly go through them. Starting from the top, Juha Kivikoski, who has been leading our business security business unit will take on the role of Chief Customer Officer. He will basically be responsible for all the customer facing people and activities globally.

Janne Pirttilahti will run the Cloud Protection for Salesforce. He is not part of the leadership team. But as said, he will report to the undersigned. Antti Koskela, Chief Product Officer. He will consolidate all of our R&D and product management activities into his unit. He will manage our overall portfolio in that regard. Ari Vanttinen will continue as Chief Marketing Officer. Tom Jansson will continue as the CFO. Charlotte Guillou will continue as the Chief People Officer. Tiina Sarhimaa will continue as Chief Legal.

And then we have a new role in the leadership team. We are elevating the role of Chief Information Security Officer to the leadership team level. Now, this is not very common in companies, at least not in Finland, but also, I think here we want to underline the fact that we need to be a benchmark in how securities is done, executed and how our company is protected, so that we can also show that to our customers. But at the same time, also, we – as many other companies, of course, see this as an existential question to be well protected.

And then finally, Tim Orchard, who has been leading the Solutions Business unit will assume the role of CTO, which was previously held by Christine. And he will drive then our future roadmap and development, especially in

that role. And then we are in the process of recruiting a new head for the Solutions Unit. That organization will be then operational 1st of January.

And then here, I will continue just to come back to the numbers. So first of all, if we look at our cloud native revenue, how that has been growing, you see the steady growth in the pillars on the left. And that is of course as said contributed by Countercept Cloud Protection and then Elements and our markets are performing well. And then we have the revenue underneath from the on premise security products has said as planned have decreased.

I'm now going to hand over actually to Tom, our CFO. He will continue from here with more details on the numbers and performance.

Thomas Jansson

Chief Financial Officer, WithSecure Corp.

Thank you, Juhani. Good afternoon for my part as well. So we still spend a few minutes on the actual numbers. So in terms of our ARR, our ARR grew year-on-year by 29% as said and also planned our on premise, obviously we're on a year-on-year basis going down and so on. We did have our – as we also mentioned in our report today, a third quarter that was quite back end loaded in terms of new deals and orders coming in very late in September. So that had a little bit of impact also on our development over also on our development toward the quarter in ARR and so on.

Then if you look at the consulting specifically, I said before, we have previously divested two parts of our – smaller parts of our consulting, South African and part of our UK consulting, which has impacted our comparable numbers. If you look at the comparable numbers, Q3, we declined about 6% or absolute terms, about €0.50 million in terms of the top line, and this is obviously a thing that we have been working on all year to improve our delivery capabilities as we do see that the market there is – strong demand continues and so on. So, we are seeing some improvement, but still we need to see better also in future in terms of actual numbers.

Then our deferred revenue is keeping quite stable. I think most of – those who follow us know that this is what we have in our balance sheet. This is obviously on a longer term, probably going to be impacted somewhat by also the business model changing to more monthly building and shorter duration. But at the moment, this is still giving quite stable and some growth if you look at it on a year-on-year basis.

Then if you come back to our P&L, so I said our official growth was 4% as earlier mentioned a comparable base is much larger. Our gross margin improved somewhat from the second quarter, and it is still somewhat some percentages lower than last year, and this is mainly related to the consulting activity that we have had all year with building up new teams and so on. As we have also mentioned before, that has had a little bit of impact on our gross margin development. But quarter-over-quarter, we did some improvement. And of course this was the first quarter where we were independent, and now we kind of are out of the boundaries of IFRS reporting. So now you have also an adjusted EBITDA that is clean from any sort of activities related to the demerger. So, there we did improve that also as planned, and this quarter was about minus €4 million on that front.

And our guidance is unchanged. So we still guide the same things as before to grow at 30% and build the company on a double-digit rate, and then the profitability really improved in the second half. And the medium-term financial targets also stay unchanged.

So I think, with this, I would ask Juhani maybe to join back, and then we could move into our Q&A part.

QUESTION AND ANSWER SECTION

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

We could take the questions in the room first, if any. So, Atte, please.

Atte Riikola

Analyst, Inderes Oyj (Research Firm)

Q

Yeah. Hi. It's Atte Riikola from Inderes. A couple of questions. Maybe first about your ambition level in consulting. Now we know that there's been pretty tough quarters now. But if we assume that the situation a little bit normalizes, are you, like, targeting for double-digit growth, or should we assume some low-single-digit growth, or what's your ambition level?

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

So I think what we target now, bearing in mind that we are coming out of and we're still not fully out of it, quite difficult here in terms of the attrition, and we've, of course, been looking into what drives attrition. And usually most of the things that impact attrition are not short-term issues to fix. It's about the working environment. It is about the strategy. It is about the career prospects. It is about the competence development and interesting projects. And we've taken a hard look at that, and I think there's still some work to do for us to build.

So, I think, yes, of course, it continues to be an important part of the portfolio and we will grow in consulting. But at the same time, we're quite focused on making sure that we also fix some of these underlying issues that have been penalizing it during this year and are actually able to run that business with a lower attrition. And I think that needs to be a priority still in the very near future.

Atte Riikola

Analyst, Inderes Oyj (Research Firm)

Q

All right. Then maybe about the profitability development, do you think now we saw a pretty nice improvement from the previous quarters, but if you look at your 2023 target that you are aiming for, like breakeven EBITDA at the end of the year, do you think you're going on with that target at the moment?

Thomas Jansson

Chief Financial Officer, WithSecure Corp.

A

Well, at the moment we are on that plan that we have also planned out for. So, from that perspective, we are still, of course, keeping that.

Atte Riikola

Analyst, Inderes Oyj (Research Firm)

Q

Okay. And then one question about Cloud Protection for Salesforce. You mentioned on your Capital Markets Day that you're trying to expand that technology to another platform also, so any updates on that?

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

We have nothing to disclose at the moment regarding that one. I think we are still amazed that the opportunity there is within the Salesforce ecosystem, it being the largest software ecosystem in the world with about 150,000 companies as customers. So, I think current conclusion is just quite a lot for us to gain still in just focusing on that now in the near future.

Atte Riikola

Analyst, Inderes Oyj (Research Firm)

All right. Thank you.

Q

Laura Viitala

Director-Investor Relations, WithSecure Corp.

Thank you. Now let's move to the online questions. We have a lot of people online today. So, first of all, a question from [indiscernible] (00:20:02). Is this the level we should assume for Q4, or is there a reason why this would increase in Q4?

A

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

Well, I think, you know, we, of course, are very focused now on continuing and accelerating the growth. So we potentially see some need for more investment, but not in the same proportion as we expect to grow the top line.

A

Laura Viitala

Director-Investor Relations, WithSecure Corp.

All right. Then could you walk us through the moving parts of the cash flow segment? Will payables return to normalized levels in Q4?

A

Thomas Jansson

Chief Financial Officer, WithSecure Corp.

Yeah, I mean, we had quite a bit of payables related to the demerger here in Q2 and Q3. So those will return to normal level or already are returning to normal level.

A

Laura Viitala

Director-Investor Relations, WithSecure Corp.

All right. And then in regards of the gross margin, could you perhaps elaborate on what part of the business witnessed an improvement? Did Countercept improve gross margins compared to previous quarter?

A

Thomas Jansson

Chief Financial Officer, WithSecure Corp.

I can start maybe, Juhani. So, yeah, we are working, of course, as we have also announced earlier in our Capital Market Day, continuously with our gross margin. And especially – specifically with Countercept, we have done good progress on that front.

A

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

Maybe just to build on that one. So, first of all, Countercept as to build on that one. So, first of all, Countercept as a solution basically is a combination of a SaaS service complemented with services from threat hunters who are real people, who will provide them that service and that solution is called Countercept.

A

Now in order to improve the gross margin, I think there are two topics. One of them is basically the cost of the technology, and we are very focused on the sensor cost because we need to implement sensors to collect the information. And we have had an ongoing program to bring down that cost and that has progressed nicely. And then the other one is to focus on areas that require a lot of manpower or manual work, i.e., how can we further automate the use of the tools that the threat hunters are using. And we've made progress on that front as well. Of course, the yardstick is that kind of how many sensors can one threat hunter look after in the end. That's the kind of metric there. And on both counts, I think there is good progress.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

All right. Then, next question is about the TSA, so the transitional service agreements with F-Secure. Could you walk us through the moving parts and the impact of the TSA agreements? And is this recurring going forward?

Thomas Jansson

Chief Financial Officer, WithSecure Corp.

A

So if I start, so we have TSA as part of the demerger, and I think probably everybody's familiar with that. The TSA addresses different areas in the company. We have technology-related and then we have some other areas like IT and some admin and so on. And obviously, these are very different. So they're short-term and long-term TSAs. And obviously, we help F-Secure to build up their own capabilities as well. So the short terms will be ending. I think we have some ending at the end of this year, and that will evolve over time, and we have some cost that are reimbursed for us and that footprint – those bases and the impact is obviously very limited. And as we go forward on the end, and we will need to look at our – address our cost base then and see what we do with that. But then, there's also a long-term that probably is for many years, especially in the technology part.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

All right. Then, I'm moving on to the questions from [ph] Félix, (00:24:07) our analyst. What does your full year low double-digit comparable group revenue growth guidance assume from consulting in quarter four, assuming that product businesses grow broadly in line with the Q3 pace, consulting would have to return to clear organic growth in Q4? You are facing, sorry, but is this realistic given your current resourcing? I'm shortening up a little bit here.

Thomas Jansson

Chief Financial Officer, WithSecure Corp.

A

Yeah. I mean, we are keeping our guidance and there's many moving parts in our portfolio and different variations of scenarios in terms of product portfolio and consulting. But clearly, we are striving for a better consulting revenue also.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

And well, this is about the ARR again. What's the deceleration in cloud ARR growth in Q3, purely a reflection of a backend loaded quarter? Has there been any incremental cautiousness in customers purchasing behavior? And was there any meaningful deal slippage from Q3 to Q4 that we should be aware of?

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

I wouldn't say there's anything material. I think that being back-end loaded, of course, contributed to having an impact there. There were a few deals that slipped to Q4 that also made a slight impact, but I wouldn't say there's anything in particular to read into that, that number.

Thomas Jansson

Chief Financial Officer, WithSecure Corp.

A

Maybe I can build on that, also to say that we have not seen any change in customer behavior during the quarter.

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

Yeah.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

All right. Then some questions from our analyst, [ph] David. (00:26:01) So first of all, could you comment on attrition and ramp up of new hires in consulting? Are you positioned to grow organically in Q4 in this segment?

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

I think we have continuously improved our position as we have communicated. But of course in some areas also there have been some adverse impact as attrition has continued. Overall in the market, the attrition is about 24%, so we're not too far off from the mark ourselves. Clearly, our current guidance, of course, will reflect also on our delivery capability for Q4 and I think we have made progress there as well.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

All right. Then second question, considering the Cloud Protection for Salesforce solution is run as a startup venture. Could you detail how many employees are assigned to this business? Are you thinking about opening up the capital of that business to venture capital?

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

So at this point, we are not disclosing the exact number of the employees there nor any other kind of plans. I think this is something that we look forward to talking more in detail as we progress.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

Very good. Then your full-year guidance implies an acceleration of organic growth in Q4. If you're indeed accelerating growth in quarter four, how confident are you that this momentum could be carried forward into 2023 in light of the uncertainties in the macroenvironment?

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

I said in the very beginning, I think we recognize, of course, the uncertainty. And of course, there are companies that consider investments in cybersecurity as part of their IT budget. And when those budgets are cut, that may have an impact on us as well. But broadly speaking, I think we are in a strong position from a demand standpoint.

We are not seeing a slowdown, or we are not seeing a decrease of demand. I think quite the contrary, we're now gearing up for becoming even better organized to capture this opportunity from the beginning of the year.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

Very good. Then your profitability significantly improved in quarter three. Were there any exceptional effects here or are you moving closer to breakeven earlier than expected?

Thomas Jansson

Chief Financial Officer, WithSecure Corp.

A

There was no exceptions. Those are obviously recorded under our IAC bucket of expenses. And of course, we are making progress and we are on the plan at the moment.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

Then about the geographic dimension. Nordic countries and Europe have been strong, while North America and the rest of the world have performed poorly in terms of revenue growth in quarter three. Could you talk about the dynamics you're seeing in these regions?

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

Well, I think we have not maybe labeled some regions as very strong and some weak. I think there are also seasonal variations and timing-related issues. It depends a little bit also on the portfolio that is strong in a given marketplace. I think, overall, I think we're seeing quite a healthy demand both in terms of Nordics but also elsewhere like in the US. I think US is potentially becoming more important for us even going forward. It's the largest cybersecurity market in the world. It's about half of the Salesforce opportunity globally. So I think all of these factors are most likely contributing it to becoming even more important.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

I'll complement Juhani's answer. So the geographic split still includes South Africa in the rest of the world. So that explains what seems like a huge drop, but is actually explained by the divestment.

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

Indeed.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

We just looked at it yesterday. All right. Moving on. And we have [indiscernible] (00:30:25) our analyst who's also online today. And I hope we already answered the question of the drivers behind backend loaded cloud native portfolio. He asks also if this has continued in quarter four.

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

Sorry. What have continued?

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

So the backend loaded cloud native portfolio sales. Has that continued in quarter four?

Thomas Jansson

Chief Financial Officer, WithSecure Corp.

A

Well, we are early in the quarter yet, so it's really difficult to say any trend at the moment. So I would say that we are on a quite normal level at the moment.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

Then there's the question about gross margin, slight improvement, so about 1.4 percentage points from quarter two. What are the main drivers for improving GM going forward? Hosting costs, have they increased due to increased electricity prices?

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

A

So no major variations in terms of the hosting cost. And as you may recall, we're a 100% AWS house, so we operate in their cloud infrastructure. And that is basically the cost element. There is the other factors impacting, as I earlier covered, are primarily related to Countercept, where it's a function of the sensor cost that we see impacting that gross margin, as well as then the efficiency of our services operation, i.e., the threat hunters. And we both have been working on both of them and showing steady progress.

Laura Viitala

Director-Investor Relations, WithSecure Corp.

A

Thank you. That was all the questions that I can see in the webcast for the time being. So if anyone has another question, now it's the time to ask. Looks like our chat has gone silent, so I guess we can start wrapping up.

Juhani Hintikka

President & Chief Executive Officer, WithSecure Corp.

Thank you very much. Thank you for your participation. Good questions sent. Meet you next time.

Thomas Jansson

Chief Financial Officer, WithSecure Corp.

Yeah, thank you very much.

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