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CPI Card Group Inc.

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Earnings Call

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Call Participants

EXECUTIVES

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Chief Financial Officer

John D. Lowe

Executive Vice President of End-to-End Payment Solutions

Michael A. Salop

Head of Investor Relations

Scott T. Scheirman

President, CEO & Director

ANALYSTS

Jaeson Allen Min Schmidt

*Lake Street Capital Markets, LLC,
Research Division*

William Charters

Presentation

Operator

Welcome to CPI Card Group's Second Quarter 2023 Earnings Call. My name is Chris, and I'll be your operator today. [Operator Instructions]

Now I'd like to turn the call over to Mike Salop, CPI's Head of Investor Relations.

Michael A. Salop

Head of Investor Relations

Thanks, operator, and good morning, everyone. Welcome to the CPI Card Group second quarter 2023 earnings webcast and conference call. Today's date is August 8, 2023, and on the call today from CPI Card Group are Scott Scheirman, President and Chief Executive Officer; Jeff Hochstadt, Chief Financial Officer; and John Lowe, Executive Vice President, End-to-End Payment Solutions.

Before we begin, I'd like to remind everyone that this call may contain forward-looking statements as they are defined on the Private Securities Litigation Reform Act of 1995. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements.

For discussion of such risks and uncertainties, please see CPI Card Group's most recent filings with the SEC. All forward-looking statements made today reflect our current expectations only, and we undertake no obligation to update any statement to reflect the events that occur after this call. Also, during the course of today's call, the company will be discussing one or more non-GAAP financial measures, including, but not limited to, EBITDA, adjusted EBITDA, adjusted EBITDA margin, net leverage ratio and free cash flow. Reconciliations of these non-GAAP financial measures to the most directly comparable GAAP measures are included in the press release and the slide presentation that we issued this morning. Copies of today's press release as well as the presentation that accompanies this conference call are accessible on CPI's Investor Relations website, investor.cpicardgroup.com. In addition, CPI's Form 10-Q for the quarter ended June 30, 2023, will be available on CPI's Investor Relations website.

On today's call, all growth rates refer to comparisons with the prior year period, unless otherwise noted.

And now I'd like to turn the call over to President and Chief Executive Officer, Scott Scheirman.

Scott T. Scheirman

President, CEO & Director

Thanks, Mike, and good morning, everyone.

During today's call, I will give a brief overview and highlight our ongoing strategy. John will discuss CPI's second quarter performance and our updated outlook for the full year, and then Jeff will review the financial results in more detail before we open the call for questions.

We will start on Slide 4. As you know, in early June, I announced my plans to retire in early 2024. This was a difficult decision for me as I've enjoyed leading CPI since becoming CEO in late 2017, but I need to give priorities to my family. Given the company has a strong foundation with an excellent leadership team, that has been executing our strategy successfully, I feel comfortable that the time is right for me to retire.

Our board is currently undergoing a search for the next CEO, evaluating both internal and external candidates and expect to name a new CEO in late 2023 or early 2024. I want to assure you that the company remains committed to the key strategic priorities that have guided our success, specifically deep customer focus, market-leading quality products and customer service, continuous innovation and a market competitive business model. Although we have adjusted our outlook for the year to reflect some near-term challenges in the industry, I remain confident in the long-term secular growth for the market and in CPI's competitive position.

As you can see on Slide 5, payment cards issued to consumers continue to grow. The latest figures from Visa and MasterCard show card circulation in the U.S. increased at a 10% CAGR for the 3 years ending March 31st, and were up 9% compared to the prior year period. Trends toward adoption of higher-priced contactless and eco-focus cards also support long-term market growth expectations. And as we have discussed in the past, the card business is reoccurring in nature, and our research shows that on average about 90% of U.S. payment card annual issuance is driven by replacement of existing cards. In short, banks and financial institutions need and want to issue cards. As the market grows over time, we are well positioned to continue to win share based on our differentiated products and end-to-end solutions portfolio our strong customer service and our team's track record of gaining share through execution of our focused strategies. We are currently being affected by softness in customer demand, which has caused us to adjust our sales outlook range for the year, but we believe the softness is temporary in nature as eventually cards will still need to be purchased and issued.

Overall, given the market conditions, I am pleased with the results we posted in the second quarter and for the first half of the year, including solid profitability growth.

I would now like to turn the call over to John Lowe to further discuss the current environment, our second quarter results and our outlook for 2023. For those of you who don't know John, he leads all of our Debit and Credit segment, which represents approximately 80% of the company's net sales and previously served as the company's CFO. He has done a great job of bringing our end-to-end payment solutions businesses together and driving our business forward. John?

John D. Lowe

Executive Vice President of End-to-End Payment Solutions

Thanks, Scott, and good morning, everyone. Happy to be on the call today.

Let me first go through some of the results for the quarter on Slide 6 before reviewing our full year outlook. For the quarter, we delivered a 1% increase in net sales, driven by 14% growth in our Prepaid business, which is led by Peggy O'Leary and her team. Our Debit and Credit business declined 1%, which reflects both challenging comparisons with the prior year quarter and cost of spending by some of our customers.

As you may recall, Our Debit and Credit segment net sales increased 29% in the second quarter of 2022. This was driven by a large card order related to an eco-focused portfolio addition with one of our largest customers. As a result, we sold nearly 15 million more eco-focused cards in last year's second quarter than the current quarter. As a reminder, as of the end of the current quarter, we have sold nearly 100 million eco-focus cards to our customers since late 2019.

Aside from eco-focused cards, we delivered increases in debit and credit in this year's quarter, primarily from our other contactless cards, contact cards and services businesses. Comparison aside, customer demand is softer than we expected coming into the year, which we believe is driven by a couple of factors. As we mentioned last quarter, we started to see some impact on orders following the banking stress that begin in the spring. Although the turmoil that affected small and regional banks have dissipated and the current environment appears to have stabilized, we continue to see cautionary spending among many of our smaller and medium-sized banking customers on cards and a related personalization. We're also hearing from our customers that they were utilizing more existing inventory as supply chain challenges that previously prompted them to carry more inventory have improved. We believe the ongoing economic slowdown concerns have also likely put more emphasis on customers optimizing inventory levels. As we talk to our customers, our belief is the softness in the market and inventory work downs will likely continue in the near term, but we believe the market will improve later in the year. As Scott noted, card issuance to consumers remains healthy, so we do expect sales to issuers to start to regain momentum once inventory levels are worked down.

Turning back to second quarter results. Despite the slight sales growth, we were able to increase adjusted EBITDA by effectively managing operating expenses. We grew net income by 6% and adjusted EBITDA by 18% in the quarter with adjusted EBITDA margins increasing 290 basis points to 20.3%. For the first

half of the year, we delivered solid 5% net sales growth, a 43% increase in net income and 15% growth in adjusted EBITDA.

Jeff will give you more details on our results in a few minutes. But first, let's turn to Slide 7 to discuss our updated outlook for 2023. Today, we are adjusting the sales outlook provided in May, while affirming our outlook for adjusted EBITDA growth, free cash flow generation and net leverage. We have updated our full year sales outlook to a range of flat to low single-digit growth, down from our original outlook of mid-single-digit growth due to the factors mentioned previously. This change is attributable to the Debit and Credit segment, as we continue to expect the prepaid segment to be similar to or slightly better than 2022 levels. Currently, we expect sales to decline in the third quarter and returned to growth in the fourth quarter as the market starts to improve and the impact of our sales initiatives takes hold. As we mentioned last quarter, due to the softness we are seeing in the market, we are executing various initiatives to drive sales in 2023. And these will primarily benefit the fourth quarter.

On the profit side, we are affirming our outlook for mid- to high single-digit adjusted EBITDA growth. Given the lower sales expectation, we have increased our focus on managing discretionary expenses such as outside services costs and managing the timing of implementation of certain projects where possible. As noted, adjusted EBITDA increased 15% in the first half of the year. So we are off to a good start. Although there is still uncertainty in the economic environment and exactly when the market will improve, we have confidence in our teams and their focus on delivering our outlook and believe we have solid plans in place to do so.

Longer term, the same positive secular trends remain intact, cards in circulation growth. Contactless card market penetration and eco-focused U.S. card growth trends where we believe we are a leader.

I will now turn the call over to Jeff to review our second quarter and year-to-date results and outlook in more detail. Jeff?

Jeffrey A. Hochstadt
Chief Financial Officer

Thanks, John, and good morning, everyone.

I will begin my overview on Slide 9. Net sales increased 1% in the quarter as strong growth from our prepaid business offset the expected softness in debit and credit. Prepaid sales increased 14%, driven by higher sales to existing customers while debit and credit segment sales decreased 1% as the previously implemented price increases helped offset some of the reduced demand.

Looking at our products and services in debit and credit, declines in eco-focused card sales were largely offset by increases in sales of other contactless cards, contact cards, personalization services, including our Print on Demand business, Card at Once instant issuance processing fees and sales of non-EMV cards. First quarter gross profit increased 1%, largely in line with sales growth. The gross profit margin decreased slightly from 35.8% to 35.5%. We've reduced SG&A expenses by \$2 million in the quarter, primarily due to lower expenses in prepaid and lower professional service expenses. Compensation expenses increased slightly in the quarter as the impact of increased headcount and salaries and the executive retention package noted in our early June 8-K, were offset by reduced short-term employee incentive compensation expense. Most of the cash and equity expense impacts from the executive retention package will be amortized within SG&A through February of next year and recorded as adjustment items to EBITDA. We had a relatively high tax rate of 38.9% in the quarter, which compared to 22.1% in the prior year and brought our year-to-date rate up to 28.6%. The increased rate in the quarter primarily reflects limitations on deductibility of executive compensation related to the CEO retention package. The year-to-date rate is still below last year's level due to higher interest expense deductibility and a favorable adjustment in the first quarter to reflect the change in state tax law. We expect a normalized rate, excluding any adjustment items of between 25% and 30% and now expect the overall 2023 rate to be near the top of that range.

Net income in the second quarter increased 6% to \$6.5 million and adjusted EBITDA increased 18% to \$23.3 million. Adjusted EBITDA margin improved from 17.4% in the prior year to 20.3% driven by

reduced SG&A expenses, while net income growth also benefited from lower interest expense, partially offset by a higher tax rate.

Turning now to our year-to-date results on Slide 10. For the first half of the year, net sales increased 5% with the Debit and Credit segment growing 5% and prepaid debit increasing 6%. Debit and Credit sales growth was driven by contactless cards, card personalization services, Card@Once instant issuance solution services and non-EMV cards.

Pricing contributed just under 4 percentage points of the overall growth in the first half primarily related to actions taken in 2022, though this impact will lessen over the remainder of the year. First half gross profit increased 5% from the prior year, with gross profit margin increasing slightly to 35.6%.

SG&A expenses decreased by approximately \$1 million in the first half, as reduced professional service expenses, including for third parties and lower expenses and prepaid were partially offset by increased compensation expenses, primarily reflecting increased headcount.

Net income in the first half increased 43% to \$17.4 million and adjusted EBITDA increased 15% to \$48.4 million. Adjusted EBITDA margin improved from 18.8% in the prior year to 20.5%, driven primarily by reduced operating expenses, while net income growth also benefited from lower interest expense and a lower tax rate.

Turning now to our segments on Slide 11. I mentioned the segment sales drivers earlier, so I will just discuss segment profitability on this slide.

Income from operations for the Debit and Credit segment decreased 1% in the quarter to \$25.1 million in line with the sales decline. For the first half, Debit and Credit income from operations increased 11%, driven by sales growth, operating leverage, including the benefits of pricing increases and lower SG&A expenses.

Prepaid Debit segment income from operations increased 43% in the second quarter to \$7.6 million. First half income from operating was flat due to first quarter costs related to the labor conversion at our prepaid production facility. As was mentioned last quarter, we expected prepaid margins to improve from the first quarter as we gained efficiencies from the labor conversion and benefited from more favorable mix and operating leverage. Compared to prior year, prepaid income from operations also benefited from lower SG&A expenses in the second quarter.

Turning to the balance sheet, liquidity and cash flow on Slide 12. On a year-to-date basis, we generated \$10.3 million of cash flow from operating activities and invested \$6.6 million on capital expenditures, which resulted in free cash flow of \$3.7 million. This compares to the free cash flow usage of \$16.3 million in the prior year period, with the improvement driven by increased net income and reduced working capital usage compared to last year's first half.

On the balance sheet, at June 30, we had \$11 million of cash and \$18 million of borrowings outstanding on our \$75 million ABL revolver. We had \$270 million of senior secured notes outstanding at quarter end as we repurchased \$7 million of notes in the open market in the quarter, bringing our total to \$15 million year-to-date.

Our net leverage ratio of 2.8x at the end of the quarter compared to 3x at year-end and 4x in the prior year second quarter. Our capital structure and allocation priorities remain focused on maintaining ample liquidity, investing in the business, including possible strategic acquisitions, deleveraging the balance sheet and returning funds to stockholders.

As mentioned earlier, we have updated our sales outlook for 2023 from mid-single-digit growth to a range of flat to low single-digit growth and affirmed our outlook for mid- to high single-digit adjusted EBITDA growth more than doubling free cash flow from last year's \$13.5 million and net leverage improvement to between 2.5 and 3x at year-end. With sales lower than anticipated, we are focused on managing costs through initiatives and delaying certain project spending to drive adjusted EBITDA growth.

I will now pass the call back to Scott for some closing remarks on Slide 13. Scott?

Scott T. Scheirman

President, CEO & Director

Thanks, Jeff, and thank you to all of our employees for their efforts in delivering our first half results in a challenging environment. I also wanted to note that we are pleased to have had our stock added to the Russell 3000 in June, which should further help us in our efforts to increase liquidity for our shares.

To summarize today's call, we faced expected demand challenges in the quarter but delivered good profitability growth and have generated solid results overall for the first half. We expect the short-term customer demand challenges to persist in the near term and have adjusted our sales outlook to reflect that but are focused on profitability and free cash flows and have affirmed our adjusted EBITDA and free cash flow outlooks for the year. We expect the market to improve over time, and we continue to remain confident in the long-term secular transfer payment cards and in our ability to continue to gain share. Thank you for joining our call today, and we will now open the call for any questions. Operator?

Question and Answer

Operator

[Operator Instructions] The first question is from Jaeson Schmidt with Lake Street Capital Markets.

Jaeson Allen Min Schmidt

Lake Street Capital Markets, LLC, Research Division

Just want to start with sort of your Q4 outlook, sort of that confidence in a return to growth in Q4. I mean, is this based on recent customer order patterns or visibility into inventory levels, or what gives you that confident that you can return to growth here later in this year?

Scott T. Scheirman

President, CEO & Director

Yes, Jaeson. This is Scott. Let me give you a couple of thoughts, and I'll let John add some color too, as he works even more closely with the customers than I do every day. But I would say based on recent conversations with customers about their project plans, we believe conditions will start to improve later in the year, Jaeson. But obviously, the timing of the market improving could change depending upon a variety of factors, economic conditions, our customers' business objectives and so forth. I think what's really important to note here is the long-term secular trends continue to be intact. Contactless cards, we'll continue to transition in the U.S. Eco-focused cards are popular, will be very popular. We're the market leader there for sure. And then 90% -- on average, annually 90% of our revenue is reoccurring. So we have a model that has secular trends reoccurring revenue in nature. But clearly, we're going through some cautious spending with our customers. And again, these are on -- based on recent conversations, and we have in the last few months, seeing some customers push large projects into '24. I know one customer that canceled an order, they're tightening their credit a bit. But again, these are temporary conditions. But John, I'll let you give some more color on what gives us some confidence in Q4, although not without risk, obviously, for sure.

John D. Lowe

Executive Vice President of End-to-End Payment Solutions

Yes. Jaeson, good to talk to you again. I mean I think Scott covered it well, but the one thing I would say is we're talking to our customers all the time. If you think about what's changed since May, right, there's really been 2 drivers. Scott mentioned this, but we've seen the large banks just be a little bit more, some of them at least focused on inventory. Some of the new projects out next year, some are tightening credit standards, which has impacted our ordering. In the small-to-medium space, you've seen the trends that I would say that were occurring in Q2, they've continued to a certain extent in Q3. We do expect those to come back in Q4. And the reason being to answer your question directly, is really, we're talking to our customers all the time. There's a significant amount of, what I would say, quoting activity projects we're working on. There's always risk in the outlook, but we feel good about the the end of the year and things picking up in relation to where we are now.

Jaeson Allen Min Schmidt

Lake Street Capital Markets, LLC, Research Division

Okay. No, that's really helpful color. I appreciate it guys. And then just looking at the prepaid segment, it seemed to be quite strong in Q2. Just curious if this would impact sort of your normal seasonal patterns that you typically see in the second half of the year?

Scott T. Scheirman

President, CEO & Director

Jaeson, it may have a bit of an impact in each of our businesses, timing can vary among quarters for sure. We're pleased with the prepaid business. Peggy O'Leary and her team are doing a great job of growing that business. And again, we see that business probably being slightly better than where it ended up in

'22. But there is a bit of seasonality in Q3 for sure, as our customers prepare for the holiday season, the gifting season. But there could be a bit of timing that moves among the quarters. But overall, I'd probably focus you on prepaid is having a solid year for sure and should be a tad bit better in '23 than it was in '22.

John D. Lowe

Executive Vice President of End-to-End Payment Solutions

Jaeson, the other thing I'd say is the Prepaid business, and again, Peggy O'Leary running the business, she's doing a great job. They've been able to diversify their products that, to a certain extent, we moved into HSA card, some other areas, doing things more than just our typical prepaid open-loop gift cards, and that's reduced some of the seasonality in the business overall. So what you'll see from kind of the second quarter to third quarter to fourth quarter, I think you see a little bit less lumpiness than what you would look at if you look back to our financials historically.

Jaeson Allen Min Schmidt

Lake Street Capital Markets, LLC, Research Division

Okay. That makes sense. And then just last one for me, and I'll jump back into queue. How should we think about gross margin here in the second half of the year?

Jeffrey A. Hochstadt

Chief Financial Officer

Yes. Jaeson, this is Jeff. I think for the gross margin for the rest of the year, Obviously, when sales dip a little bit, we typically get a little bit of operating leverage with higher sales. So the -- so that will put a little pressure on the gross margin, also our pricing is lapsing from last year that we implemented that it's been about a year or so. So gross margin will be a little bit of pressure. But on the same token, we are managing our expenses pretty effectively, and we don't really give guidance per se on gross margin. But on the adjusted EBITDA, we still affirmed our guidance for the year. There's a lot that we can, again, tighten our expenses in the second half and watch those closely. So we feel good about the adjusted EBITDA guidance in light of slower revenue growth.

Operator

[Operator Instructions] The next question is from Bill Charters with Sabal Capital.

William Charters

I just wanted to get some clarity on the guidance. So regarding third quarter guidance, you mean third quarter is down year-over-year, and that's up of like \$124 million and \$28 million last year. And so then you expect Q4 to grow somewhat, and that's how you get to the almost \$100 million EBITDA for the year. Am I thinking about that correctly?

Michael A. Salop

Head of Investor Relations

Yes, that's correct.

William Charters

Okay. And then in 2015 and '16 with EMV traded a cyclicity with lower maturities from from 5 years down to 3 years and lower margins. What cyclicity, if any, do you expect from the contactless conversion?

John D. Lowe

Executive Vice President of End-to-End Payment Solutions

Yes. Bill, good to talk to you again. Contactless is very different from what we saw in '15 and '16, right? I mean I think if you go back, the mandate from Visa and MasterCard, there was a very clear set date. That was October '15. You fast forward to the contactless transition, really started to pick up slightly in late '18. If you look at the broader market, we've seen the penetration as of the end of '22, roughly 50% to 60%.

We expect that to be in the 80% -- mid-80s, if you will, in the next few years. So the transition has been slower. There's no mandate. So I wouldn't say this particular change in guidance or what's happening in the current year has anything to do with the contactless transition in its totality. I would say that's a much more slow transition, which is good for our customers, it's good for us. And we do expect that to continue in the coming years. So the cyclical from that, I would say, isn't really comparable to what we saw from the inventory building and the boom in the industry that we saw back in the '15 and '16 time period from the Visa and Mastercard mandate.

William Charters

Okay. Great. And you expect everything to be fully kind of, I guess, fully implemented by 2025, is that kind of what you're thinking?

John D. Lowe

Executive Vice President of End-to-End Payment Solutions

Well, I mean, you're never going to get to 100% penetration, so I do believe kind of '25, '26 time period during the 80% to 85% range. But keep in mind, our business, 1/3 of our revenue on the debit and credit side comes from our largest issuers, 2/3 of our revenue comes from the small-to-medium issuers and the small-to-medium issuers are the ones that are much slower to transition. So we expect, even if you get to 80%, 85%, that's a fairly long tail. And the other thing I would say is the secular trends just broadly still remain. The cards in circulation, Scott mentioned this, they're up at a roughly 10% CAGR over the last 3 years. Overall, card issuance is roughly 90% recurring. And if you're looking at the eco-focus market where we believe we're a leader, we sold nearly 90 -- or 100 million of those through Q2, and we expect that market to grow at a 50% CAGR over the next few years. So I understand the question about the cyclical and contactless, but we feel good about where we are in the market.

William Charters

Yes. Okay. Great. And then the last question I have is on CapEx. What is maintenance CapEx? I noticed like last year was higher than historic. The first quarter was higher, but then this quarter it was lower. What do you feel about CapEx and maintenance, if you just give us some more color on that.

John D. Lowe

Executive Vice President of End-to-End Payment Solutions

Yes, John, again. If you go back several years ago, where we were very tight on cash, I would say, we're probably in the \$8 million, \$10 million range. I think in the current environment, we're probably more in that \$15 million to \$20 million range. We do have projects that are ongoing. We're always trying to improve our operations from an efficiency perspective capability perspective for our customers. In doing that, we expect to continue to spend kind of in that \$15 million to \$20 million range over the course of the future. And I'd break that down just to your question, there's CapEx for true maintenance for the organization. There's CapEx for projects and improvement. And the maintenance side is probably more in the \$5 million to \$8 million range, if I had to put a number around it.

William Charters

Yes. And the rest is growth or efficiencies.

John D. Lowe

Executive Vice President of End-to-End Payment Solutions

That's right.

Operator

We have no further questions at this time, and this will conclude today's CPI Card Group's second quarter earnings call. Thank you for joining. Have a good day.

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