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Earnings Call

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Call Participants

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Presentation

Operator

Welcome to CPI Card Group's Third Quarter 2024 Earnings Call. My name is Rob, and I will be your operator today. [Operator Instructions] Now I would like to turn the call over to Mike Salop, CPI's Head of Investor Relations.

Michael A. Salop

Head of Investor Relations

Thanks, operator. Welcome to the CPI Card Group's Third Quarter 2024 Earnings Webcast and Conference Call. Today's date is November 5, 2024, and on the call today from CPI Card Group are John Lowe, President and Chief Executive Officer; and Jeff Hochstadt, Chief Financial Officer.

Before we begin, I'd like to remind everyone that this call may contain forward-looking statements, as they are defined under 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 a 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 slide presentation 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 September 30, 2024, will be available in CPI's Investor Relations website. On today's call, all growth rates refer to comparisons with the prior year period, unless otherwise noted.

The agenda for today's call is on Slide 3. John will give a brief overview of the third quarter and our strategies, and Jeff will provide more detail on the results and our financial outlook, and then we'll open the call for questions.

And now we can move to Slide 4, and I'll turn the call over to John.

John D. Lowe

President, CEO & Director

Thanks, Mike, and good morning, everyone. We are excited to share our strong third quarter results and increased outlook this morning. We delivered the second largest sales quarter in the company's history and generated nearly 20% growth in both net sales and adjusted EBITDA. We also continue to make advances with our adjacent market strategies and are seeing growing interest in our expanding set of digital solutions.

As we highlighted at the beginning of the year, we expected the first half to be challenging as channel inventories continue to be worked down and expected to see good growth in the second half, and the third quarter reflects that.

Net sales increased 18% in the quarter, with product sales, which primarily represent debit and credit cards, growing 25%, led by strong sales of eco-focused contactless cards. While channel inventory levels are still elevated, they are improving, and we believe we are winning business in the market.

In addition to our card performance, we continue to grow our Card@Once instant issuance solutions and our personalization businesses, and our prepaid business remains strong, delivering 13% growth in the quarter. We also made great progress improving our profitability with gross margins increasing 170 basis

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points compared to prior year and adjusted EBITDA increasing 18%, and we completed some significant financing and capital strategy items, issuing new Senior Notes extending maturities out to 2029, and supporting a secondary offering by our majority stockholder group, which should aid trading liquidity for our stock over time.

Based on our results and current expectations for the fourth quarter, we have updated our full year outlook for 2024, increasing our net sales range due to strength across our portfolio and also increasing our adjusted EBITDA and cash flow expectations.

Jeff will provide you more detail on our results and outlook in a few minutes, but I will first review our strategic progress on Slide 5. Our strategies remain focused on the customer, innovation, and high quality to grow and gain share in our traditional businesses while enhancing growth by expanding into adjacent markets, including digital solutions over the long term. One innovation example is our recently announced ability to produce cards with a new advanced contactless chip that integrates the antenna within the chip itself. This feature allows for more flexibility on card design and reduces carbon footprint as it eliminates the need for separate layers within the card for the antenna. Although there are generally long adoption cycles for changes in chip technology, we are now ready to initiate pilots with customers, positioning CPI as a potential early adopter of an important new technology.

In addition to driving growth in our traditional core businesses, we are advancing our efforts to capitalize on new opportunities by adjacent markets, including offering more products and digital solutions to existing customers and expanding to new customer verticals.

During the quarter, we announced another digital solution offering when we signed an agreement with Ripplshot to offer their fraud prevention tools to our customer base. Ripplshot's tools generate predictive analytics, leveraging data from thousands of financial institutions generating millions of transactions each day. We believe these tools will help our small and medium-sized financial institution customers reduce losses by identifying fraud patterns to block attacks before they strike, detecting compromised merchants and high-risk cards.

In addition to this offering, we also continue to see growing interest in our broader digital solutions, including push provisioning. These are just a few examples of our progress, and we believe these opportunities will supplement our growth over the coming years.

Turning to Slide 6. We continue to expect our core markets to provide solid long-term growth. On this slide, you can see the latest U.S. cards in circulation trends from Visa and Mastercard. For the 3 years ending June 30, cards in circulation in the U.S. increased at a 9% CAGR and reports from large issuers also indicate a healthy card market. As an example, JPMorgan Chase reported an 11% year-over-year increase in cards outstanding and Bank of America noted the addition of 1 million credit card accounts. The issuance trends are strong, channel inventory is being worked down, and we believe we can continue to win in the marketplace with both our traditional businesses and as we expand into adjacent markets, including digital solutions.

I would like to now turn the call over to Jeff to discuss our third quarter financial results and 2024 outlook in more detail. Jeff?

Jeffrey A. Hochstadt
Chief Financial Officer

Thanks, John, and good morning, everyone. I will begin my overview on Slide 8. As John mentioned, we delivered very strong sales growth in the quarter with increases across our portfolio. The sales growth drove gross margin expansion, and we also delivered a strong increase in adjusted EBITDA despite increased performance-based employee incentive compensation expenses.

Net income declined in the quarter due to the impact of debt refinancing costs as we completed the retirement of our previous Senior Notes and the issuance of new notes due in 2029. Free cash flow generation was healthy, and our net leverage ratio of 3.2x at quarter end improved slightly compared to the second quarter despite the cash outflows associated with debt refinancing costs.

Turning to the detailed third quarter results on Slide 9. The overall 18% sales increase reflected a 19% increase in our Debit and Credit segment and a 13% increase in our Prepaid segment. Debit and Credit segment growth was led by unit volume increases from our card business, driven by eco-focused contactless cards and continued growth from Card@Once instant issuance solutions and other card personalization services.

Prepaid segment growth continues to reflect demand for higher-priced fraud-focused packaging solutions as we discussed last quarter. Gross profit increased 24% in the quarter as gross margins increased from 34.1% in the prior year quarter to 35.8%, driven by operating leverage. SG&A, including depreciation and amortization, increased \$3.7 million from the prior year, primarily due to increased performance-based employee incentive compensation expense as accruals in the third quarter of last year were minimal.

Interest expense increased \$6.7 million in the quarter, primarily due to payment of a 2.156% call premium or \$5.8 million to redeem the \$268 million outstanding of our Senior Notes due 2026. We also recorded a \$3 million loss on debt extinguishment and other expense, which reflects the write-down of unamortized deferred financing costs on our retired debt and credit facilities.

We recorded an income tax benefit in the quarter, which brought our year-to-date tax rate to 24%. The benefit reflects increased deductibility of stock compensation primarily related to certain option exercises, which triggered recognition of updated values of the option expense for tax purposes.

Net income in the third quarter decreased 66% or \$2.6 million due to the \$8.8 million of pretax debt refinancing costs. Adjusted EBITDA increased 18% to \$25.1 million and adjusted EBITDA margins were consistent with prior year at 20.1% as the improvement in gross margin was offset by the increased incentive compensation expenses in SG&A.

Turning now to our year-to-date results on Slide 10. For the first 9 months of the year, net sales increased 4% with the Debit and Credit segment increasing 2% and Prepaid increasing 16%. Within debit and credit, the year-to-date sales increase can be attributed to growth in contactless card sales led by eco-focused cards and consistent growth from Instant Issuance and other card personalization services, partially offset by declines in contact card sales.

Year-to-date gross profit increased 7% as gross margin increased from 35.1% to 36.2%. SG&A increased \$12.7 million from the prior year period, driven primarily by an increase in CEO transition-related costs and increased performance-based employee incentive compensation compared to 2023. The CEO transition-related costs increased approximately \$4 million from prior year due to increased stock compensation expense from special key employee grants issued in the second half of last year and executive severance expenses, partially offset by reduced impact from the CEO retention award, which was completed in the first quarter.

The year-to-date tax rate of 24%, declined versus last years of 30.5% as this year's rate reflects increased stock compensation deductibility and last year's rate reflected limitations on deductibility of executive compensation expense.

Net income in the first 9 months decreased 40% to \$12.7 million, affected by the debt refinancing costs and CEO transition-related costs, and adjusted EBITDA increased 1% to \$70 million. Adjusted EBITDA margin of 19.7% was down from 20.4% in the prior year, primarily due to the increase in performance-based incentive compensation expense, partially offset by improved gross margins.

Turning now to our segments on Slide 11. I discussed the segment sales drivers earlier, so I will highlight segment profitability on this slide. Income from operations for the Debit and Credit segment increased 30% to \$27 million in the third quarter, driven by the sales increase and strong gross margin expansion and declined 1% year-to-date due to the impact of increased compensation-related expenses. Prepaid debit segment income from operations increased 7% to \$7.1 million in the third quarter and 27% year-to-date, driven by sales growth with the year-to-date increase also driven by strong gross margin improvement.

Turning to the balance sheet, liquidity, and cash flow on Slide 12. For the first 9 months of the year, we generated \$16.7 million of cash from operating activities and invested \$4.2 million in capital expenditures,

which resulted in free cash flow of \$12.5 million. This compared to operating cash flow of \$22.3 million and free cash flow of \$16.2 million in the prior year. The lower generation in this year's period was primarily driven by increased working capital usage, partially offset by lower capital spending. Working capital usage reflects an increase in inventory driven by purchase commitments for contactless chips.

As mentioned previously, we are carrying more contactless chip inventory than normal this year due to our agreement with our main supplier, but we expect to be able to use these chips going forward.

Free cash flow through the first 9 months of 2024 was also affected by incentives related to the customer contract signed in the first quarter and the payment of former CEO's retention award, partially offset by lower short-term employee incentive payments based on 2023 performance.

Capital spending is down just under \$2 million from our prior year, but we expect spending to increase in the fourth quarter as we advance the build-out of our new secure card production facility in Indiana.

On the balance sheet at quarter end, we had \$14.7 million of cash, no borrowings on our ABL revolver and \$285 million of senior secured notes outstanding at quarter end. Our net leverage ratio was 3.2x, down slightly from the second quarter despite payment of the \$5.8 million call premium on our retired Senior Notes and approximately \$6.5 million of other cash outflows related to our debt refinancing. Our capital structure and allocation priorities remain focused on investing in the business, including possible strategic acquisitions, deleveraging the balance sheet and returning funds to stockholders.

As mentioned last quarter, in July, we completed the refinancing of our debt, issuing \$285 million of 10% coupon senior secured notes due in 2029 and entering into a new \$75 million ABL revolving facility while retiring our Senior Notes that were due in 2026. With our share repurchase program, we have bought back approximately \$9 million since inception in the fourth quarter of last year.

In the third quarter, we completed the purchase of 121,000 shares for \$2.2 million from our majority stockholder group, funds affiliated with Parallel49 Equity pursuant to the stock purchase agreement announced in March. Under that agreement, we continue to repurchase shares from Parallel49 at a ratio of 3:1 to the number of shares we repurchased in the open market from April to June at a price of 98% of the average open market repurchase price over that period. We did not execute any open market repurchases in the third quarter.

Also on September 30, we announced a secondary offering of shares of common stock from funds affiliated with the majority stockholder group. On October 2, the offering closed and 1.38 million shares were sold in a public offering. CPI did not sell any shares or receive any proceeds from the offering. We believe this offering will be beneficial for shareholders as more shares will move to the public float and majority ownership was decreased, as the transaction resulted in the majority stockholder group ownership decreasing from 56% of shares outstanding to 43%. This transaction was structured and executed by Parallel49 Equity, and it will be their decision if they pursue additional offerings in the future.

We cannot speak on their behalf, but we will say they are very constructive and long-term focused. They have been in this investment for many years and believe that increasing the public float could be beneficial for both the company and the economics of potential future offerings. We also note that a controlling person of our majority stockholder group purchased 250,000 shares in the offering through his family office, which indicates strong belief in the Company's future.

Turning to our 2024 financial outlook on Slide 13. As John mentioned, we have updated our financial outlook for 2024. We have increased our net sales range to mid to high single-digit growth, up from mid-single digit previously due to strength across our portfolio, and we have increased our adjusted EBITDA outlook to low single-digit growth, up from slight growth in our previous outlook.

We have also increased our full year free cash flow outlook to be slightly below the 2023 level compared to approximately half the prior year level in our previous outlook, primarily reflecting working capital improvements, lower expected capital spending and a lower tax rate. We now expect our year-end net leverage ratio to be similar to the 2023 year-end level compared to our previous outlook of between 3.0x and 3.5x.

Net leverage was 3.1x at year-end 2023. Improvement this year was negatively impacted by the cash outflows associated with the debt refinancing, but our goal is to continue to work it down over time.

I will now pass the call back to John for some closing remarks on Slide 14. John?

John D. Lowe

President, CEO & Director

Thanks, Jeff. To summarize, we are very pleased with the third quarter performance. Our Debit and Credit card business provided strong growth, while we continue to also drive growth in prepaid, instant issuance, and our other card personalization services. Based on the strength of our portfolio, we updated our full year expectations, increasing our net sales, adjusted EBITDA, and free cash flow outlooks.

We continue to advance our strategies to gain share by leading in customer service, quality, and innovation and increasing our addressable market through expansion into adjacencies, including digital solutions over time. We are pleased with our positioning and progress and look forward to continuing to drive performance for our shareholders.

Operator, we will now open the call up for any questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Jaeson Schmidt from Lake Street Capital Markets.

Jaeson Allen Min Schmidt

Lake Street Capital Markets, LLC, Research Division

Congrats on the nice results. Just want to start with sort of the revenue momentum. I know the excess inventory was creating some headwinds earlier this year. But is it fair to say that is completely behind you now?

John D. Lowe

President, CEO & Director

Jaeson, so I would say not necessarily behind us. I mean, things are improving, not over, but the market is strong. Cards in circulation are still growing at a 9% CAGR over the last 3 years. And if you go back in time to the beginning of this year, we did expect growth in the second half after kind of a down -- a little bit of downside in the first half. And the third quarter reflects that. We had a strong third quarter with performance across the card side, including eco-focused, Prepaid had a good quarter. And our Software-as-a-Service digital solution, Card@Once had a great quarter, and our personalization business has had a great quarter. So overall, market momentum is still there, but channel inventories are still working themselves down, but we do believe we're winning business in the market.

Jaeson Allen Min Schmidt

Lake Street Capital Markets, LLC, Research Division

And then just as a follow-up, your commentary about news on the integration of the chip and antenna design. Maybe it's a bit too early, but can you help us think about how we -- how that will impact either ASPs or gross margins longer term?

John D. Lowe

President, CEO & Director

Yes. I mean, look, we're excited about the, what we call the all-in-one chip that creates a chip where the antenna is essentially put within the chip itself versus adding card layers within the card. So it helps our customers expand their design options, reduces carbon footprint. But we're in early stages, right? It will take years to really ramp up. So we don't necessarily know the pace. So I wouldn't want to speak to the financial impact quite yet. But we're excited to be an early adopter. And hopefully, we'll see adoption faster than slower.

Operator

Your next question comes from the line of Andrew Scutt from ROTH Capital Partners.

Andrew Scutt

ROTH MKM Partners, LLC, Research Division

First one for me, you guys have kind of spoken to strength in some of the ancillary businesses like Card@Once and push provisioning. Can you kind of -- as far as push provisioning goes, you've been a couple of months into the MEA partnership. Can you kind of talk about momentum that you're seeing there?

John D. Lowe

President, CEO & Director

Yes. I mean momentum is strong. I'd say it's still a very minor impact to our financials at this point in time. But just, Andrew, to your question, MEA, as a reminder, they probably have 300 FIs that they work

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with. We're now able to work with their FIs, providing them push provisioning. There is a pipeline that we're kind of working with. And push has been successful so far, but it's kind of slowly ramping, right, banks are always slow to adopt and ramp things up. But there's definitely strong interest, which is great. And if you think about our Card@Once solution, right, our Software-as-a-Service solution, we've been in that business for more than 10 years. That's a business where we're in more than 16,000 branches across the United States. And that's been a strong growth business for us. It's a high-margin business, similar to what our broader digital solutions are as well. So we'll share more on push prospectively from a metric perspective. But what I can say is there's a strong momentum, but it's still early days.

Andrew Scutt

ROTH MKM Partners, LLC, Research Division

Awesome. No, great to hear. And second one from me. You kind of spoke on the revenue momentum in Debit and Credit. We also saw a nice bump up in Prepaid in the quarter. Can you just kind of speak to what you saw in that business over the last few months?

John D. Lowe

President, CEO & Director

Yes. I mean Prepaid is having a great year. I've got to thank the team up in Minnesota because they're just doing a great job. 13% year-over-year growth is a really strong quarter for the prepaid side. And it's really driven by 2 sides. I'd say one side is the kind of increase in fraud protection demand by our customers. We're constantly innovating with our partners in terms of putting more fraud protections into the package. That creates a higher value package, which is great for us, but also protects our customers' customers, if you will. And then the other side is there's a number of prepaid areas we're moving into from an adjacency perspective into the healthcare side, and that's benefiting our Prepaid business. So strong quarter for the Prepaid team, and we're hoping for a strong growth for the remainder of the year.

Operator

Your next question comes from the line of Peter Heckmann from D.A. Davidson.

Peter James Heckmann

D.A. Davidson & Co., Research Division

Following on that last question, your -- the raise in your full year guidance does imply another strong quarter for the fourth. And just trying to think about in terms of thinking about seasonality in Debit and Credit versus Prepaid debit, I guess, could you give a little bit of thoughts in terms of the relative strength of those 2? It certainly looks like Prepaid is on track to have a really great year and Debit and Credit a good year. But I guess that's dependent upon my forecast. So in terms of how you're thinking about the fourth quarter, would you expect it to -- in terms of the relative growth rates of the 2 segments, would you expect it to be about the same? Or would you expect there to be a significant variance?

Jeffrey A. Hochstadt

Chief Financial Officer

Yes. Actually, I mean, a good question. We really, over the years, we haven't been as fluctuating as seasonally as we had in the past. So we feel like both businesses will have a good continuation in Q4. I don't think there's really a significant seasonality in either of these businesses at this point.

Peter James Heckmann

D.A. Davidson & Co., Research Division

And then just in terms of your new production facility in Indiana, can you talk a little bit about how that process is coming and when you would expect to go live? And then if you could, I don't think you've done this in the past, but if it's possible, if you could maybe quantify a little bit about that additional volume commitment you received from that customer and when we might see that start to hit in results?

John D. Lowe

President, CEO & Director

Hello, Pete, good to talk to you. I'll let Jeff talk about kind of Indiana and capacity. And on the customer contract side, the one we locked into in Q1, just as a reminder, that's a 6-year deal, commitments that really ramp in '25 and the outer years. This year was kind of the start to it. So we continue to strengthen our relationship with that customer, and it's a good way for us to win share, and we're excited about it. But I don't really want to comment on the performance quite yet, given it's a 6-year deal. That said, Indiana, we're excited about it. I think as I understand it, we've got walls up and a roof on. So we're slowly getting it up and running. I think it's mid next year before it's starting to be operational. But Jeff, do you want to comment?

Jeffrey A. Hochstadt

Chief Financial Officer

Yes, Pete, it will be -- like John said, we broke ground and walls are up. We should be in by the end of 2025. We did say previously that the cost of -- the whole cost of the facility will be about \$20 million. We think that will be a cash flow impact for the first 2 years of about \$13 million, \$12 million to \$13 million. So that has increased our CapEx this year. We are increasing our footprint in Indiana. We're doubling our footprint in Indiana. And that overall is about a 10% increase in our overall footprint company-wide. So it does -- it will increase capacity over time.

And another note is we're buying new equipment. We're investing in automation. So not only do we have more capacity, but our throughput should be more efficient with new equipment and automation. So we're really excited to get that up and running next year.

Operator

Your next question comes from the line of Hal Goetsch from B. Riley Securities.

Harold Lee Goetsch

B. Riley Securities, Inc., Research Division

On the sales growth, you were lapping you had 25% growth in product sales, lapping a minus 22%. So really just kind of getting back to where you were maybe at 2022 levels. Could you give us a little color on how much of that is normalization of existing customers and how much of that is potentially new programs? Kind of what's the composition of the growth kind of year-over-year?

John D. Lowe

President, CEO & Director

Yes. I'll give you a high level, Hal, and good to talk to you, and then pass it off to Jeff. But if you go back to 2022, I mean, that was a record year. That was predominantly driven by payment card sales, right? I mean that was when the market had extremely high demand and drove our Secure Card business to have significant growth. And ultimately, we had a nearly 30% year-over-year growth in that year. If you look at this year, while year-over-year in Q3, card sales were strong, right, and our volumes have been increasing progressively through the year, we're still not necessarily at the levels that we were in '22 and still have enough of ways to go, if you will, from an inventory rebalancing perspective. So I think the other areas of our business, think of our Instant Issuance business, it's grown since '22. Our Personalization businesses are performing strong. And if you think about our Prepaid business, that's performing really well in 2024 about that as well. But Jeff, do you want to?

Jeffrey A. Hochstadt

Chief Financial Officer

Yes. I think you're right in the sense that it's coming back. But also we've seen some really strong sequential growth from Q1 to Q2, Q2 to Q3. So as John mentioned at the outset of the call, our second highest quarter ever. So we're -- like John mentioned earlier, the rebalancing is still going through the system, but we feel like the other parts of our portfolio are also performing at high levels. So we feel some good momentum.

Harold Lee Goetsch

B. Riley Securities, Inc., Research Division

So what to say, would you say it's mostly existing customers or some new -- a mix of both?

John D. Lowe

President, CEO & Director

Hal, it's a great question. No, we are winning new customers in the market across the portfolio.

Operator

As there are no further questions in queue, I would now like to turn the call back over to John Lowe for closing remarks.

John D. Lowe

President, CEO & Director

Okay. Well, thanks, operator. Thanks, everybody, for joining the call. I want to again acknowledge and thank all of our CPI employees for everything they do for our company and our customers as they execute on our vision, values, and strategies every day and continue to drive our business forward. Thank you all for joining our call this morning, and we hope you have a great day.

Operator

This concludes today's conference call. Thank you for your participation. You may now disconnect.

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