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MKC - Q3 2017 McCormick & Company Inc Earnings Call

EVENT DATE/TIME: SEPTEMBER 28, 2017 / 12:00PM GMT

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PRESENTATION

Kasey Jenkins

Good morning. This is Kasey Jenkins, Vice President of Investor Relations. Thank you for joining today's call for a discussion of McCormick's third quarter financial results and our current outlook for 2017.

To accompany this call, we've posted a set of slides at ir.mccormick.com. (Operator Instructions) With me this morning are Lawrence Kurzius, Chairman, President and CEO; and Mike Smith, Executive Vice President and CFO.

During our remarks, we will refer to non-GAAP financial measures. These include adjusted gross margin, adjusted operating income and adjusted earnings per share that exclude the impact of transaction and integration expenses related to the Reckitt Benckiser Foods or RB Foods acquisition and special charges as well as information in constant currency. Reconciliations to the GAAP results are included in this morning's press release and slides.

As a reminder, today's presentation contains projections and other forward-looking statements. Actual results could differ materially from those projected. The company undertakes no obligation to update or revise publicly any forward-looking statement whether as a result of new information, future events or other factors. As seen on Slide 2, our forward-looking statements also provide information on risk factors that could affect our financial results.

It is now my pleasure to turn the discussion over to Lawrence.

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

Thank you, Kasey. Good morning, everyone. Thanks for joining us. Our third quarter performance, led by sales growth, was incredibly strong with results which continue to differentiate McCormick. We drove double-digit adjusted operating income growth and expanded our adjusted operating income margin. That makes 7 consecutive quarters of margin expansion. The strength in our base business drove adjusted earnings per share growth of 9% versus the third quarter of last year.

And our results are not the only great news of the quarter. In the third quarter, we had an important and exciting milestone for McCormick. We announced and then subsequently closed on our acquisition of RB Foods on August 17. This is the largest deal in our company's history. The acquisition strengthens our flavor leadership with the addition of iconic French's and Frank's RedHot brand store portfolio, which are now our #2

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and #3 brands, respectively. This flavorful product portfolio with simple, high-quality, clean ingredients fits perfectly within McCormick as we continue to capitalize on the growing consumer interest in healthy flavorful eating.

McCormick now has leading positions in categories that consumers use most when flavoring fresh foods. Our one-stop shop for condiment, spice and seasoning needs provides our customers and our consumers with an even more diverse and complete flavor product offering. This transaction reinforces our focus on growth, reflects McCormick's commitment to making every meal and moment better and drives significant shareholder value. I will comment more on RB Foods integration and business in a few moments and Mike will also address our updated fiscal 2017 outlook, which includes the impact of RB Foods. But first, speaking of our focus on growth, I'm pleased to further discuss our third quarter results and provide some business updates.

McCormick's strong third quarter results continue our momentum for growth and reflect the effectiveness of our strategies and the engagement of our employees around the world. We are driving both sales growth and significant productivity improvements. We delivered growth in sales and on an adjusted basis, operating income, earnings per share and operating margin expansion. With our year-to-date performance and growth momentum heading into the last quarter of fiscal '17 as well as the acquisition of RB Foods, we're well positioned to deliver excellent financial results in fiscal year '17.

Our strength this quarter, like last quarter, was evident in our top line results. In constant currency, we grew sales 8% for the total company with solid performance from both segments. Base business growth, new products and acquisitions, our 3 drivers of long-term sales growth, were all contributing factors. Incremental sales from acquisitions contributed 4%, including 2% from RB Foods subsequent to the transaction close. Year-to-date, we've grown sales in constant currency 6%.

In the third quarter, we increased constant currency adjusted operating income 19% and expanded our adjusted operating income margin by 140 basis points. These results were led by the higher sales and savings from our Comprehensive Continuous Improvement program, CCI. Both segments on an adjusted basis achieved an increase in operating income and higher operating income margins. Year-to-date, we have achieved 13% constant currency increase in adjusted operating income, above the high end of our guidance and have expanded our adjusted operating income margin 70 basis points.

We are extremely pleased with our third quarter adjusted earnings per share of $1.12, which was 9% higher than the year-ago period. Our strong growth in adjusted operating income drove this increase, partially offset by a higher 2017 tax rate and an increase in interest expense from debt related to the RB Foods acquisition. Overall, our RB Foods adjusted earnings per share impact was neutral as 2 weeks of operating results offset 3 weeks of interest expense. Keep in mind that the year-to-date comparison of adjusted earnings per share for the third quarter includes the unfavorable impact of foreign currency exchange rates.

I'd like to turn next to some business updates. I will begin with highlights from our consumer and industrial segments and follow with some comments on RB Foods. In the consumer segment, starting with the Americas, we grew constant currency sales by 7%, including 3% from our acquisition of RB Foods. Base business growth of 4% was driven by higher pricing, volume and product mix. This growth was a sequential improvement from the growth in the first 2 quarters of the year. In the U.S., our IRI data indicated strong third quarter category dollar growth for spices and seasonings at 7%. During the same period, McCormick's U.S. branded spices and seasonings grew 5%. As in the past quarters, we have continued to have strong growth in unmeasured channels, including club, e-commerce and Hispanic retail chains.

Overall, we continue to see good growth in our spice and seasoning brands in the U.S. market, we've narrowed the gap on market share loss and we know we have more room to grow. Our products remain well-aligned and on trend with consumer demand for flavorful healthy eating. The environment remains dynamic, and we're well positioned to capitalize on these changes through increased brand marketing and commercial resources, a greater focus on customer intimacy and greater product innovation. We're staying relevant with the consumer and have compelling product offerings for every retail strategy.

Our outlook for the U.S. sales of spices and seasonings for the balance of the year remains strong and unchanged from our prior projections. We remain confident in the initiatives we have underway to position us to continue our trajectory of long-term growth. We have several successes in

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initiatives in place, which drive our optimism for the Americas consumer businesses. To name a few, we remain excited and are experiencing strong retail acceptance on our significant second half innovation lineup that we outlined on our June earnings call.

This includes a new breakfast platform and ready-to-serve gravies. We're strengthening consumption of the spices and seasonings in dollars and units and have grown consumption in other areas as well: Kitchen Basics, Simply Asia, Stubb's, Gourmet Garden and McCormick recipe mixes. Canada is also growing consumption in spices and seasonings and recipe mixes. We're increasing brand awareness through our brand marketing investments, and it is paying off. We made successful investments in Grill Mates and the Stubb's. In the fourth quarter, we'll be investing in marketing in support of our new products as well as the holiday season.

We see continued success with our content creation and consumer engagement in the digital space. Just last month, we were recognized for the fourth straight year by L2 Research in their Digital IQ Index. This year, we were ranked third among approximately 100 food brands for effectiveness of website, e-commerce, digital and social media. And importantly, our products remain well aligned and on trend with consumer demand for flavorful healthy eating.

Now turning outside the Americas. In Europe, Middle East and Africa, EMEA, a difficult retail environment has persisted and affected our consumer business. The primary impact is in the U.K., where a challenging retail environment has hindered our performance, driven by a large retailer's reduction of shelf space for food products. During the third quarter, we began to lap this impact versus year ago and saw sequential improvement in that region versus the prior quarter's performance. Additionally, we're building momentum with the new product introductions we mentioned in our June earnings call.

In the Asia/Pacific region, China grew sales with liquid products, the most common way of flavoring in China. E-commerce growth continued to be strong, and we expect this performance to continue throughout 2017. We're also pleased with our performance in India, where sales grew at a double-digit rate. We're also excited about our recent spice mix launch in India. Third quarter sales across the consumer segment were up 5% over the year-ago period in constant currency. With the benefit of higher sales and our CCI-led cost savings, we grew third quarter adjusted operating income 9% in constant currency and expanded our consumer adjusted operating income margin by 80 basis points.

Turning to the industrial segment. We had exceptional performance starting at the top line with 14% constant currency sales growth. All 3 of our regions contributed double-digit constant currency sales growth this quarter. In the Americas, we had broad-based sales growth across the entire portfolio. We continue to benefit from shifting our portfolio to more value-added products, expanded distribution, the increasing trend of consumer snacking and from our customers moving forward with better-for-you products.

A significant part of our volume increase for the quarter was driven by new products. We had successes with new customers and are making inroads with additional restaurant chains. In our branded foodservice business, we had double-digit sales growth-driven by expanded distribution. Together, these successes are driving not only top line growth, but strong profit growth as well.

In EMEA, incremental sales from our Giotti acquisition contributed to double-digit sales growth in the third quarter of 2017. Our integration is progressing well and nearing completion. And we're delighted with Giotti's sales and profit performance. Base sales in the region continued to benefit from winning with our customers through new products, expanded distribution and promotional activities with quick service restaurants. Industrial sales in the Asia/Pacific region, mainly China, benefited from new product and promotional activities of quick service restaurants.

We continue to see positive results from our margin improvement strategy in this segment with the migration of our portfolio to more technically insulated and value-added categories, flavors and branded foodservice. This portfolio shift, including the addition of Giotti, strong brand growth in branded foodservice and growth in flavor, such as savory flavors from Brand Aromatics, has been a significant driver of the increasing adjusted operating income margin in our 2017 results.

And the addition of Frank's RedHot and French's in our branded foodservice business will further shift the portfolio and favorably impact margins. The segment's overall 14% constant currency sales growth, portfolio shift and our cost reduction efforts drove a 44% constant currency increase in adjusted operating income. We expanded our industrial segment adjusted operating margin 270 basis points from the third quarter of 2016.

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Concluding my business updates, I'm excited to discuss RB Foods further. First, the RB Foods employees have built a great business. And we were pleased to welcome them to McCormick. We have begun to selectively integrate the business and drive plans to capitalize on the growth and synergy opportunities. Integration activities are well underway. We have a dedicated team in place executing against our plan to transition RB Foods into our business. Customer response to the acquisition has been favorable as we offer a broader portfolio to meet their needs. Our alignment of the commercial organizations is underway to create a stronger, focused team to deliver on opportunities quickly and aggressively drive growth.

As we gain a deeper understanding of the business, we become even more excited and confident that we will deliver our acquisition plan and meet our performance expectations. This confidence is also bolstered by our strong history of successfully integrating and delivering performance on our recent deals: Brand Aromatics, Gourmet Garden, Kitchen Basics, Stubb's and Wuhan Asia-Pacific Condiments. We've created value, achieved synergies and are obtaining results per our plans. Our strong year-to-date 2017 results include significant contributions from these recent acquisitions.

We were pleased with RB Foods' approximately 2-week contribution to our third quarter results. Like McCormick's base, the RB Foods business is a seasonal one with sales being weighted heavier and operating profits even more so in the fourth quarter. Based on the plans the RB Foods team already had in place, we expect a strong holiday season. As you may know, French's Crispy Vegetables are a holiday tradition. The commercial organization has quickly connected to ensure strong fourth quarter execution. We're excited to have just begun the most profitable quarter for our entire portfolio and look forward to delivering excellent fiscal year 2017 results.

Our enthusiasm for this acquisition and our confidence that the combination of our powerful flavor brands will drive significant shareholder value continues to grow. We're well positioned to capitalize on the opportunities for growth and cost savings. We reaffirm that we expect the transaction to be accretive to McCormick's adjusted earnings per share in its first 12 months with an increase of approximately 5%, excluding the transaction and integration expenses as well as ongoing RB Foods amortization expense. This expectation increases to approximately 10% once synergies are fully realized.

Now let me summarize by restating that we have achieved strong results through the first 3 quarters of 2017. Our base business results continue to differentiate McCormick, and we're excited by our momentum, even more so now with the incremental contribution from RB Foods. We have confidence in our growth plans for the new products across both our consumer and industrial segments, strong brand marketing programs and our opportunities to expand distribution. We're balancing our resources and efforts to drive sales growth with our work to lower cost. Our expected sales growth and focus on profit realization will drive excellent 2017 results as indicated in our updated outlook, which Mike will review in detail in a few moments.

I want to recognize McCormick employees around the world, including those recently added with the RB Foods acquisition for their focus on growth, driving high performance and engaging in our success. It is now my pleasure to turn it over to Mike. Mike?

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

Thanks, Lawrence, and good morning, everyone. I'll provide some additional remarks and insights on our third quarter results, provide an update on our RB Foods financing activities and conclude with the details of our updated 2017 financial outlook. As a reminder, our third quarter results reflect 2 weeks of the RB Foods operations and 3 weeks of acquisition-related financing cost. Overall, the RB Foods impact to the adjusted EPS was neutral in the third quarter.

As Lawrence mentioned, we are very pleased with our strong third quarter results and have good momentum heading into our last quarter of 2017. On a constant currency basis, we grew sales 8%. Acquisitions, pricing taken in response to higher material costs and higher volume and product mix each contributed to the increase as seen on Slide 11. Both segments grew sales with the industrial segment being particularly strong. The consumer segment grew sales 5%, which is a sequential improvement from the first and second quarter growth.

On Slide 12, consumer segment sales in the Americas rose 7% in constant currency with 3% from pricing actions as well as higher volume and product mix on the base business. Pricing actions were taken in response to commodity increases. And the expected elasticity impacts were reflected in volume and mix on this slide.

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Additional sales were driven by new products, expanded distribution and increases in base unit consumption. Drivers of the sales growth include McCormick and Lawry's brand spice and seasonings, Gourmet Garden and Stubb's products and McCormick brand recipe mixes. Partially offsetting this growth was sales weaknesses in Zatarain's products. The acquisition of RB Foods contributed 3% in constant currency growth.

In the EMEA, constant currency sales were down 2% from a year ago. Similar to the first half of the year, the primary decrease was in the U.K., where a challenging retail market continues to adversely impact sales. This included a reduction in the number of Schwartz brand products by a large U.K. retailer, which has been rationalizing its portfolio to gain space for general merchandise. As Lawrence mentioned, we started to lap this impact during our third quarter.

Consumer sales in the Asia/Pacific region were up 3% in constant currency. In China, sales increases were driven by liquid products, including sauces and cooking wines, partially offset by the timing following a strong second quarter. Sales growth in India was led by new consumer pack formats, price management and the launch of spice mixes.

For the consumer segment in total, our third quarter adjusted operating income rose 10% to $140 million. In constant currency, adjusted operating income rose 9% from the year-ago period. The impact of sales growth, CCI-led cost savings and favorable selling, general and administrative costs more than offset higher material costs and higher brand marketing.

Turning to our industrial segment in Slide 16. We had excellent results this quarter in both sales and profit, continuing our momentum from the first half of the year. Starting with sales growth, we grew constant currency sales 14% with increases in each of our 3 regions. Our acquisitions of Giotti and RB Foods contributed 7% of the sales growth.

As shown on Slide 17, we grew industrial sales in the Americas 10% in constant currency with RB Foods contributing 4%. The remaining growth was broad-based and led by pricing actions as well as continued momentum in branded foodservice. Base business growth and new products drove sales increases to both packaged food companies and quick service restaurants.

Sales of Giotti contributed 25% of our 31% constant currency growth in EMEA. The remaining growth was driven by higher volume and product mix and pricing in response to rising commodity costs with both quick service restaurants and packaged food companies. Sales growth was partially offset by the discontinuation of low-margin South African business. We grew industrial segment sales in the Asia/Pacific region 17% in constant currency. The main driver was strong sales to quick service restaurants in the region, benefiting from both new products and promotional activities.

As shown on Slide 20, adjusted operating income for the industrial segment ended the quarter up 43% at $64 million. In constant currency, the growth was even greater at 44%, driven by higher sales, a shift to more value-added products, the impact of our CCI program and lower selling, general and administrative costs. We increased marketing for this segment in support of our branded foodservice business.

Across both segments, adjusted operating income, which excludes the transaction and integration costs related to RB Foods and the special charges, rose 18% in the third quarter from the year-ago period. In constant currency, adjusted operating income grew by 19%. Adjusted operating margin expanded 140 basis points from the third quarter of 2016. Adjusted gross margin, which excludes transaction costs related to RB Foods, was down year-on-year, a 20 basis point decline. This decline was driven by a stronger mix of industrial sales in the third quarter of 2017 than the year-ago period.

Our selling, general and administrative expenses as a percentage of net sales was down year-on-year by 160 basis points from the third quarter of 2016. Leverage from sales growth as well as CCI-led cost savings and favorable employee-related cost during the period drove the decline. We realized this leverage while also increasing our brand marketing $8 million, driven by the U.S. Below the operating income line, interest expense increased $7 million in the third quarter of 2017 from the year-ago period, primarily driven by the debt secured on August 11 for the RB Foods financing.

Turning to income taxes on Slide 22. The tax rate on a GAAP basis this quarter was 24.8% compared to 22.3% in the year-ago period. Both periods were favorably impacted by discrete tax items. We continue to expect the rate for the full year to approximate 28%, which considers the change in the accounting for taxes related to equity awards.

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Despite the unfavorable currency, income from unconsolidated operations was comparable to the year-ago period. The performance of our largest joint venture, McCormick de Mexico, has been masked by the unfavorable currency impact as it continues to perform well with sales in constant currency up 9% year-to-date. Based on prevailing currency rates, we continue to expect a mid- to high single-digit decline in 2017 income from unconsolidated operations.

At the bottom line, as shown on Slide 24, third quarter 2017 adjusted earnings per share was $1.12, up 9% from $1.03 for the year-ago period, mainly due to the higher adjusted operating income, offset partially by higher tax rate and an increase in interest expense. This year-to-year comparison includes the unfavorable impact from currency on both consolidated and unconsolidated income.

We have summarized highlights for cash flow and the quarter-end balance sheet on Slide 25. Through the first 3 quarters of 2017, cash flow from operations was $303 million compared to $322 million in the year-ago period. This decline is driven by the timing of income tax payments and incentive compensation payments related to 2016's financial performance as well as payments related to the RB Foods transaction expenses. We returned $312 million of cash to shareholders through dividends and share repurchases and used $108 million for capital expenditures.

In regards to the RB Foods acquisition, Slide 26 shows an update on our financing activities as well as refined estimates related to onetime cost and amortization expense. First, in August prior to the closing, we completed an equity issuance, secured financing of new debt, including prepayable term loans and senior notes, and kept an investment-grade rating. We expect to deleverage approximately 3x debt-to-EBITDA by the end of fiscal 2020.

By curtailing our share repurchase program and M&A activities and utilizing the expected strong cash flow from the combined businesses, we will pay down prepayable debt. We are committed to returning to our historic credit profile over time. We have paid a dividend for 90 consecutive years with annual increases in the past 31 consecutive years. We are a dividend aristocrat and plan to maintain that status.

Related to our financing activities, our interest expense is estimated to be favorable versus our original expectations driven by lower interest rates. The shares issued were approximately 6.4 million, which was higher than originally estimated. It is important to note that the impact of this share issuance will be different in the third and fourth quarters versus the full year due to the calculation of average shares outstanding.

For fiscal year 2017, we now expect our shares outstanding to be comparable to fiscal year 2016, which is a change from our previous expectations of reducing shares outstanding 2% in 2017. Our current outlook reflects the net impact of the shares repurchased through the first half of 2017, the average impact of the shares issuance in August and the subsequent curtailment of our repurchases. Our increase to annual amortization expense was previously estimated in the $20 million to $25 million range. We now expect this range to be $8 million to $10 million based upon a preliminary valuation of the acquired assets.

And finally, as stated in our acquisition announcement, we expected to incur approximately $140 million of transaction and integration expenses with the majority to be incurred in 2017. These expenses include noncash-related charges related to purchase accounting reflected in cost of goods sold as well as other debt cost reflected below operating income. We now estimate these total expenses will be approximately $100 million. And in the third quarter of 2017, we have realized $46 million, which are excluded from our adjusted results. These expenses are included in our non-GAAP to GAAP reconciliations included on Page 30 of the deck.

Let's move now to our current financial outlook for 2017 on Slide 27. We expect strong growth for the fiscal year 2017 and are updating our projections to reflect our year-to-date performance and growth momentum as well as the RB Foods acquisition. At the top line for the year, we expect to grow sales approximately 9% to 10% on a reported basis and approximately 10% to 11% in constant currency. This implies a fourth quarter increase of 19% to 23%.

We expect to grow fiscal 2017's adjusted operating income approximately 20% to 21% from $657 million in 2016. In constant currency, our estimated rate of growth is 21% to 22%. This implies a fourth quarter increase of 37% to 40%. We are increasing our guidance for gross margin from comparable to 50 basis points higher to 25 to 75 basis points higher than 2016 on an adjusted basis. We expect brand marketing to increase at a high single-digit rate versus previously a mid- to high single-digit rate. And we are raising our cost savings target to at least $105 million from our previous estimates of at least $100 million.

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Reflecting the changes above, we are increasing our guidance range for adjusted earnings per share to $4.20 to $4.24. Excluding an estimated 1 percentage point impact of unfavorable currency rates, this range is an increase of 12% to 13% from adjusted earnings per share of $3.78 in 2016. Based on this fiscal year 2017 range and considering the shares issued in August, this implies an adjusted earnings per share for the fourth quarter of $1.49 to $1.53. This is an increase of 17% to 20% from adjusted earnings per share of $1.27 in the fourth quarter of 2016.

Our 2017 constant currency outlook for adjusted results, sales, operating profit and earnings per share growth is above each of our long-term targets. Our 2017 projection of the transition and integration expenses related to RB Foods acquisitions is approximately $77 million. Our 2017 projection of special charges has increased to approximately $22 million from $20 million mentioned in our June earnings call. In conclusion, we are pleased with our strong third quarter results. And our updated outlook reflects both the strength of our base business and our confidence in the incremental impact of RB Foods.

That completes my remarks. So let's turn now to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is coming from the line of Robert Moskow with Crédit Suisse.

Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

It's great to see a guidance raise of this size, definitely. But I have a couple of questions about RB Foods and how it's going in the first couple of weeks. We're looking at Nielsen data that shows at least in measured channels that the growth rate this year was a lot lower than its normal run rate, and it looks like pretty low single digit. So I wanted to know if you had noticed the same thing or if maybe there's some alternative channels that it's not capturing and whether that had any influence on the 2-week contribution. And then also on gross margin, there was a lot of scrutiny last quarter on your gross margin. And I think a lot of us thought that it would pick up quite a bit in the third quarter. Can you help us break out to the extent that RB Foods helped your gross margin in the quarter? Or was it no impact? Because I would have thought that, that would have been very accretive. Maybe you could help us with those elements.

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

Rob, this is Lawrence. I'm going to start, I'll talk about by RB sales trends, then I'll pass it to Mike to talk about the margin question that you've got. But first of all, this is really early days for us. We have owned the business now, I believe we're in the fifth week. And so we're really just getting into it. The scanner data that's being reported is in line with the trend that we saw in the business going forward. And it reflects the operations of the business before we took ownership of it. We're really more focused on what we're going to do with the business in the rest of this year and going forward. So far, the integration is going really well. We've made -- making tremendous progress. This is something that we've done a lot with other deals. And we are increasingly confident about what we're finding at RB mainly because we're not finding any surprises. Our understanding of the business that we thought we had before the deal closed is being confirmed through our ownership of it. We're pleased with the strength of the fourth quarter plans that they had already put in place. We got our commercial teams together, it's really one of the very first things that we did. And we continue to be positive about the business, which is what's reflected in the outlook. Mike, do you want to talk about gross margin?

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

Yes, well, maybe as we step back and talk about RB Foods' impact on the quarter and as we talk about really from an EPS perspective, there was no impact. The 2 weeks of operating results we had in there from an operating profit perspective were offset by the 3 weeks of the debt financing cost. So it didn't have much of an impact on most of the lines in the P&L. It was slightly positive on gross margin but not a whole lot. Our guidance for the year though, we've raised our gross margin target from 0 to 50 basis points to 25 to 75 basis points. So that's where you see, especially in

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the fourth quarter, that will be coming through. For the base business gross margin, in the second quarter, we were down 80 basis points. And if you remember, we talked about the FX transactional impact hitting us hard in the second quarter. That has eased in the third. And you'll see it ease even more in the fourth as FX rates continue to go our way. If you look at the gross margin in the third quarter, we're actually only down 20 basis points, so you had sequential improvement. And that was really driven by some of the segment mix, where industrial constant currency sales were up 14%. Consumer is still strong, up almost 5%. But you have some negative segment mix there. But overall, fourth quarter for the base business, we think, there's really strong plans from a CCI perspective, which we raised on this call. Our pricing is fully impacted in the fourth quarter and continued FX favorability will help us.

Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. Maybe just one follow-up. Is your gross margin in the consumer business from a core standpoint, is that kind of flattish? Because -- and therefore, if we're seeing dilution in gross margin, it's really just mix? Or is gross margin in consumer weak as well?

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

We really only talk about it at the adjusted operating profit level, Rob. And you could see from our disclosures that both consumer and industrial were up nicely this quarter. Our CCI efforts go against both cost of goods sold and SG&A, too, so -- and as you know, we have some components that other companies have in cost of goods sold and SG&A, like freight and distribution, which makes it a little bit messy. But both segments saw strong operating margin improvement this quarter.

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

If I could say something else about margins, and that is when we spoke on our second quarter call, we talked about there was still some pricing action to come in response to the raw material cost increases. All of that pricing action was taken in the third quarter and is fully in place. So we got the full impact of cost in the third quarter but only a partial impact from the pricing, which like I said is now fully in place for our strongest quarter of the year.

Operator

Our next question is from the line of Alexia Howard with AllianceBernstein.

Alexia Jane Burland Howard - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

So I've got a couple of quick question. Firstly, on the industrial business, it seems as though there was a big surge in profitability this time around, I guess, partly because of the operating leverage and the cost-cutting and maybe better mix. Is that something -- have you just taken the business to a whole new level and we can expect this to be the new sort of base going forward? So that's the first question. And then on the e-commerce side, it sounds from your comments, I guess, recently as though e-commerce is growing phenomenally well for you at the moment. How concerned are you with the Amazon acquisition of the 360 -- or Whole Foods and hence, the 365 brand? How do you expect that to play out over time? How confident are you that your market share online and your profitability online is going to be at least as good as in the base business?

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

Sure, Alexia. So we've been talking for the last 2 years about the work that we're doing on the industrial business to shift the portfolio towards more value-added and technically insulated into the portfolio, which would include flavors, seasonings and also branded foodservice. And we've made a number of investments there. And some of them are quite visible externally, like buying Brand Aromatics and Giotti flavors, others may be less visible on the outside but are quite significant on the inside. We've had important customer wins on the flavor side of the business. And so

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that has been an area of focus that is, we believe, is going to drive a long-term improvement in the margin. And I know we've talked about that at like the investor conference and on other calls. And I will say it is lumpy. And so the industrial business does not come in a straight line, sometimes it comes in chunks. But that would be -- I think when you about the trend in that business, this is representative of the level that we're trying to take the business to. And I'll let -- Mike, if you want to comment on that further, I'll let you chime in. On e-commerce, you are right. That is an area that is growing tremendously. We have over-resourced e-commerce for the last several years because we just believe that it's inevitable that, that's going to be an important part of the consumer buying behavior. We just don't believe that consumers long term are going to buy groceries any differently than they buy other product. So we've leaned in pretty hard on e-commerce. We've got some external recognition about it. You mentioned a particular customer. We are trying to get away from talking about that particular -- whose name I am not even saying, that particular customer specifically on the call. That has been our policy of not to talk about specific customers in the last several quarters just because of the focus on e-commerce, a very large e-commerce customer keeps coming up by name. And so we're going to try and get away from that. But I will say that we're really positive about the trend line in our e-commerce business. The fact that we've got in there early with important e-commerce customers, that's given us a great partnership. If you try out some of these home devices for ordering and ask about ordering spices, you're going to find out that McCormick items come up at the top. And so we see more opportunity than risk, frankly.

Operator

Our next question is from the line of Ken Goldman with JPMorgan.

Kenneth B. Goldman - *JP Morgan Chase & Co, Research Division - Senior Analyst*

One quick one for me and then a broader one. I just wanted to make sure I had my arms around all the special charges. In particular, there's that $15.4 million of transaction and integration expenses included in other debt cost that I think we're excluding. Is all of that debt issuance? Is there anything else in there? I'm just trying to get a sense of what's being excluded because I know there's a lot of different moving pieces.

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

This is Mike. Yes, that was the cost setting up the bridge. We didn't have to fund the bridge, which is one of the -- we've got our debt financing in place, so that's one of the reasons that number wasn't higher. But that is exclusively related to setting up the bridge.

Kenneth B. Goldman - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. And then it doesn't seem in the numbers that the answer is yes. But have you had any difficulty at all passing along some of your cost inflation to some of your retail customers? And I know the business you're in is quite different. I know you have tremendous brands. So again, the proof would suggest that the answer is no. But some of your competitors or peers rather in the food group have suggested that they have had more pricing pressure lately or difficulty passing it on. So I just kind of wanted to ask your take on that if you've seen any increased challenges along those lines in the last few months.

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

Yes, Ken, there's always a healthy commercial tension and discussions about pricing with the customers. And so I'm not going to say that it is easy. But I will say that we've really gotten it all in place and largely on schedule. We did have a real cost basis for taking the actions that we did. It's very clear to the customer. And in particular, all of their alternatives frankly either had to go up as well or were not able to supply. So we were able to get all of the pricing away. And really, it's actually a rearview mirror thing at this point because the pricing actions that we intended to take were executed in the third quarter.

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Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

And they were primarily -- as you remember, we had 2 large commodity shocks with vanilla and garlic. So those were very well-known shortages of supply. Other suppliers couldn't supply vanilla, for example, so in those cases very well documented. It wasn't an across-the-board price increase, which in this environment is really difficult.

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

I'll also say that we've taken several moves on vanilla. The cost of vanilla beans has moved from single digits per pound to well over $200 a pound. And so that's been well understood in the industry, and so the price increases have been accepted. We also modeled a considerable amount of consumer elasticity. And some of the increases we took last year, we saw elasticity that might have been a bit higher than we thought as consumers got used to the higher levels of pricing. But right now, we're actually seeing less elasticity than we had modeled.

Operator

Our next question is from the line of Brett Hundley with Vertical Group.

Brandon Groeger

This is actually Brandon Groeger on for Brett Hundley. The press release noted the industrial business benefited from new products, it expanded distribution, customer intimacy. I was curious where the company is on the computation on creativity program for its industrial business. It's been said earlier in the year that commercial application might be ready by the end of the year. I was wondering if that was still the case and what the biggest value of the program is. Is it more to engage companies in becoming partners with McCormick? Or is it more related to innovation timing and competitive success?

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

I have got say this is the first question on this topic that we have gotten, and it's fantastic. This is a game-changer that we are very proud of. I think at our Investor Day, we talked about this externally for the first time at any depth. And we said we would be putting it into use. We are actually -- we actually do have the system up and running with one particular customer right now. I don't want to say too much about it just yet other than it is very exciting. We intend to talk quite a bit more about this next year at one of the major investor conferences.

Brandon Groeger

All right, that's helpful. We'll look forward to that. And then quickly if you could, can you put any more parameters around the revenue and synergy opportunity related to RB Foods? I'm thinking about Frank's. What does it take to get that to a 5% share globally or a 10% share globally? What's realistic? And can you leverage your experience and how long it might take to actually start seeing some material sales growth abroad? We see real opportunity related to it, just kind of looking for some more color on how it all comes together.

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

So I mean, I'll talk about the cost side, then we'll talk about revenue synergy in a second. Obviously, the cost side, we laid out the synergy level at $50 million, which we feel comfortable with based on our historical performance with our acquisitions and our CCI program and in the cost of goods sold areas, like procurement obviously or in SG&A across the business. On the revenue synergy side, I mean, you're reading from our playbook. We did see a lot of -- one of the challenges for RB Foods in the U.S. was growing internationally. They really couldn't utilize the resources globally. So we have a global infrastructure with over 40% of our sales outside the U.S. So we do see a runway for growth there that (inaudible) in U.K. and Latin America, but China, other areas of APZ, bringing those products both on a foodservice and a consumer side.

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Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

I'll just add to that, that our financial model was not dependent on growth in the international business. We did model growth in the international business, and we saw it as an opportunity. But the bulk of the financial return has to come from performance in the Americas. And our growth internationally is really upside to that model to justify the deal in the first place. We see the opportunity to make Frank's RedHot the #1 hot sauce in the world as a very real goal.

Operator

Our next question is from the line of Dave Driscoll with Citi.

David Christopher Driscoll - *Citigroup Inc, Research Division - MD and Senior Research Analyst*

Wanted to ask you guys just one kind of big-picture question, if you could just simply state what is the different pieces that have gone into the guidance change today. Because I'm getting a lot of questions about the impact of the acquisition and kind of the real improvements that we've seen in industrial and the gross margin changes. But I'd just like to hear it from you, how do you guys think about the increase in guidance both top line and bottom line? And really just what are the factors driving the increase today?

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

David, that's a great question. This is Mike. And really, I mean, like I said before, the RB business didn't have much impact in the third quarter. It is going to have a nice impact on the fourth quarter. But our core -- what we're really excited about is our core business. Through the 3 quarters, you can see the numbers on a net sales adjusted operating profit and EPS, very strong. Our guidance before on EPS was $4.05 to $4.13. This is when the time of the year we'd normally narrow the range. And given the fact that we're over -- we're at or above our net sales targets or in guidance, our operating profit, adjusted operating income guidance for the year were above that and at the high end of our EPS range. The core business, we would have brought that up into the -- at the top of the range. So you could model that at $4.12 to $4.14. You can then do the math. But the remainder of our call-up was due to the RB Foods business impact in the fourth quarter. The key point of RB Foods, it's a very seasonal business. 30% of the sales are in the fourth quarter, higher margins in the fourth quarter just like our businesses at McCormick. A lot of the holiday items have a higher margin, which is good for us. So there is a nice impact in the fourth quarter for us. The interest expense, as you know, happens on a quarterly basis, [25, 25, 25]. So that extenuates the RB impact in the fourth quarter this year. On top of that, too, we issued shares for this thing, as you know, 6.5 million shares. Based on the average shares outstanding calculations, only about 1/4 of that gets into this year, but the whole impact is into next year. So what you see is while we're still saying it's 5% cash-accretive over a 12-month first year basis, that's pulling some of that into the fourth quarter. So it's a little lumpy, but we're really pleased. And I hope I gave you kind of the color behind why the fourth quarter -- what our full year call-up is. But I want to also emphasize the core underlying business is doing very well.

David Christopher Driscoll - *Citigroup Inc, Research Division - MD and Senior Research Analyst*

And then just one detailed follow-up, I believe you said in the script that the amortization expense for the RB Foods transaction was reduced by, I think, more than half. Can you just say what happened there to cause that revision of that magnitude?

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

No, there were a couple of things. Obviously, on an acquisition this big, you use a lot of external people to help value things. A couple of things, we have had initially when we thought there'd probably be a value on a non-compete with the previous owner. But based on analysis and the understanding, we didn't have to put an intangible value on that. Also I think some of the other assumptions on the values of some of the brand tangibles or customer relationships and things like that moved around based on some of the modeling we did. So we're a little conservative, I think,

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overall on that. But we wanted to make sure we corrected that. As we learn more and more about the business, too, and as Lawrence said that we've only owned it now for 6 weeks. And that is a preliminary evaluation, too, as my controller is thinking right now, so wanted to make sure. But $8 million to $10 million range is a good estimate for now.

Operator

Our next question is from the line of Adam Samuelson with Goldman Sachs.

Adam L. Samuelson - *Goldman Sachs Group Inc., Research Division - Lead Analyst*

So maybe following up on David's question on kind of the base business, and I appreciate some of the kind of commentary that you would would've had your base guidance kind of move into like $4.12 to $4.14 range or so based on the year-to-date performance for the organic. Would your base business sales expectations have actually changed? Or have they changed? It's somewhat unclear based on the revised guidance.

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

They'll be at the high end of the range.

Adam L. Samuelson - *Goldman Sachs Group Inc., Research Division - Lead Analyst*

Okay.

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

Yes, they'll be at the high end of the range on the base business. Then if you do the math, they'll seem to have a really good fourth quarter. And a strong fourth quarter, really when we talked in the past, back half of the year, we're going to have a strong new product sales, a lot of launches in the U.S. market with liquid gravies and our breakfast platform. If you look at industrial last year, it was a little weak. We're expected a strong fourth quarter there. And we're lapping EMEA consumer, some of that challenge we had earlier in the year. So we feel strong it's sales on the core business in the fourth...

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

I wouldn't underestimate the sequential improvement that you're seeing in our sales also because we're up -- these are not up against soft comparisons, these are up against strong comparisons from a year ago.

Adam L. Samuelson - *Goldman Sachs Group Inc., Research Division - Lead Analyst*

Right. And that was kind of the follow-up there was the understanding there's a mix between the different businesses. And so is it both consumer and industrial? Or is it just the confidence on some of the new product launches and momentum into the holidays on the consumer side, specifically in the U.S. and maybe the comps on EMEA?

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

It's confidence on both of our segments, so it's pretty -- it's broad-based.

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Adam L. Samuelson - *Goldman Sachs Group Inc., Research Division - Lead Analyst*

Okay. And then in the industrial business on the margin side, clearly some very sizable year-on-year margin gains drove a lot of the corporate EBIT growth. Can you help us think about the drivers -- some more drivers, just the Giotti mix and just the customer acquisition, raw materials? I mean, just help us think a little more of the variances there because it's a sizable increase in that business.

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

Yes, I mean, it's all the above. I mean, we talk about Giotti, as we talk about our strategy of moving up the value chain, higher-end flavors do help us, the strength of our branded foodservice business, which is a higher-margin business. And we did have, again, we talked about strength in North America for that, so that helps us. A combination of CCI initiatives across both business has helped. It seems like a big number, but it's all the above. And they seem to be firing on all cylinders now. It is lumpy. As Lawrence said, you've got to be a little careful to project forward all these great results. But they've had a good couple quarters now. We feel confident with the visibility to the new product pipeline and the margin-increasing activities that we'll continue that...

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

And I want to be clear that a big driver, especially over -- taking the quarter out of it but thinking long term is the portfolio shift. There are different categories, more value-added than others. We've really focused on the more value-added areas that have these technology as an element or our branding as an element to create value.

Operator

Our final question is a follow-up from the line of Robert Moskow with Crédit Suisse.

Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

Actually, for Mike, I think you were trying to be very clear that the fourth quarter for RB Foods will provide a lot of that first year accretion. It's about $0.11 is the implication. And I think that if you go by this 5% kind of accretion guide, that would -- I think that's about $0.20. So can I assume that the difference there, this extra $0.09, would help your normal algorithm for 2018 kind of something a little extra to your normal algorithm for '18? I know you don't want to give '18 guidance but can't blame you...

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

Yes, I don't want to give it -- you're right, you're correct, Rob. And I'd be a little careful, I mean, that you went to the $0.11 number. Because if you do the math, it's actually $0.07 to $0.11. You can arrange the RB impact based on what I said. But similar to ours, it has seasonality the first quarter, just like our business is the smallest of the year. But you're right. We're going to get to that 5%. What you have to model in is getting -- we're going to have 133 million shares outstanding all of next year. The math and the way it works this year is like 128.5 million or so. So you're getting that a little bit headwind in these first 3 quarters and actually the whole year from this. So just remember that.

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

Yes. But I don't want to lose the thread that we talked about 5% accretion. As we've got it and we saw no reason we're going to miss that 5% accretion. And that was 5% accretion over the first 12 months, not of fiscal '18. So this quarter and the first 3 quarters of '18, this is as much guidance as, I guess, we're going to give on '18 at this point. But those things -- that time period is what we said we were going to get 5% accretion. And we still believe we're going to do so.

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Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

Just mathematically though, it's got to help.

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

The CEO should not be talking about accretion. I'm going to let -- give it back to Mike.

Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. But mathematically, it's got to help you in '18 just in terms of the numbers.

Michael R. Smith - *McCormick & Company, Incorporated - CFO and EVP*

Definitely, yes, there's no question. It's incremental to our base business. You're right. It plays a little bit with the percentage growth rates. And remember when more shares are coming through, the 6.5 million shares full impact does create a little bit of headwind on the percentage growth basis from a bottom line.

Operator

At this time, I will turn the floor back to Lawrence Kurzius for closing remarks.

Lawrence E. Kurzius - *McCormick & Company, Incorporated - Chairman, CEO and President*

Well, thanks, everyone, for your questions and for participating in today's call. McCormick is a global leader in flavor, a growing and advantaged business platform, which is now even broader with the addition of the RB Foods. We're continuing to capitalize on the global and growing consumer interest in healthy flavorful eating, the source and quality of ingredients and sustainable and socially responsible practices. We're aligned with the increased demand for great taste and healthy eating and are confident in our growth plan. With a steadfast focus on growth, performance and people, we're building value for our shareholders and are well positioned to deliver even stronger financial results we've outlined today for 2017.

Kasey Jenkins

Thank you, Lawrence, and thanks to everyone for joining us today. If you have any further questions regarding today's information, please give us a call at (410) 771-7140. This concludes this morning's conference call.

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