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EDITED TRANSCRIPT

UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

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OVERVIEW:

Co. reported 1Q20 sales of \$18.2b and GAAP loss per share of \$0.10.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Raytheon Technologies First Quarter 2020 Earnings Conference Call. My name is Ashley, and I will be your operator for today. As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the call over to Ms. Kelsey DeBriyn, Vice President of Investor Relations. Please proceed.

Kelsey DeBriyn - Raytheon Technologies Corporation - VP of IR

Good morning, and welcome to the Raytheon Technologies First Quarter 2020 Earnings Conference Call. With me on the call today are Greg Hayes, our Chief Executive Officer; Toby O'Brien, our Chief Financial Officer; and Neil Mitchill, Corporate Vice President, Financial Planning and Analysis and Investor Relations.

This call is being carried live on the Internet. And there is a presentation available for download from Raytheon Technologies website at www.rtx.com.

Please note, except where otherwise noted, the company will speak to results from continuing operations, excluding restructuring costs and other significant items of a nonrecurring and/or nonoperational nature, often referred to by management as other significant items.

Before we get started, just a few comments on the structure of the business and our leadership team. Concurrent with the merger, we realigned the segments to create 4 industry-leading businesses: Raytheon Intelligence & Space, led by Roy Azevedo, is a combination of the legacy Raytheon Intelligence, Information and Services and Space and Airborne Systems segments. The second, Raytheon Missiles & Defense, led by Wes Kremer,



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

is the combination of the legacy Raytheon Missile Systems and Integrated Defense Systems. Third is our Collins Aerospace business, which is now led by Steve Timm. And finally, Pratt & Whitney, which is led by Chris Calio.

When we speak to Raytheon Technologies' overall results for the first quarter, we will be referring to United Technologies stand-alone, including Carrier and Otis, while speaking to Raytheon Company's company level results separately. At the legacy Raytheon Company business unit level, we will be speaking to each segment on a pro forma basis as the go-forward Raytheon Technologies businesses.

The company also reminds listeners that the earnings and cash flow expectations and any other forward-looking statements provided in this call are subject to risks and uncertainties. RTC's SEC filings, including its 8-K, 10-Q and 10-K, provide details on important factors that could cause actual results to differ materially from those anticipated in the forward-looking statements. (Operator Instructions)

With that, I will turn the call over to Greg.

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

Okay. Thanks, Kelsey, and good morning, everyone. So just a few things going on, and I recognize this is -- it's a little bit confusing. But before we get started, let me just -- one logistical item to cover here. So everybody knows we completed the spins of Carrier and Otis on the 3rd of April, concurrent with the merger with Raytheon, which created Raytheon Technologies. But since the transaction occurred right after the close of the first quarter, the Carrier and Otis results are, of course, included in our numbers for Q1. However, we're not going to discuss that today because they're going to be holding their own earnings calls later today, and then again, tomorrow morning for Carrier. So our commentary today is going to only cover the New Raytheon Technologies which, of course, is simply a focused A&D company.

So with that, if you turn to Slide 2 in the webcast. Let me just begin my remarks by talking about the COVID-19 pandemic and what we're doing to fight or help in the war on the pandemic. First, let me just thank our team, and particularly those of the production lines who are supporting our customers worldwide. I also hope that you and your families are safe. To put this in perspective, we have about 195,000 employees at Raytheon Technologies. Roughly 95,000 of those folks are working from home today. And the other 100,000 are coming to either the office or to the factories to support our customers.

And again, I think our -- just to keep in mind, our top priority is to ensure the health, welfare and safety of all of our employees. And so we're focused on making sure we do everything we can and to implement best practices. We're of course, deep-cleaning our facilities daily between shifts. We're temperature-scanning our employees upon entry. We're rotating shifts for social distancing and providing appropriate personal protective equipment for employees that can't work from home. Preliminary cost of that was going to be about \$0.08 to \$0.10 for the year. Most of those costs will be incurred throughout the rest of the year. It's a necessary expense, however, to ensure the safety of our folks.

Maintaining business continuity is also essential in order to support our commercial and defense customers during this time as we always do. We'll continue to serve our customers with mission-critical products and services in the U.S. and internationally, and importantly, help them rebound when this is over.

To support the frontline workers, we have donated nearly 1.5 million pieces of PPE to health care professionals and the first-responders globally. We're also using our 3D-printing capabilities to manufacture 20,000 face shields per month. And we're working with suppliers to provide parts to support production of ventilators. In fact, our business in the U.K. and our business in Canada have actually come up with designs of ventilators, and we're working with local governments to begin manufacturing.

Supply chain stability, of course, is also top of mind. We've engaged with thousands of our small business suppliers to support them, including disseminating relevant COVID-19 information and working with them to enhance and make processes more efficient.

In terms of the impact on the business, the pandemic has led to unprecedented economic uncertainty and, of course, a huge slowdown in commercial aerospace.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

While both stand-alone UTC and Raytheon began the year with a strong start, it's clear the rest of the year is going to be under significant pressure as a result of the pandemic. Notwithstanding those challenges, however, we expect the rest of the year, Raytheon Technologies continues to be well positioned to deliver value over the long term.

At the same time, we're going to take immediate and necessary actions to reduce costs and to ensure we maintain a position of financial strength and market leadership so that we can emerge from this crisis stronger. To that end, we're taking about \$2 billion of cost reduction actions and about \$4 billion of cash conservation actions on the commercial aerospace side. And we'll discuss this in further detail in the next few slides.

Okay. Turning to Slide 3. I want to underline why this merger is even more important given the environment we face. As the world's most advanced A&D systems provider, our portfolio is balanced and diversified against commercial aerospace and defense as well as across geographies. This enables us to be resilient across business and economic cycles, evidenced by strong Q1 defense bookings and a record defense backlog of over \$70 billion at a time when commercial aerospace is facing severe headwinds.

Interestingly, Raytheon had a great first quarter book-to-bill of 1.44 and came into the merger with \$50 billion of backlog. The legacy UTC aero business has had about \$20 billion of defense backlog. So stronger together, clearly.

Our key defense franchises are also well funded. Most importantly, we're well aligned with the National Defense Strategy, which is expected to shape future DoD budgets. And when the aviation market and passenger traffic rebound, and they will, we will be even better positioned to deliver solid growth. Additionally, the scale and complementary nature of our combined businesses allows us to continue to invest for breakthrough technologies for our customers as well as identify opportunities for technology revenue synergies.

With that, just a few highlights from our 4 industry-leading segments. Let me start with Collins Aerospace. So Collins saw a continued capture of synergies in the first quarter with nearly \$60 million, and that's on top of the \$300 million we realized last year. Collins remains on track to achieve about \$600 million of cost synergies. That's from the UTC's acquisition of Rockwell Collins in late 2018. Collins is particularly well suited with its air management interiors business to also provide solutions to the airline industry to further enhance passenger health and safety.

At Pratt, the GTF engine program achieved 2 significant milestones as the first in-service GTF engine exceeded 10,000 service hours. And more importantly, the program reached 5 million revenue flight hours across the combined GTF-powered fleet. Importantly also at Pratt, the Joint Strike Fighter program delivered the 500th production aircraft. We're just getting started with both of these programs. Great future.

At Raytheon Intelligence & Space, during the quarter, the U.S. Air Force awarded RIS the Force Element Terminal Development program. That's expanding our Family of Advanced Beyond Line of Sight Terminal, our FAB-T franchise, to modernize and secure communication terminals on both the B-52 and the RC-135 aircraft.

Finally, our Missiles & Defense business booked over \$2 billion on the Standard Missile-3 IB multiyear during the quarter. Shortly after the quarter closed, RMD was also selected by the U.S. Air Force to develop the long-range standoff weapon, a strategic weapon that will replace the service's legacy air-launched cruise missile. That's a great, great achievement for the company. This franchise will be worth approximately \$10 billion over its lifetime.

I think the most important takeaway, though, is each of these businesses is a leader in their respective markets and are all well positioned to generate significant value over the long term by combining technologies to generate revenue synergies across all of our businesses.

Okay. Slide 4. Fundamental to our success is the strength of our financial profile. And let me be clear, the balance sheet is strong and our liquidity position is solid. Following the merger, we had about \$8.5 billion of cash, net debt of about \$25 billion and a solid investment-grade credit rating. Combine these with the \$5 billion revolver and a new \$2 billion revolving credit facility, and we have plenty of financial flexibility. And that's before an additional \$2 billion or so of proceeds from the previously announced divestitures, the majority of which are anticipated in the second half of the year.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

And as I mentioned earlier, we're taking immediate actions to reduce costs by \$2 billion and preserve liquidity with \$4 billion cash actions. We're reducing capital expenditures in the investments, we've deferred merit increases across the commercial businesses and we're cutting discretionary spending, just to name a few. While many of these measures have been difficult, it is the right thing to do for the business.

We're also on track to deliver the \$1 billion in gross cost synergies that we committed to when we announced the merger last June. We've got a strong execution track record and an excellent playbook from Rockwell Collins and Goodrich acquisitions. And after months of integration planning, our teams are working seamlessly as one company. And we're already executing on a detailed work plan to drive our synergy commitments.

Regarding shareowner returns. As you might expect, we will not be repurchasing shares this year given the current environment. However, we do remain committed to return significant capital to shareowners. As a result, the return of the \$18 billion to \$20 billion that we outlined last June will more likely take place over a 4-year versus a 3-year time frame. We also remain committed to the dividend which our Board approved last week. And we have sufficient cash and liquidity to maintain a competitive dividend even in this very difficult environment.

Finally, before I turn it over to Toby to take you through the results, let me make a comment on how we're thinking about our outlook. Given all the uncertainty in our commercial aero business, we're not going to provide a Raytheon Technologies outlook at this time for 2020. Toby will give you some important information on how we're thinking about the business. And we'll be back later in the year to provide more color as the situation continues to evolve.

With that, let me turn it over to Toby to take you through the first quarter results.

Anthony F. O'Brien - Raytheon Technologies Corporation - VP, CFO & Director

Okay. Thanks, Greg. Moving to Slide 5. As Greg said, in spite of the developing COVID-19 pandemic, Q1 was a good start to the year for Raytheon Technologies. Since the spins and merger occurred on April 3, our reported Q1 results for Raytheon Technologies reflect the legacy United Technologies' stand-alone results, which include Carrier and Otis. Going forward, Carrier and Otis will be reflected as discontinued operations, and Raytheon's legacy business will be included from April 3 onward.

Reported sales were \$18.2 billion, down 1% versus prior year, including flat organic sales and 1 point of FX headwind. Adjusted EPS was \$1.78, down 7% versus the prior year, which you'll recall is above our expectations for the quarter.

Within the quarter, segment profit growth was more than offset by approximately \$0.10 of COVID-19-related charges, the majority of which was noncash within Pratt & Whitney and Collins. Except for interest, below-the-line items were higher versus prior year as expected. On a GAAP basis, EPS was a loss per share of \$0.10, down year-over-year and included \$1.88 of net nonrecurring charges and other significant items, of which \$1.66 related to the portfolio separation charges. \$0.18 from noncash impairments, primarily related to Carrier and Otis and \$0.02 of restructuring.

Just a quick comment on our tax rate in the quarter. You note the reported effective tax rate for the first quarter was 98.5%, which was a result of tax separation expenses. On an adjusted basis, the effective tax rate was 22.4%, which is closer to the effective tax rate that we expect for RTX going forward in 2020.

Free cash flow was better than expected at approximately \$250 million and included about \$700 million of onetime cash separation payments. Total cash separation payments in the quarter were approximately \$1.5 billion, of which approximately \$700 million was reflected as financing outflow principally associated with make-whole payments in connection with the early retirement of debt.

Turning to Slide 6. Raytheon Company, while not included in Raytheon Technologies' first quarter results, had a strong first quarter with bookings of \$10.3 billion and a book-to-bill ratio of 1.44, leading to a record backlog of \$51.3 billion. Net sales were better than expected at \$7.2 billion, up 6.5% year-over-year. Not on the page, but cash flow from operations was also better than expected at an outflow of \$98 million in the first quarter or a \$313 million improvement versus the prior year, a solid start to 2020.

MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

With that, I'll hand it over to Neil to talk through the segment results. And then I'll come back and share a bit about how we see the current environment.

Neil Mitchill - Raytheon Technologies Corporation - VP of FP&A and IR

Thank you, Toby. So starting with Collins Aerospace on Slide 7. Sales were \$6.4 billion in the quarter, down 1% on an organic basis. Commercial OEM sales were down 12%, driven by the 737 MAX grounding and anticipated declines in legacy programs partially offset by new program growth driven by the A320neo, 787 and A220.

Commercial aftermarket sales grew 3% driven by provisioning, which was up mid-teens, and parts and repair, which was up mid-single digit, partially offset by high single-digit declines in modifications and upgrades driven by anticipated lower ADS-B mandate volume. Military sales were up 10%, led by higher F-35 volume. And we also saw continued solid performance in our mission systems, communications, navigation and guidance solutions and ISR businesses.

Operating profit of \$1.1 billion was up 3% from prior year with 80 basis points of margin expansion, drop-through on higher military and commercial aftermarket sales and continued synergy capture of an incremental \$60 million as well as favorable FX and contract settlements in the quarter partially offset by headwind from lower commercial OEM sales and approximately \$40 million in COVID-related charges.

Shifting to Pratt & Whitney on Slide 8. Sales of \$5.4 billion were up 12% on an organic basis. Commercial OEM sales were up 25%, driven by GTF and PW800 deliveries, which were partially offset by anticipated declines in V2500 production and lower deliveries of other PWC engines in March driven by COVID-19 impacts.

Commercial aftermarket was up 4% in the quarter. Growth in the GTF aftermarket was offset by a reduction in legacy shop visit inductions. Pratt & Whitney Canada aftermarket saw growth from higher shop visit content and a customer contract closeout partially offset by lower shop visits. Ramping JSF production continues to drive growth at Pratt's military business. Military sales were up 16% on higher aftermarket sales across key platforms and increased F135 production volume.

Adjusted operating profit of \$439 million was down 2%. Operating profit benefited from drop-through on higher military sales, continued GTF cost reduction, lower E&D and a customer settlement. These benefits were more than offset by higher G&A, which was primarily driven by COVID-related reserves of approximately \$60 million; FX headwind; and the absence of the Q1 2019 divestiture and licensing agreement for approximately \$30 million. Commercial aftermarket operating profit was flat, driven by a customer contract that was offset by GTF and legacy sales mix.

Turning now to Slide 9. I'll talk through the legacy Raytheon businesses Q1 results. As Toby mentioned, while these results are not included in Raytheon Technologies' first quarter reported results, we thought it would be helpful to share how these businesses performed. You will find a reconciliation from the former legacy Raytheon segments to our pro forma new segments in the appendix.

So with that said, starting with RIS. For Q1, RIS sales were \$3.6 billion, operating profit was \$379 million and ROS was 10.6%. Of note, RIS also booked approximately \$350 million on the GPS next-generation operational control system or GPS OCX program. And it's worth mentioning the former Raytheon SAS business grew sales 15% driven by higher volume across numerous programs. Additionally, the former Raytheon IIS business saw operating profit declined \$45 million, primarily due to \$34 million of gains from the first quarter of 2019 that did not repeat.

Moving to RMD. Q1 sales were \$3.9 billion, operating profit was \$573 million, and ROS was 14.9%. At legacy missiles, operating profit was up \$49 million or 26% driven by higher net program efficiencies. At legacy IDS, operating profit was up \$79 million or 31% driven by higher net program efficiencies, including \$35 million from a contract settlement.

In addition to what Greg mentioned, booking highlights in the segment during the quarter also included approximately \$500 million to provide advanced Patriot air and missile defense capability for the Kingdom of Bahrain.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

With that, I'll hand it back to Toby to provide an update on the current environment.

Anthony F. O'Brien - Raytheon Technologies Corporation - VP, CFO & Director

Thanks, Neil. I'm on Slide 10 now. As Greg mentioned, we are clearly in uncertain times particularly for our industry. That said, not everything about our future is unknown. There are several factors we know or are getting comfortable with right now. And there are certainly a number of elements that we're monitoring closely. Let me take you through how we see it today.

First, for some knowns that should serve as tailwinds. We see our defense businesses on solid ground. We have record backlog and visibility to grow our defense businesses over the next few years. Our franchises are well aligned with the National Defense Strategy, which should shape future budgets. And we see demand for our advanced solutions internationally. We have a robust synergy playbook that will utilize to create additional lift from Rockwell Collins acquisition synergies as well as generating the Raytheon Technologies synergies. And as you heard from Greg, we are taking aggressive cost reduction and cash conservation actions in response to the current environment.

Now as I mentioned, we are optimistic about our defense business growth, and our expectations are largely consistent with when we began the year. We are monitoring our defense supply chain and any potential disruptions that can occur. However, we have good visibility into the demand side of our defense business and as a result, have provided a detailed outlook for our RIS and RMD segments in the appendix.

At a high level, for RIS and RMD, we have guided to 6% to 8% sales growth versus 2019 and discussed the ability to improve operating income. As a result of the COVID-19 impacts, we are lowering RIS and RMD sales by \$200 million or a little less than 1%. Operationally and on a full year 2020 basis and for the remaining period of Q2 to Q4 2020, we see no changes to the previous defense outlook provided for legacy Raytheon businesses other than the COVID-19 impacts.

Note, there are a few changes to the way we will report our numbers for RIS and RMD driven entirely by the merger and related accounting, including the stub period, EAC resets and purchase accounting impacts. You'll note that the appendix slide highlights the expected effects these items will have on these segments. It is important to note, the EAC reset is merely a matter of timing and not a permanent loss of profit as the profit improvements will now be recognized over the remaining life of each program.

We are confident in our defense growth in the future. And although we are not providing an outlook for 2021, what I can say is that we are in a strong position to continue to grow these businesses and will not see the merger-related impacts on the accounting beyond next year.

And finally, as you know, defense made up a little less than 30% of sales within Collins and Pratt in 2019. We continue to expect Collins and Pratt's defense sales to grow mid-single-digit organically in 2020 as we discussed at the beginning of the year.

Now for what we're monitoring. As we've discussed, the COVID-19 pandemic clearly has and will continue to impact our business in the aerospace sector as a whole. The year can unfold in multiple ways but will certainly result in significant headwinds for our commercial aerospace segments. We are monitoring several factors that will have a direct impact on the commercial aerospace market, including OEM production levels, airline financial condition, fleet groundings, revenue passenger miles and aftermarket data.

A few comments on these factors. We know that OEM production rates have been significantly reduced. Aircraft fleets around the globe are parked, and IATA's latest forecast estimates 2020 RPMs will be down 48% year-over-year, all of which will have a significant impact on the commercial market in our segments and the commercial aerospace industry as a whole, including our commercial supply chain. While we have and will continue to see disruptions in the supply chain, we are working very closely with our suppliers to ensure they remain financially stable and are able to meet our production requirements.

So let's discuss Collins. While I can't provide an overall view on commercial OE or aftermarket sales and operating profit at this time due to the evolving market conditions, here's what I can tell you. We would expect a sharp deceleration in both OE and aftermarket. On the sales side, we expect OE sales to decline in line with OEM production and airline delivery schedules. Aftermarket is equally as difficult to quantify, but we generally



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

expect sales declines to be in line with RPM declines with a prolonged rebound that does not recover to 2019 levels within 2020. We also continue to expect a point of headwind from lower ADS-B sales.

Moving on to Pratt. As with Collins, we expect a sharp deceleration in both OE and aftermarket. For Pratt OE, we expect our sales to decline in line with our main OEM customers, which is primarily Airbus for our large commercial engines. On the aftermarket side, GTF overhaul activity will continue as we upgrade engines to the latest configuration. However, legacy shop visits are now likely to be down 50% or more over the prior year. As you're aware, Pratt & Whitney Canada was approximately 25% of Pratt's total sales in 2019. Pratt Canada will see a significant sales impact albeit not as large as the expected decline in the large commercial engine business.

With respect to free cash flow, we expect to generate positive free cash flow for the year, which will be driven by our defense businesses. Given the range of outcomes that could materialize within our commercial aero businesses, we would expect these businesses to be about breakeven for the year. And that's despite taking \$4 billion of cash actions this year as we see headwinds at the commercial aero businesses largely due to working capital impacts as we work to ensure the health of our supply base and address under absorption.

The strong operating results in Q1 highlights the performance capability of Pratt & Whitney and Collins Aerospace and is indicative of the potential and growth the segments will see again as we rebound from the temporary market impacts resulting from COVID-19. But for now, there are clearly a number of moving pieces with more unknowns than knowns. We will continue to provide updates as the situation develops and we have a clear understanding of the pandemic's effect on our operations.

As for some Q2 color, as we have already said, we expect sales to be down significantly at Pratt and Collins. We see Q2 operating profit at Pratt to be a loss and operating profit at Collins to be approximately breakeven. And for RIS and RMD operationally, it's business as usual but for the previously mentioned EAC reset and stub period that will impact the results. Finally, we expect adjusted EPS in Q2 to be positive. As it relates to the full year outlook, we will reevaluate our ability to provide our traditional sales, EPS and cash outlook after Q2.

Turning to Slide 11. We have provided you with some information to help with your modeling. You will see our current thoughts on Q2 through Q4 ranges for these line items. Of note, CapEx for Collins and Pratt will now be over \$800 million lower than we expected at the start of the year to help mitigate COVID-19 pressures. Additionally, as far as corporate expenses for Q2 to Q4, approximately \$400 million will be allocated to Pratt and Collins, leaving about \$250 million to \$300 million of residual corporate costs, which primarily relate to LTAMDS, a corporate project for the company.

Lastly, we are making a few changes to the way we measure our results and therefore speak to them externally. We will continue to discuss our sales and earnings on an adjusted basis, consistent with UTC's legacy approach of excluding significant and nonrecurring items with a few changes. Given the considerable acquisition and merger activity, we will be reporting our segment profit, adjusted earnings and adjusted EPS, excluding the noncash net expense associated with amortization, PP&E step-up and parity adjustments. We believe this will provide investors with a better understanding of our results in relation to cash performance.

With respect to our segment operating profit, we will now be allocating the majority of corporate costs to our segments. And finally, we'll reflect the FAS/CAS pension adjustment at RIS and RMD restructuring below segment operating profit in our statement of operations.

Okay. With that, I'll hand it back over to Greg.

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

Okay. Thanks, Toby. I know that's a lot to digest, a lot going on. Let me just maybe summarize it in my own way. I think everybody needs to step back and take a deep breath. I know a lot of change, a lot of uncertainty. At the end of the day, the reason Raytheon and UTC came together were 3 simple reasons: It was technology, it was talent and it was balance.

The technology is self-evident. And I would tell you the talent is also self-evident in the fact that we've got great leaders in our business from Wes to Roy to Steve to Chris. Experienced leaders who know how to work in this challenging environment. We'll do the right thing, as we always would.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

We've also got a great corporate staff. About half of it from Raytheon, half of it from legacy UTC. And again, we've lived through these crises before. And we will support the businesses and some of the very difficult things that they're going to have to do. But at the end of the day, we'll get through this as we always have.

As we think about the remainder of 2020, our priorities are pretty clear. First of all, it's supporting our employees, keeping them healthy and safe, supporting our customers and importantly, our suppliers, also delivering technology and product innovation for our customers. And we've got a lot of work to do on executing on the merger integration and delivering synergies, but we know how to do this.

Throughout our history, we've weathered a lot of challenges. And we'll weather this one and come out stronger on the other side. I remain excited about the future of our company. And I'm confident that the teams we have in place will drive sustainable long-term value creation that will benefit customers, employees, shareowners and our communities.

With that, Ashley, let's go ahead and open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question will come from the line of Ron Epstein.

Ronald Jay Epstein - BofA Merrill Lynch, Research Division - Industry Analyst

Thanks for the complete call and all the info. Just maybe starting off with defense because I'm certain you're just going to get bombarded with commercial questions. When you think about international defense markets, in particular Saudi and what's going on with oil prices, and how important Saudi is to the legacy defense businesses at Raytheon, how should we think about that? And is there any risk to those contracts? And is there any risk to the Middle East, particularly Saudi business?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

Ron, look, there's always uncertainty. When oil is \$20 or \$30 a barrel, obviously, the Kingdom of Saudi Arabia is challenged, as are most of the Middle East customers during this time. At the same time, I don't think peace is breaking out anytime soon in the Middle East. And providing a solid defense posture to our customers over there remains a priority both for the U.S. government as well as for the Kingdom of Saudi Arabia and all of our other customers over there.

So look, I'm -- so it's about 30% of legacy Raytheon business was international and I think it is not all Middle East. It's obviously a big piece in the U.K. we support, we've got the Patriot system in Poland. We've got big operations in Australia. It's not just a Middle Eastern business. It's an important element of it, but it's not the whole thing. So, so far, we have continued to see good cash come in from the Middle Eastern customers during the first quarter, surprisingly even with oil out there. They need the equipment, they want the equipment and we need to help them defend themselves.

Toby, anything you want to add?

Anthony F. O'Brien - Raytheon Technologies Corporation - VP, CFO & Director

Yes. I think the only thing I'd add, Ron, is we're looking at a big award here in Q2 -- late Q2, maybe early Q3. The production for the TPY-2 system for KSA, right, that's on track and it falls in line with what Greg said. The threat environment hasn't changed. The need for our equipment is still there. And then if you remember back, it was -- I'm going to be off 3, 4 years ago, right, when oil was down and same logical type of questions, and we came out of that strong with no implications. And that's how we see this playing out as well.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

Operator

Your next question comes from Sheila Kahyaoglu.

Sheila Karin Kahyaoglu - Jefferies LLC, Research Division - Equity Analyst

Greg, you're right. That's a lot to digest. I realize you weren't guiding, but you gave us a few pieces to pull together. So I think you said UTX aero free cash flow was breakeven. And if we assume Raytheon free cash flow is \$3.5 billion as a baseline because that's what it was last year and UTX generates free cash flow of about \$1 billion stand-alone, does that provide a framework for about \$4.5 billion combined as the bottoming of free cash flow in 2020? Or are there other items like tax pension and working capital to think about?

Anthony F. O'Brien - Raytheon Technologies Corporation - VP, CFO & Director

Yes. Sheila, I think that's probably a little aggressive from the different modeling and the scenarios that we're coming up with here right now. I think what you got to take into account is with these type of volume drops that we're seeing and how they're hitting us all at once, there are significant absorption impacts that we're dealing with and trying to, at least, start to mitigate with the cost and cash actions that Greg mentioned in his opening comments.

And the drop-through margin on this type of volume loss, especially when you look at the entire mix of the business between heavy aftermarket at Pratt, about 50% of their business, about 35% at Collins is aftermarket. When you piece that all together, including the other parts, we're talking about north of 50% type of drop-through. Combined with managing inventory levels with suppliers, right, and ensuring the health of the supply chain, working with customer request on extended terms, we see a little bit more headwind than I think you're thinking there.

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

Yes. Sheila, I think the thing to keep in mind is really working capital. We've got a lot of inventory. Typically, as you know, on the commercial aero side, lead times are somewhere between 12 and 18 months. So even as Boeing and Airbus reduced production schedules, we were not going to be able to take out all of the working capital associated with that. We've also assumed, I would tell you, some slower payments from some of our customers, which will put pressure on cash.

So with all that, I think your \$4.5 billion is optimistic, I would say. It'll be a decent year. We'll be able to fund the dividend, but I wouldn't get too much above that.

Operator

Your next question comes from Carter Copeland.

Carter Copeland - Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense

Greg, I wondered if you could just kind of give us a little bit more specificity and help map to the \$2 billion in cost out. From what we've heard from a lot of other folks, it seems like your production plan now is probably 30%, 40% down on OE, 50%, 60% down on aftermarket. Military is still holding in. Volumes that are down, I don't know, call it, 40% on the year or something like that. Is that about how you're thinking about production? And how do you think about the cost structure and how that \$2 billion maps to that in terms of what's a run rate saving versus a onetime or somewhat temporary cost out? Any color there would be helpful.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

Yes, carter. So look, there's obviously, as you said, a lot of moving pieces here. I would think about it more broadly like this. Think about commercial OE, probably down about 50% for the rest of the year. That's in line with the 48% reduction in traffic that IATA forecasts. Now it will vary by platform, as you look at 737 versus A320.

So we're trying to match OEM production with what the customers, Boeing and Airbus and Bombardier and others, are telling us today. But roughly speaking, you can think about OE down about 50% for the rest of the year and aftermarket down probably in that same range. So those are our big numbers.

Now what are we going to do about it? So Chris and Steve on the commercial side have identified a number of actions. The biggest, of course, is probably a reduction in E&D, about \$450 million. Now it seems like a lot of money. We spend about \$2.5 billion a year on the commercial aero side on E&D, so it's roughly a 20% reduction in E&D. About \$300 million of that is going to come out of Pratt. About \$150 million of that comes out of Collins. So just to give you an idea.

Of course, also, we have stopped hiring. We've put a hiring freeze in place. We've deferred merits. We're furloughing folks, both at the corporate office and across the commercial businesses. Also, we've furloughed people in the factories. And I expect there will be further reductions as we sort through all of these volumes.

The key is we don't want to cut the talent so deep that when the recovery happens, we don't have the right people. So we're trying to be judicious. We're trying to keep as many jobs as we can. And to that end, the legacy Raytheon businesses have 2,000 openings today for folks, and we are actively working to try and take engineering talent and other talent that we've got in the legacy UTX business and move those folks over to programs on the Raytheon side.

So there's a lot of pain to come yet, a lot of very tough decisions ahead of us in terms of production volumes. But just generally speaking, think about 50 and 50, and you're going to be in the ballpark.

Operator

Your next question comes from Robert Stallard.

Robert Alan Stallard - Vertical Research Partners, LLC - Partner

A quick question on the Boeing 737 MAX. Are you guys actually shipping any product at the moment? And as you look forward from here, are you aligning your cost base and capacity in line with what Boeing is saying about production rates heading back over 30 next year?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

So we continue to support Boeing in the return to service for the 737 MAX. The folks out in Cedar Rapids have been doing software turns and continuing to work with Boeing to make sure that we've got a certification standard that FAA will approve here. Right now, I don't believe we're shipping anything today to Boeing. We are aligning with their plans to ramp up production later this year and into next year. Again, the lead time on that, roughly 12 to 18 months.

So we've been on pause here for a couple of months of -- while Boeing has paused production. We'll ramp up as they ramp back up. I think they've probably got plenty of inventory today that they're going to need to work through. So we're trying to match our ERP demand with what Boeing is out there forecasting. But right now, we're -- I think we're pretty well in lockstep across all the platforms, whether it's 787 or 737s.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

Operator

Your next question comes from Myles Walton.

Myles Alexander Walton - UBS Investment Bank, Research Division - MD & Senior Analyst

Greg, I guess timing is everything. I definitely got -- first, a clarification and a question. So Toby, the clarification. On reported margins of the Raytheon businesses as they relate to EAC, I think you said something to the effect of -- the effect would be gone after '21. So just can you elaborate on what that -- we should think about as the margins looking from '21, I guess, into '22 on the accounting side?

And then the real question, maybe for Greg, is on Pratt. In the aftermarket, you could have whole types of fleets retired, accelerated over the next year or so. How much of Pratt's aftermarket is not V2500 at this point?

Anthony F. O'Brien - Raytheon Technologies Corporation - VP, CFO & Director

So let me -- I'll hit the first one, Myles, on the EACs. The EAC reset to 0% complete. That's not purchase accounting, but it's really reflective of the acquisition accounting around the merger and the go forward, right? So effectively, the merger reflects the to-go part of the programs that Raytheon has.

We still expect, just to be very clear, the same types of productivity that historically, on an annualized basis, have been close to 200 basis points, 180, 200 basis points of margin. They're just going to be spread out over the next, call it, 18 to 24 months, given that everything is reset to 0% complete. Post '21, we'd expect margins more in line with what the historical Raytheon business has been delivering, with the same focus on working to improve those and to grow the segment margin contribution from RIS and RMD.

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

So let me try and address the question on Pratt, and again, I'll give you some broad outline. If you think about it, there's really 4 engine families that contribute to the aftermarket. The JT8D for the old MD-80s and such, which Delta is retiring, don't really have a significant impact at all anymore. That's all gone years ago. The biggest obviously is the V2500, as you know, and there's about 7,000 engines that we've sold. About 6,000 of those are still in active service. You, of course, got the GTF, which isn't really contributing much in terms of aftermarket today in terms of profit. There's sales associated with it. And then, of course, you've got the legacy Pratt 2000, which is on the 757, and you've got the legacy PW4000, which powered some of the first 777s, some A330s, et cetera. The V accounts for about 50% of the aftermarket today. The 2000, 4000 roughly, together, was about 1,000 aircraft out there. You're talking maybe 20% or so of the aftermarket for Pratt.

So some of that will go away, some of it naturally. I think as we think about it, those things have been on the decline for the last 10 years. They will continue to decline. We'll see what comes back into service. With fuel prices as low as they are, the need for new aircraft is probably somewhat lessened, and people will probably fly some of the older, less efficient aircraft for a few more years to save on the capital of buying new airplanes, which as -- you'll probably see these things come back into service, although not in the numbers that we saw. So that's all contemplated in this reduction that we've been talking about for the aftermarket at Pratt.

Operator

Our next question comes from David Strauss.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

David Egon Strauss - Barclays Bank PLC, Research Division - Research Analyst

Wanted to ask about what you saw out of the aftermarket in April, maybe splitting it out between Collins and Pratt. And then Greg, can you comment on the -- what all this does, the lower production rates on E320, what that does to the GTF's loss profile balancing? You'll be delivering fewer engines, but you'll also, I assume, be coming down the learning curve more slowly.

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

So on the GTF, obviously, as everybody knows, we lose money every time we ship an engine. And so there's actually good news from the lower production on the GTF. That is offset somewhat by the lack of absorption. So all of the negative engine margin that we would typically see is not all going to flow to the bottom line. You've got lack of absorption. And importantly, you're coming down the learning curve. You're taking 5% to 10% of the cost out every year. That's going to be slower as volumes go down. You don't have the leverage in the supply chain.

So overall, you're probably going to get about \$100 million of pickup as a result of the lower volumes on GTF. But I think that's a -- it's a relatively modest number because of the absorption impact.

I'm sorry. What was the first part of the question?

Kelsey DeBriyn - Raytheon Technologies Corporation - VP of IR

Aftermarket in April.

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

I'm sorry. Aftermarket -- let me just give you 2 data points that I think are indicative of where the aftermarket is going. So Pratt typically gets about 1,000 engine inductions a year for the V2500. And most of those inductions were right about online. We were seeing roughly 80 or so a month, January, February, even into March. April, not so good. There was about 20 -- call it, 25 or so engines inducted into the overhaul shop.

And so we'll see that revenue impact here in the second quarter because typically, as we repair these engines, they consume spare parts. We recognize the revenue. That's going to be the -- probably the biggest place where you'll see the impact.

On the Collins side, again, a similar number. If you think about repair input, that is the things that come back to our shop around the world. We've got a lot of shops. Repair input for the month of April is down about 55%. Again, this -- we think this is probably as bad as it gets, but it's happened very, very quickly. And so hopefully, we'll see a slower recovery.

I think the best thing -- and you track the flights every day. I get your little note there. that's appreciated. But the China business actually is coming back, slowly, but it is coming back. Passengers are coming back and flying in China again. And I suspect 2 months down the road, we'll see a slight recovery start. Maybe it's 3 months or 4 months.

But there is some light at the end of this. It's just going to take a little while, but we certainly have already seen the impact in April of the airline slowdown.

Operator

Your next question comes from Peter Arment.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

Peter J. Arment - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Greg, maybe just to ask the question on the V2500 in a different way. That 6,000 engines that you have out there, what's -- do you have like an average age? Are we talking that this is still in the...

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

About 11 years.

Peter J. Arment - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Low-teens? 11 years. So you still have a long...

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

Yes. So think about it. About half of the Vs that are out there have not had its first major overhaul, and the other half have only had once. So if you think about it -- and you know the life cycle of these engines. You go through 2, sometimes 3 major overhauls. So we're still in the third inning, I would say, of the life of the V2500 in terms of the aftermarket.

Operator

Your next question comes from Seth Seifman.

Seth Michael Seifman - JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst

So I was curious. I saw in the notes that there was kind of a small intangible impairment at Collins Aerospace. I mean how do you think about the risk of further impairments there? And what are the pieces of the Collins business that you see as most at risk here? How much of the aftermarket is discretionary? How do you see things playing out at the Vs business? And are these the places where you see the greatest risk of kind of a more permanent kind of reduction?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

Well, as you can expect, Seth, we took a hard look at all of the intangible assets as we were closing out first quarter. And we obviously ran a bunch of different sensitivities analysis against these. There was a small impairment. I think it was \$40 million at Collins related to some small businesses that they had that were part of the original acquisition of Rockwell Collins.

But we have looked at all of the other intangibles. Even with a worst-case scenario on aftermarket for the next 2 years, we did not see any potential for impairment. There was plenty of runway there, additional cash flows, again, assuming a 2- or even a 3-year kind of recovery here.

So I'm not expecting big impairments here. Now again, as the world changes, we evaluate this thing every single quarter, but we did a pretty good scrub.

And I guess, Neil, I'd ask you...



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

Neil Mitchill - Raytheon Technologies Corporation - VP of FP&A and IR

Yes. I would just add to that. I mean when you think about the Rockwell Collins acquisition, which didn't happen that long ago, those were the assets that were marked to fair value most recently. And so they're the ones that are most susceptible. But all of this is noncash.

And so we will go through a process. We'll continue to monitor the near term, midterm, long term and update that accordingly. But I agree with everything that you just said there, Greg.

Operator

Your next question comes from Noah Poponak.

Noah Poponak - Goldman Sachs Group Inc., Research Division - Equity Analyst

Toby, since you sort of spoke to a kind of floor in the 2020 free cash, and I know a lot of your investors are focused on the 2021 target that had been provided, and maybe there's less, sort of abnormal, below-the-segment working capital type of disruption, I wanted to see if I could get you to kind of speak to that.

And I had -- outside of a bottoms-up model, I had kind of top-down just crudely been thinking, in the slides, when you -- from the deal, you had the 3 plus 3 from each business. Pro forma 6 goes to 8. So if I just cut the UTC 3.5, I take out 1.5. Or if I look at the S-4 on a levered basis, it was kind of a 4 and 4 split to get to that 8, not quite. But -- so if I just took that 4 and cut it in half, I lose 2. So if I just took 1.5 to 2 out of the 8, can I think of 6 to 6.5 as the free cash kind of floor in 2021? Or would you still have some of these working capital disruptions or something else?

Anthony F. O'Brien - Raytheon Technologies Corporation - VP, CFO & Director

Yes. So I understand the question, Noah, right. Obviously, we haven't guided to 2020. So we need to figure that out first. Stating the obvious, the 2021 numbers you're referring to, right, certainly didn't consider there would be this type of environment because of the pandemic.

And I think the 2 things -- 2 or 3 things to help you a little bit, right? Obviously, we expect defense to continue strong, right? So that should be a tailwind for us going into next year. The variable on the commercial aero side and any of the math that you're referring to is really the shape of the recovery and what type of trajectory we come out of 2020 at Collins and Pratt going into '21. And too early to tell at this point, but as you mentioned, some of the figures, right, both businesses have a strong history of delivering strong cash flow. Just go back to 2019 results and you'll see it there.

So we'll get back there at some point, right? We're going to -- we're not seeing any change to the underlying fundamentals of the Pratt or the Collins business as evidenced by even the Q1 results. It's just too early to speculate more on 2021.

Operator

Your next question comes from Robert Spingarn.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst

Greg, I wanted to follow on the commercial aero questions asked so far because it seems like you see aftermarket leading the recovery over OE. And I want to ask you, first, if I'm interpreting that correctly. And second, how you differentiate the recoveries in your commercial aero market versus commercial OE businesses in terms of time line and then how that translates to Collins' and Pratt's recoveries.



MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

Well, I guess the way I would think about it is as long as the airlines continue to fly, you're going to see aftermarket demand. And I think, again, as I mentioned earlier, with fuel prices where they are, we would expect to see aftermarket demand pick up a little bit more quickly than OE demand just because today, you've got 55% of the world fleet parked.

The good news is if you think about it, really about 40% of that is COVID-related. Back in January, before all this started, you had roughly 15% of the 30,000 fleet parked. So that means that 40% parked is a result of COVID. Those planes will come back into service slowly. And I think what you're going to see is those planes will come back before you see a lot of new OEM demand come back.

And so that's why we're thinking you're probably going to see a much -- not much. You will see a quicker return on the aftermarket than you will on the OE side over the next couple of years. As you know, I mean it's tough right now for both Boeing and Airbus to place planes because of the financing constraints that some of their customers are under. Obviously, we'll work with Boeing and Airbus on that. But I really think it's that parked fleet returning to service first before you see a lot of new aircraft out there.

Kelsey DeBriyn - Raytheon Technologies Corporation - VP of IR

Ashley, we have time for one more question, please.

Operator

Your last question comes from Cai von Rumohr.

Cai von Rumohr - Cowen and Company, LLC, Research Division - MD & Senior Research Analyst

So if you look at 2009, the aftermarket for the industry was down in low- to mid-teens, essentially about a 6% to 7% or less traffic decline. If you expect traffic to be down 50%, why won't the aftermarket be down more? Because this time, we also have ADS-B going against us, we have airlines talking of more retirements, and we have a much weaker OE backdrop and therefore, less provisioning. So why isn't the aftermarket, if you're down 50% in traffic, going to be down 70%?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

Well, look, I think how much it's actually going to be down is the question of the day. I would tell you, the ADS-B mandate, that was over at the end of December. So we actually already factored ADS-B into our forward-looking guidance for aftermarket. So I would tell you that's really outside of the 50% drop that we're talking about for an aftermarket.

It really just depends. If you look and take a snapshot of where we are today, obviously, aftermarket is going to be down a lot more in April and May than the 50%. So we are expecting a gradual recovery through the course of the year.

And keep in mind, many of these -- many of the aftermarket contracts that we have on the Pratt side are hours-based. So even if planes aren't flying full, if they're flying, they're generating revenue, they're generating aftermarket. So that will help here as well to offset. So I think about 70% probably of the Pratt fleet today is powered by the hour. And I think if you look at where China is today, they started this kind of slow recovery back up to about 40% over time, up from 20%. We expect to see kind of that same gradual recovery during the course of the year.

I'll tell you, we aren't going to know what the aftermarket looks like until we probably get to December 31. We'll continue to give you guys an update as we speak, looking at this really month by month to see what the recovery profile looks like. It's not a sharp V. It is more like a U-shape. And I still -- I think it's going to be a full 2 years before we see a recovery close to what we saw in terms of 2019 levels of aftermarket. And that could be -- it could well be 3 years.

MAY 07, 2020 / 12:30PM, UTX - Q1 2020 Raytheon Technologies Corp Earnings Call

At the end of the day, we'll survive this. We'll get through it, but it's going to be painful because, as you know, that is a relatively high-margin business, which affords us the opportunity to make these big investments in engines and other technologies across the portfolio.

Operator

I will now hand the call back to Greg Hayes for closing remarks.

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO & Director

Thank you, Ashley, and thank you, everyone, for listening in. I recognize a lot of data here, a lot of change going on. Neil, Kelsey and team will be around today to answer your questions. Thank you all for listening, and I would just ask everybody to be healthy and safe. Take care.

Operator

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

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