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PulteGroup, Inc. (PHM)

J.P. Morgan Homebuilding & Building Products Conference

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Michael Rehaut

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MANAGEMENT DISCUSSION SECTION

Michael Rehaut

Analyst, JPMorgan Securities LLC

Good morning. Welcome to Day 1 of the 16th Annual JPMorgan Homebuilding & Building Products Conference. My name is Mike Rehaut. I'm excited to start off the day. We have a great two-day agenda, 18 companies across our universe, eight homebuilders, one land developer and nine building products companies.

We're thrilled to start off the day with Pulte Group. CEO, Ryan Marshall's with us, along with VP of Investor Relations, Jim Zeumer.

The format of the conference will be predominantly fireside chat. I'll start off with a series of questions. This is about a 35-minute session. And if you would like to ask a question, there is an ability to do that through the conference portal. You can click on the Ask a Question icon and those questions will be fed to me, and we'll go from there. Hopefully, there'll be enough time for everyone to ask and get answered.

QUESTION AND ANSWER SECTION

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

So I'm going to kick it off again with Ryan and Jim. And I think the first question that most people are interested in is just, to the extent possible, any update on demand trends. How do you characterize – and I guess, specifically, there's been a lot of talk obviously in the last month or two, or three even, about the somewhat of a return of demand to the marketplace, not coincidentally alongside rates stabilizing, even pulling back a little bit, which is very typical. Curious, number one, Ryan, would you characterize the recent improvement in demand as being consistent with seasonality or do you feel like it's something a little stronger than normal at this point in time and the year?

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

Yeah. Mike, so maybe I'll start with. We've not given any kind of market commentary update since we released earnings a few weeks ago. So just maybe as a kind of housekeeping item. A lot of my comments will kind of refer back to the comments that we gave then.

We did talk, Mike, that the – through the third week of April, which is when we released earnings for the first quarter, that we were continuing to see a really strong build of momentum coming out of the first quarter and into the first two or three weeks of April.

So with that being said, I think if we look at some of the fundamental drivers of that strong demand, those same drivers are still there. Predominantly, we've got really tight supply, especially on the resale side, which is making the new home opportunity a bigger piece of the total market than it's ever been. So I think it's a real tailwind for the industry.

Rates have continued, I think, to moderate, settle in, and combined with that – that combined with, at least in the case of Pulte Group, a reallocation of our incentives predominantly directed toward interest rate buy-downs that allow a consumer to get into a 30-year fixed mortgage at really attractive rates that are sub-5% on a 30-year fixed mortgage, I think really works to address some of the affordability challenges that we've seen from the consumer.

So, broadly speaking, Mike, we are very confident about the health of the consumer, what the inventory situation is and kind of what that means for our ability to continue to sell homes.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Great. Thanks. And by the way, my enthusiasm of jumping in and starting off on the questions, I should have first said, welcome, and thank you for joining and kicking us off today. So very much appreciate you guys being here and participating. So please excuse my jumping right in there. So...

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

We'll try to do our job like a good leadoff hitter, Mike, and get on base.

Michael Rehaut

Analyst, JPMorgan Securities LLC

That's right.

Q

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

Don't hit me by a pitch or anything like that.

A

Michael Rehaut

Analyst, JPMorgan Securities LLC

No, I don't know. My arms are getting rustier by the day, but I'll try my [ph] best (00:04:31). So I appreciate that, Ryan. And it kind of leads me to my second question around affordability. You mentioned the rate buy-downs and sub-5% is – we've heard more about probably in the mid-5s where the buy-downs have been able to go. Curious on, maybe you can just walk us through, number one, the mechanics of what a buy-down costs, if you're going from, let's say, where the prevailing rate is, I don't know if that's, let's say, for argument's sake, 6.25% or 6.5%. How much does it cost to buy it down to 5.5% or 5%? And maybe just kind of take us through the mechanics of it a little bit.

Q

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

Yeah. Mike, so the mechanics of it are pretty straightforward. We're going out into – we're using our mortgage company and we're going out and we're buying tranches of mortgage commitments in the market. And then we've got an obligation to fill those. So we've effectively created a ladder of tranches of forward commitments at certain rates. There is an upfront fee that we pay to essentially secure that commitment. And then there are some additional incentives that need to be paid on the back end by the individual deal that goes into that commitment.

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So today, with the prevailing rate kind of being in mid-6s, maybe even low 6s, the cost effectiveness of getting to 5% rate, as an example, is the economics are much better for us today than they were 60 days ago. So today, that's – to get to a 5% type 30-year fixed is probably costing us around 5 points, right there in the kind of 5 to 6-point range.

So it's not inexpensive. The biggest thing for us, Mike, is we've been able to reallocate other incentives toward that. So it's not – and you probably saw from our Q1 gross margins and then even the guide that we gave for Q2 on gross margins. It's not having detrimental impact to our ability to deliver outstanding best-in-class gross margins. It's simply been reallocating the available incentives to things that really matter for the customer.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Okay.

Q

James P. Zeumer

Vice President-Investor Relations & Corporate Communications, PulteGroup, Inc.

Yeah. The only thing I might add to that, Mike, real quick is that what we're seeing with the consumers, they're not taking the rate buy-down all the way to 5%, for example. They're actually taking it more to 5.25%, maybe even 5.5% is very common. That gets them sort of their monthly payment. And then they're looking to say, okay, give

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me the rest of the associated incentives on something else. It might be closing cost. It might be I want upgraded floorings. I want better cabinets or countertops or something like that.

So the consumer has a number in mind and they're – we're able to get them there. And it's actually – it's been interesting. It's a little bit higher and kind of the Ryan – what Ryan was mentioning all the way down to a 4.99% or a 5%. I think it's pretty consistent with a couple of the – that John Burns and some others who put some numbers out there that says the sweet spot's kind of around 5.5% in terms of what consumers are looking for.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Right. And so maybe you're talking about 5 or 6 points of total incentives or hit to the gross margin, but those numbers are, again, more or less being fully baked into your current guidance, your current gross margin level.

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

That's correct, Mike.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

So I guess in that context, how would you view today's level of affordability? Because, obviously, I think that's one of still the big concerns that are out there. Affordability metrics are still pretty stretched relative to history. You're seeing a good level of demand where you're able to get those incentives down or add – allow those incentives to maybe make things a little more affordable than people realize. But how do you view the – your current product in that affordability matrix? And is this something where, over the next year or two, we should be thinking about adjustments to price point to even better solve for that affordability equation?

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

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So Mike, the short answer is I think affordability remains on the challenged side. It is – that being said, it's much improved from where we were a year ago. And the markets that were most challenged from an affordability standpoint, I think, those are the markets where you've seen the biggest price adjustments. Some combination of those price adjustments in the really challenged markets, smaller price adjustments kind of more broadly across the United States, combined with the mortgage rate environment stabilizing. I think we're in a workable spot from an affordability standpoint.

Mike, you hit the nail on the head. Historically speaking, affordability and the cost of housing remains too high. And I – but I don't see anything structurally changing as it relates to the supply side of the affordability equation that's going to change that. Entitlements remain very difficult. Land development is taking as long as it ever has. And so there's not going to be an opportunity for a whole bunch of new supply to come on in the market. And we've effectively reduced the amount of available resale supply by 25% to 30% just by virtue of you got so many buyers that are locked into low interest rates, and they're just not willing to give them up.

So through some combination of reduced new home and lower resale supply, Mike, I think supply is going to remain tight for the foreseeable future, which I think provide some stability or some floor underneath home prices generally. And in that time, at least the forecast that I'm seeing here suggests that rates are going to continue to come down. The most recent one that I saw suggested something in the kind of 5.25% to 5.5% for the actual market 30-year fixed rate.

And then if we continue to see some wage inflation, maybe those three levers of asset price plus wages, plus interest rate, we end up into a livable zone when we're talking about affordability.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Right. And in terms of the actual home price, the product that you offer, how would we – how should we think about ASP from Pulte over the next year or two? I mean, is this something where – because some companies have talked about potentially trying to actively lower their average selling price through, over the next year or two or three, adjustments to floor sizes attached versus detached. But anything on the drawing board in terms of trying to actively, if not lower, let's say, bluntly, typical normal increase in ASPs over the next couple of years?

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

Yeah, Mike. We – I think we've done a nice job historically and we continue to focus on this, where when you go into many of our master planned communities, we offer a number of lot sizes. So we'll typically have product that's as small as 30 feet wide will very often offer a 30-foot-wide product, a 40-foot wide product and then a 55-foot wide product, those will go on three different lot sizes.

So the 30-foot wide product, as an example, those are homes that are typically two-bedroom, two-bath or three-bedroom, two-bath, and they're in the 1,400 to 1,700 square foot range. So that product line is always meant to be our most affordable targeted at, in some cases, an active adult buyer that's downsizing, or in the case of an entry-level, first-time buyer, that'll be the first home that somebody buys coming out of an apartment or a rental home.

So I think in our portfolio, Mike, we've got a wide variety of product that's very affordable. To even be more efficient with land values and really stretching those, the residual cost of the land over as many homes as possible, we use town homes. We also, in some communities, will use quads, which are effectively four single-family homes that are all single story.

So we're also – we're using some motor court type products that really leverage and get efficient with the use of driveways. So you've got a shared driveway area between six or eight homes that help to really drive some affordability in some of the high-cost land markets.

So I think from a product portfolio, Mike, I'd put our product line up against anybody in the industry in terms of options that allow us to drive affordability. Beyond that, the consumer has got the ability in our system to choose as much or as little as they want [ph] – if this (00:15:09) they want to from an – if they can afford it or we can make choices on fit and finish and structural options that keep the overall cost down.

And then maybe just the last thing, Mike, we have, over the last four to five years, made a deliberate push to have more of our product line be affordable, first-time entry level. Today, it's 40% of our business. We have – the other roughly 40% is move up and about 20% is active adult.

So we continue to be very geographically focused, but also – geographically diversified, but also diversified in terms of the consumers that we're serving. And with 40% of our business being first-time entry level, that is helping to push our price point further down from maybe where we historically would have operated.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Right. No, that's a good point. I appreciate that. Maybe just switching back to incentives for a moment. Maybe you could remind us where we are in that life cycle or the current cycle rather. Where were incentives plus discounts at its peak, perhaps at some point late in 2022? Where are they today? Where do you think they might be as things continue to normalize?

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

Well, Mike, my view would be most of your price – your downward price adjustments in most markets have taken place. And unless you've got some kind of an odd poor position, poor location, poor product choice, I don't necessarily anticipate seeing any further downward price adjustments. In fact, most of our communities, we're actually seeing price increases. They're smaller in nature relative to maybe what you would have seen 18 months ago, but some combination of small price increases or reduction in incentives, we're seeing prices kind of move up. As we highlighted and talked on our most recent call, Mike, demand is good. And there's such short supply that we are seeing some relief of pricing pressure on the – from the consumer and we're starting to go the other direction.

James P. Zeumer

Vice President-Investor Relations & Corporate Communications, PulteGroup, Inc.

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And Mike, just keep in mind that the timing difference between when we may take a contract and when we're going to close that home. So for example, in Q1 of this year, our incentives were, to use your word in terms of peak, they were still at 6%, I mean, which was up over Q4 and would, at this moment in time, be the highest we've recorded in the recent housing cycle. So you do just have to be mindful of the fact that you've got a quarter, maybe two quarters, even though we're doing a little bit more specs [ph] or the closings, you're (00:18:15) a little bit more real time between when you sign that contract and when you're going to, for purposes of our reporting, realize that incentive.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Right. No, that's a great point, Jim. And maybe this kind of brings me back to the original question. So if you're saying – and part of it was certainly on the trends of pricing as well, which is kind of it's always one side or the other of the same coin. But just focusing on the incentives and discounts, you mentioned 6%, Jim, in the first quarter and I guess that's the high watermark, where are incentives plus discounts trading perfectly on incoming orders?

James P. Zeumer

Vice President-Investor Relations & Corporate Communications, PulteGroup, Inc.

A

We have not.

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

So – yeah, Mike, we haven't provided kind of that data historically on incoming orders. So I'm not going to – I don't want to share that today. I think some of – anticipating where I think you're maybe going with the question is how much is – maybe an easier way for me to answer is how much have prices adjusted from potentially where we peaked.

I think most markets saw price adjustments in the high single digits to roughly 10% range. Those were the types of price adjustments that we saw from peak to where I think things started to firm up again. There were certainly some markets that got way overheated on price, if you went back to the COVID days. And those types of markets, Austin would be in that category, maybe San Francisco, maybe things – markets like Seattle, there's a few of those markets that I think had price adjustments that were certainly much bigger because the price runoff was just that much higher.

Michael Rehaut

Analyst, JPMorgan Securities LLC

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Right. And so those price adjustments, just to be clear, exclude any additional adjustments on increased incentives and discounts.

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

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Yeah. Mike, I think the way I would probably suggest you look at it is when our incentives start to get large, we as a company philosophically pivot to making price adjustments. I think once your available incentives and discounts start to exceed 6%, 7% of your asking price, it's time for...

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Yeah.

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

...it's time to probably go into a price adjustment type situation. So – and look, things are always fluid. Things are changing. But as I mentioned when we started the call, for the most part, what we've tried to do is take the available incentives that we have and we've directed those toward interest rate buy-downs because we just think that's where – that's what's really talking to the consumer right now.

And as Jim highlighted, some go all the way to 5%. We find a lot of consumers settle at around 5.5%, which seems to be the magic number psychologically and financially. And then that still leaves them a little bit of money from the available pool of incentives that we are offering for closing costs or cabinet upgrades or something else that they want to use that money for.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Okay. And is it fair to say that your normalized level of incentives are closer to 2% to 3%?

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

Normalized incentives, yeah, probably closer to 2% to – yeah 2% to 3% is I think a fair range for probably normalized incentives.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Great. Let's switch to some company-specific questions. I think the biggest thing that people have noticed and your stock has had some nice outperformance this year is the relative staying power of the gross margins and it's something that we view as a relative positive and probably, to be honest, part of our overweight rating. We felt that the relative valuation hasn't properly reflected that. And I think you finally started to get some credit for it this year.

Your 2Q guidance gross margins of 27.5% to 28%. I think maybe just a shorter-term question before the bigger picture question around your gross margin approach and your return approach. But how should we think about when you're thinking about the second quarter guidance, any impact of delayed impacts from the softer second half environment, and I'm talking about the lag between orders and deliveries, if the second quarter guidance kind of fully reflects all of the challenges and tougher pricing that we saw in the back half of last year, is there a little bit more to come on the downside or some of those negative after effects either from higher incentives or cost inflation? Just trying to think about the puts and takes on back half gross margins relative to where you are today.

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

Yeah. Mike, without getting too far into the weeds, what I would – I'd probably try and frame it is this. As a company, we've historically had structurally higher gross margins than the rest of the industry. In the COVID era, where I think what we saw is the predominantly spec builders, given the ability to take full advantage of all of the market price appreciation at the time that they went to market with the spec, they were able to catch up and normalize with kind of where we were operating historically.

You're now – in the current environment, I think you're seeing more of a reversion to the way things historically operated, which gave us as a company structurally higher gross margins somewhere in the 300 to 400 basis points higher than the rest of the industry. Today, with our Q1 actual results as well as our Q2 guide, we're 700 to 800 basis points higher than some of our near and large competitors.

So we delivered a great Q1. We've given a great Q2 guide that still shows that the margins are holding strong. And that is reflective, Mike, of all of the parts and pieces of the current environment: current cost, current land, current incentives. And as you've heard us talk about, 60% of our sales over the last kind of two to three quarters have been spec homes. So these are kind of near term for us anyway. There are near-term deals that are selling and closing sometimes in the same quarter. While we still do have a big backlog in the current environment with the consumers' preference to buy spec, specs are a much bigger piece of our overall closing volume than what it historically has been.

So our – while we have not given a full year guide on gross margins, there's just enough – I think there's enough moving kind of pieces more broadly in the market that we just stuck with given the Q2 guide. But we're very kind of bullish on our ability to continue to deliver high gross margins.

I would be remiss if I didn't take the opportunity to say, you've heard from me, hopefully, over the last two to three quarters, we're not going to be margin proud. Volume and throughput are incredibly important in this space. And our number one focus is and will continue to be on delivering high return on invested capital and a big part of that ROIC equation is inventory turn. And so some combination of optimizing margins, which happen to be great, and we're not going to discount just to discount, but we are going to make sure that we're pushing inventory through the system as well.

Our Q1 sign-up number, I think, demonstrated exactly that. We had a pretty phenomenal – even though it was down on a year-over-year basis relative to the peer set, we were one of the strongest performers on year-over-

year sign-up volume change, which I think highlights the fact that we are striking and kind of toeing the line of that balance between price and volume.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Right. No, no, I appreciate that. Got a question from the audience and I want to make sure we have about – I think about eight minutes left for the session. So I just want to make sure that I'll weave in some questions from the audience. The question is your cash flow and growth in equity has been very strong. Is there a floor in terms of how low net debt – your net debt ratio could be on a sustainable basis?

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

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Well, Mike, we're lower than what we typically run at. And I think that's really a by-product of the fact that the cash-generative properties of the business have been so strong. That being said, we've made significant investments into land. We've made significant investments into share buybacks and we continue to pay our dividends.

So we're executing on all four – really all three key elements of our capital allocation philosophy. Our next long-term debt maturities, we have one in 2026, we have one in 2027, I don't necessarily see us changing anything with that in the near term. But as we continue to generate cash, certainly as strong as the business is, you could see the net debt continue to go lower.

But I guess I'd just kind of bring you back to, Mike, I think we're doing all the things that we've promised to shareholders, which is to, number one, invest in our business, pay our dividend and then we've still been able to significantly repurchase – over the course of the kind of 10-year buyback program we've been on, we've repurchased 45% of the company.

So I think we're creating significant value for our shareholders in all three elements of our capital allocation strategy.

James P. Zeumer

Vice President-Investor Relations & Corporate Communications, PulteGroup, Inc.

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The only thing I would add, Mike, is if we had to carry more cash, while Bob O'Shaughnessy, our CFO, would kind of suggest that our balance sheet is being a little bit lazy, I think we've also demonstrated it won't burn a hole in our pocket. We're not going to go out and force it into dirt and over-accelerate into, in terms of share repurchase. We've been pretty methodical on that. So with the idea at the end of the day, because to your point, the potential for very strong cash flows, we'll be very thoughtful. And it gives us an opportunity and certainly gives us a lot of flexibility.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Right. Maybe just going back to product mix and margins. There's obviously been a lot of volatility between spec and to-be-built margins. There's been comments more recently in this past earnings cycle that spec has kind of reverted, at least a couple of companies have noted, the more typical discount to-be-built. At the same time, the demand for spec is probably as strong as it's ever been. So just wanted to, from your perspective, hear about if that indeed is true, if spec homes have kind of reverted to that typical several hundred basis points spread lower

than to-be-built? And how do you think about product mix, if that's the case, around the margins kind of reverting back to those normalized dynamics?

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

Yeah. Mike, we are – we have – we would validate or we'd affirm that spec homes are trading for at a discount to the to-be built. The distinction that I would probably want to point out though, the majority of the spec homes that we're building are in our Centex product, which is our first time entry-level home footprint and brand structure. Those are homes where we typically turn more volume each month relative to our Pulte move-up communities or even our Del Webb communities where we'll sell fewer homes in a community per month.

So while the margins are lower, the volumes higher, the return attributes are still very attractive. And that's what we continue to focus on. But where you started your question, are specs trading at a discount, the answer is yes, they are.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

And I mean, you also alluded to about 60% of your closings today being spec, which is, I want to say, at least 10, 20 points higher than normal. Is that something that we should expect that type of level of spec percentage to persist in the near term and – or over time, would you expect it to revert more – in your own company's approach, would revert more towards your typical mix?

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

A

Yeah. Mike, I would – I think it'll depend on the normalization of the mortgage rate environment. So to your point, we've – historically, our spec sales have probably been closer to 30%. Today, we're at 60%, partly driven by the fact that we're building more entry-level product. And then the biggest driver has been consumers have just had a preference to buy things that are near-term because it allowed them to lock in a known mortgage rate for an affordable amount of upfront fees.

As you got into longer kind of build time, cycle times, it became cost prohibitive or even impossible to lock in an interest rate. So I think that was the big driver of the preference for spec. You'd also layer into that a little bit that the challenged supply chain, where it was creating some real uncertainty around, when is my home going to be delivered because I'm waiting for appliances or I'm waiting for windows or I'm waiting for some of the other things that were in short supply, that part of it's also, I think, largely kind of healed and normalized.

So my guess is over the next six to nine months, Mike, we'll start to see somewhat of a reversion to a more normal spec to-be-built type volume, but the big driver there is going to be stabilization in the mortgage environment.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Right. No, that makes a lot of sense. And I think we're basically just coming up on the 08:50 mark. So I want to keep things on time, at least at the beginning of the day. And so I want to thank you again, Ryan and Jim, for your participation. You guys have actually, I believe, kicked us off on our conference for several years now. So it's always a pleasure to see you and have you participate.

We'll have our next session at the top of the hour with – we're switching to building products. We have the AZEK Company and then followed by Masonite before our first break. Again, thanks so much, Ryan and Jim. Have a great rest of the day. I know you have a bunch of meetings scheduled. So I appreciate your participation and we'll talk to you soon.

Ryan R. Marshall

President, Chief Executive Officer & Director, PulteGroup, Inc.

Okay. Thanks, Mike.

James P. Zeumer

Vice President-Investor Relations & Corporate Communications, PulteGroup, Inc.

Thanks, Mike.

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