

Horace Mann Educators Corporation NYSE:HMN

FQ2 2024 Earnings Call Transcripts

Thursday, August 8, 2024 1:00 PM GMT

S&P Global Market Intelligence Estimates

| | -FQ2 2024- | | | -FQ3 2024- | -FY 2024- | -FY 2025- |
|----------------|------------|--------|---|------------|-----------|-----------|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| EPS Normalized | 0.18 | 0.20 | ▲ 11.11 | 0.85 | 2.73 | NA |
| Revenue (mm) | 394.27 | 388.10 | ▼ (1.56 %) | 411.20 | 1601.00 | NA |

Currency: USD

Consensus as of Aug-08-2024 2:55 AM GMT

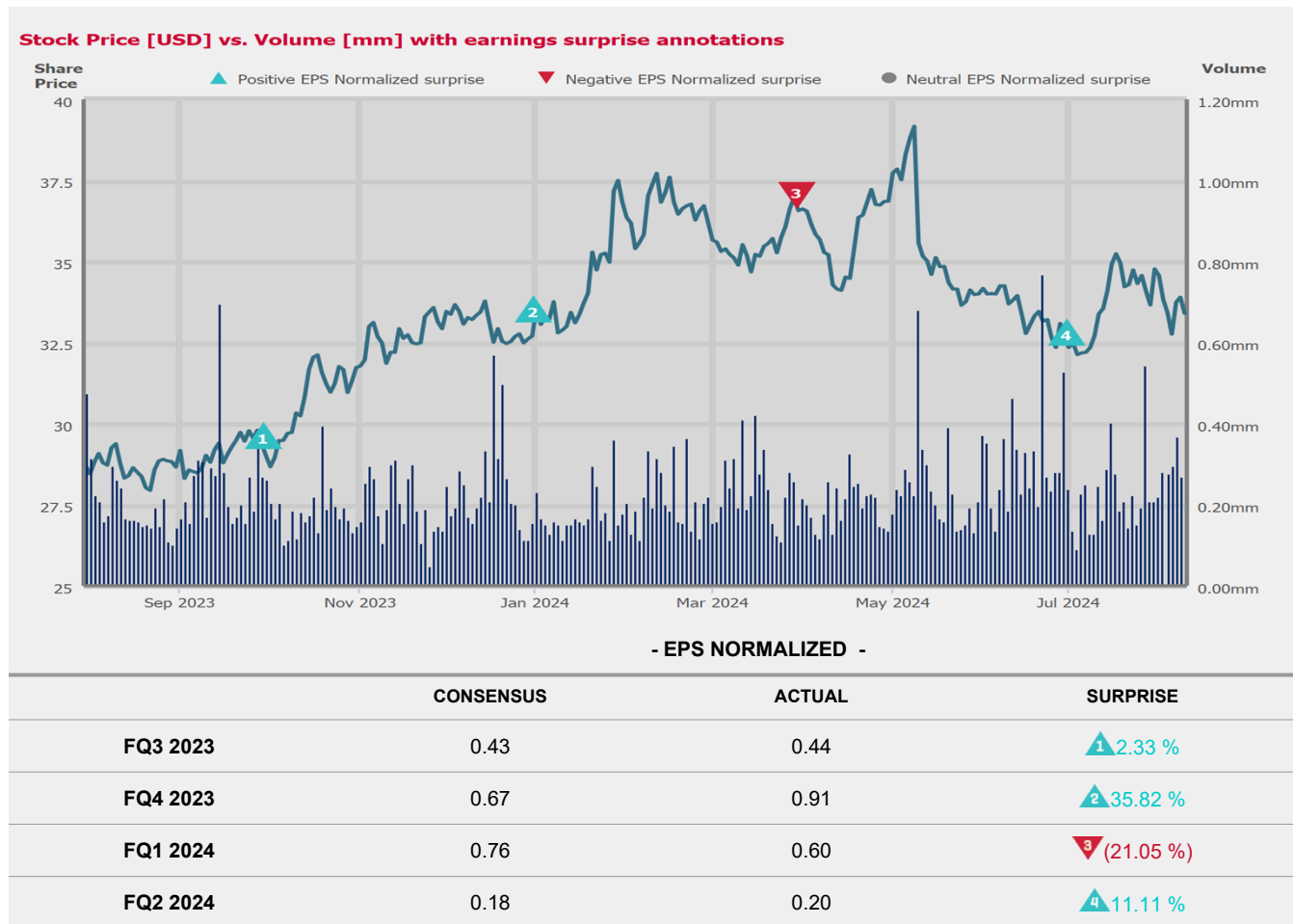


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Call Participants

EXECUTIVES

Brendan Dawal

Bret Alan Conklin
Executive VP & CFO

Marita Zuraitis
President, CEO & Director

Mark Richard Desrochers
*Chief Corporate Actuary & SVP of
Property and Casualty*

Ryan Edward Greenier
*Deputy Chief Financial Officer & Chief
Investment Officer*

ANALYSTS

Meyer Shields
*Keefe, Bruyette, & Woods, Inc.,
Research Division*

Wilma Carter Jackson Burdis
*Raymond James & Associates, Inc.,
Research Division*

Presentation

Operator

Good morning and welcome to the Horace Mann Second Quarter of 2024 Results Conference Call. [Operator Instructions] Also, please be aware that today's call is being recorded.

I would now like to turn the call over to Brendan Dawal, Vice President, Investor Relations. Please go ahead.

Brendan Dawal

Thank you. Welcome to Horace Mann's discussion of our second quarter results. Yesterday, we issued our earnings release, 10-Q, investor supplement and investor presentation. Copies are available on the Investors page on our website.

Marita Zuraitis, President and Chief Executive Officer and Bret Conklin, Executive Vice President and Chief Financial Officer, will give the formal remarks on today's call. With us for Q&A, we have Matt Sharpe, Steve McAnena, Ryan Greenier and Mark Desrochers.

Before turning it over to Marita, I want to note that our presentation today includes forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. The company cautions investors that any forward-looking statements include risks and uncertainties and are not guarantees of future performance. These forward-looking statements are based on management's current expectations, and we assume no obligation to update them. Actual results may differ materially due to a variety of factors, which are described in our news release and SEC filings.

In our prepared remarks, we use some non-GAAP measures. Reconciliations of these measures to the most comparable GAAP measures are available in our investor supplement.

I'll now turn the call over to Marita.

Marita Zuraitis

President, CEO & Director

Thanks, Brendan, and good morning, everyone. Yesterday, we reported second quarter core earnings of \$0.20 per diluted share, a significant improvement over prior year and in line with our pre-announcement. Total revenues were up 9% with net premiums and contract deposits earned up 8%. Our Property & Casualty profitability restoration strategy remains on track to reach an underwriting profit in 2024 and target profitability in 2025. Our agency force is driving profitable growth in both our retail and worksite divisions.

Property & Casualty sales were up 37%. Supplemental & Group Benefits sales were up 20%. These results underscore our confidence in achieving our objective of a double-digit shareholder return on equity in 2025.

As we noted in our pre-announcement, in the first half of 2024, we recorded some mark-to-market valuation adjustments related to our commercial mortgage loan fund portfolio. The CML portfolio is roughly 9% of our total investments and is held within our Life & Retirement and Supplemental & Group Benefits portfolios. Bret will give more details, as well as the specific accounting requirements later in the call.

First, I want to take a step back to provide some perspective on our year-over-year investment results. In the first half of 2024, total net investment income on the managed portfolio rose more than 3% over prior year, despite the returns on commercial mortgage loan funds that were meaningfully below historical averages. The core fixed maturity portfolio is performing very well in the high interest rate environment. At the end of the second quarter, our pre-tax investment yield rose to 4.46% and new money rates exceeded the portfolio book yield by 163 basis points.

Even with the revised outlook for commercial mortgage loan funds in 2024, we expect higher total net investment income for the full year on the strength of our core managed portfolio performance. While the valuation pressure in the commercial mortgage loan portfolio has impacted reported investment income, we do expect to see a tailwind in investment income as market factors impacting the commercial real estate sector begin to recover. Most importantly, these valuation marks have not impacted cash returns on this portfolio, which remains strong at about 7.5%.

Today, I want to focus my remarks on the strength of our underlying business, the results we are seeing from a fully engaged and more productive agency force and the value we are providing to our educator and employer customers. In Property & Casualty, we

continue to make progress towards our objective of an underwriting profit in 2024. Our reported combined ratio of 111.5%, which reflects expected second quarter seasonality, improved 13 points over prior year. We also recorded favorable prior-year development, a net \$6.2 million reserve release, primarily related to lower-than-expected severity in auto physical damage claims from accident year 2023. The auto combined ratio for the quarter was 97.2%, which includes 6.2 points from the favorable prior-year development. We continue to see physical damage trends moderating and feel confident in our ability to reach target profitability in 2025.

We continue to successfully implement our auto and property rate plans, and will monitor and respond to trends as necessary. We are at rate adequacy in the vast majority of our book and have line of sight to reach rate adequacy in the remainder. In addition, we continue to react to state-level loss trends with additional rate filings as necessary. As we've noted before, second quarter historically comprises about half of our full year catastrophe load. The \$41 million in losses from 28 PCS-declared catastrophes in the second quarter stemmed primarily from record severe convective storm activity across the country. These losses were slightly lower compared to catastrophes in second quarter 2023, but continue to trend above our 5-and 10-year historical averages, in line with industry experience.

We have implemented new roof rating schedules, which are effective at policy renewal in 6 of our most wind-prone states. Our first look at the potential impact this quarter appeared favorable with close to \$1 million in estimated cost savings. As a reminder, we expect the full impact of this program to be about 3 points on the property loss ratio when earned in through all applicable 12-month policies.

In Life & Retirement, we continue to see educators respond positively to our value proposition and our core product offerings. This segment remains a cornerstone of our value proposition for educators to protect what they have today and prepare for a successful tomorrow. We are able to partner with employers to bring financial wellness and retirement planning resources to educators, including 403(b) plans and our Retirement Advantage mutual fund platform. 403(b) plans are how many educators are introduced to Horace Mann and enable us to cross-sell complementary products to new customers. These core 403(b) product deposits have increased 6% year-to-date and have a healthy sales pipeline.

Against this backdrop, we're realizing improvements in the number and quality of leads our internal teams are providing to agents. We upgraded our website, improved our online quoting functionality, and tested a number of digital marketing programs. We're now working to scale up the most successful approaches in the back half of the year and into 2025. Taken all together, the result is strong retail sales growth from an engaged agency plan. Auto sales were up 29% in the second quarter. Life sales were up 27%. Our close ratios remain consistent with historic levels. The growth is coming from more agencies writing more policies and writing higher premium policies.

In the first half of 2024, average agency income increased 14% over prior year. Our retail distribution recruiting is strong and slightly ahead of our plans. We are seeing more new agents reach key milestones faster, which speaks to the quality and productivity level of our agency force.

Similar to retail, our worksite division has realized productivity increases in the agency force. Worksite direct sales are up 14%. Notably, recent sales results have even surpassed NTA's pre-pandemic levels. Customers and agents are responding well to recent product enhancements to our offerings and we continue to update our product set to meet customer needs. Benefits utilization continues to remain below pre-pandemic levels, but is trending towards our long-term target of 43% on a sequential basis.

In the employer sponsored business, our number of covered lives is 830,000, a 2% increase over prior year. As we've noted before, this business has a longer sales cycle up to 18 months and sales quarter-to-quarter can be lumpy. We continue to leverage our existing broker partnerships to expand distribution and are focused on adding more partners.

Before I turn the call over to Bret, I want to reiterate how well positioned Horace Mann is to reach our goals of an expanded share of the education market and a sustainable double-digit ROE in 2025 and beyond. Our diversified business model provides strong steady earnings. With the broader P&C earnings pressure facing the industry over the past few years, we've been able to consistently report income on a consolidated basis. And while Life & Retirement earnings have been lower in the first half of 2024 due to lower net investment income, we anticipate eventual recovery of most of the CML mark-to-market valuation adjustments.

To put it more simply, we have a clear line of sight to target profitability in all segments in 2025, and we are growing profitably across the business. This is the basis of our current view of company value. One of the levers to create further shareholder value is to buy back shares when we believe market conditions are favorable, and we believe that has been the case recently. So far in 2024, we've bought back 230,987 shares at a total cost of \$7.7 million.

In addition, I want to touch on some of the activities we've been doing in schools to bookend the summer. Before the school year ended, we completed an entire month of teacher appreciation activities, including exclusive virtual events with celebrities and

entertainers who thanked teachers directly. Our website traffic doubled over the beginning of the year and we were able to follow-up with thousands of educators who wanted to hear more about Horace Mann.

As our educators head back to school this month, our agents will be there right alongside them. Our aim for the third quarter is to help educators be set for success, both professionally and personally. We are confident in our ability to increase our share of the education market precisely because we're here for educators, and we know how to help them succeed better than anyone else.

Thanks. And with that, I'll turn the call over to Bret.

Bret Alan Conklin
Executive VP & CFO

Thanks, Marita. Second quarter core earnings were \$8.4 million or \$0.20 per diluted share, a significant increase from \$0.03 a year ago. Our P&C profitability restoration strategy remains on track to return an underwriting profit in 2024 and reach target profitability in 2025. We're also seeing strong growth momentum across the segments.

As we noted in our pre-announcement, we now expect a full year core EPS of \$2.40 to \$2.70, primarily due to lower-than-anticipated income on our commercial mortgage loan funds as well as first half catastrophes that were above our 5-year exposure weighted average. Today, I'll start my remarks with more detail on investments and then speak to the performance of each of the 3 segments. Within our \$7 billion investment portfolio, over 80% of our assets are invested in our fixed income portfolios, which have a weighted average credit rating of A+. These portfolios have clearly benefited from the higher interest rate environment and are performing above our expectations. At the end of the second quarter, our core new money yield was 5.88% well above the core pre-tax yield of 4.25%. The portfolio is concentrated in investment-grade corporates, municipals and high-quality agency and agency MBS securities.

We have \$627 million or about 9% of our portfolio in commercial mortgage loan funds. We hold these assets in fund structures across a diverse group of managers to provide access to broader markets, geographies, property types, borrowers and loan types versus the direct loan origination strategy used by many of our life industry peers. We, therefore, follow the equity method of accounting for these funds. Essentially, we're booking quarterly adjustments based on current real estate property valuations that have a 1 quarter lag and can be impacted by market factors like interest rates and the level of real estate transaction. Most of the underlying loans within these funds have maturities of 5 years or less.

If loans that have been mark-to-market mature and potentially pay off or refinance at par, we would expect to see a tailwind in investment income. Most importantly, as Marita mentioned, these valuation marks have not impacted cash returns on this portfolio, which remains strong at about 7.5%.

The majority of our total commercial real estate exposure is in multifamily and industrial, both of which are generally performing well. We continue to monitor office exposure closely, which represents less than 3% of the total investment portfolio. These investments are concentrated in senior commercial mortgage loan funds. It is primarily well amenitized, well located and generally newer construction Class A exposure. What this means for 2024 is overall net investment income that is slightly higher than 2023 compared to the high single-digit increase we assumed in our original guidance.

As I previously mentioned, valuations are based on market factors and we see the potential for an investments tailwind in the future. The commercial mortgage loan funds report on a 1 quarter lag, so we have some early insight into Q3 returns. Right now, we expect \$10 million to \$12 million of net investment income from CMLs in the second half of 2024, a notable increase from the \$4 million of net investment income in the first half of the year. This is due to a lower level of negative valuation adjustments across the funds. As a result, we expect CML income to remain below historical averages on a full year basis. We expect further improvement in 2025.

Turning to the business segment performance. Property & Casualty, net written premiums rose nearly 17% to \$199 million, primarily on premium increases implemented over the past 18 months. The reported combined ratio of 111.5 improved 13 points over prior year, including 3.5 points of favorable prior year reserve development. The \$6.2 million reserve release is primarily related to auto physical damage claims from accident year 2023.

Catastrophe losses of \$41 million added almost 23 points to the reported combined ratio compared to over 26 points a year ago. We have mentioned before that second quarter typically accounts for about half of our full year cat load. Second quarter losses were above our 5-year and 10-year historic averages. This is consistent with the broader industry, which experienced record levels of severe convective storm activity.

In auto, net written premiums of \$122 million increased 15% over prior year, primarily on rate actions. The combined ratio of 97.2% improved 17 points over prior year. In terms of loss cost trends, we saw favorable severity trends in the quarter. Frequency

was unfavorable on a quarterly basis, but flat year-to-date. Policyholder retention remains strong at 86.6% despite substantial rate increases.

In property, net written premiums were \$77 million, a 20% increase over prior year. The combined ratio reflected cat losses that were below prior year, but elevated compared to our historical averages. Despite higher premiums, our policyholder retention remains strong at 90%.

Looking ahead to the full year, we slightly narrowed our P&C earnings guidance range to \$36 million to \$39 million to adjust for first half results, primarily on higher cat costs. We continue to expect to reach a segment underwriting profit in 2024.

Turning to Life & Retirement. Core earnings of \$12 million were below prior year by 29% due to lower-than-anticipated income on our commercial mortgage loan funds and higher interest credited. In the retirement business, deposits in our core 403(b) products have increased 6% year-to-date and accounts on our fee-based mutual fund platform, Retirement Advantage surpassed 20,000.

As Marita mentioned, our retirement products are a cornerstone of Horace Mann's value proposition, an important entry point to the education market. Annualized life sales increased 27% over prior year. Mortality costs for the quarter were comparable to the prior year and persistency remains strong at about 96%. For the full year outlook, we have adjusted Life & Retirement segment earnings down to a range of \$50 million to \$56 million due to lower expected net investment income related to the commercial mortgage loan funds.

Turning to worksite, in the Supplemental & Group Benefits segment, earnings of \$14 million were above prior year by 19% on higher net investment income and lower policyholder benefits utilization. Premiums and contract charges earned were \$64 million, down slightly from prior year. The blended benefits ratio of 39% was below prior year, but trending toward our target of 43% on a sequential basis. Sales were up 20% mostly on the strength of the worksite direct line. Our employer-sponsored sales were up as well, but like the broader group benefits industry, our second quarter generally has light sales volume.

For the full year, we have adjusted our Supplemental & Group Benefits segment up to an earnings range of \$49 million to \$52 million, which is mostly due to lower benefits utilization in the first half of the year. While we continue to expect utilization will return to pre-pandemic levels, the pace is slower than we originally anticipated.

As we move into the back half of the year, we continue to prioritize long-term shareholder value creation. At our targeted profitability across the segments, Horace Mann is capable of generating about \$50 million in excess capital above what we pay in shareholder dividends and interest expense annually.

Our first priority remains on funding profitable growth. Second, we are committed to increasing the annual shareholder dividend as we have for the past 16 years. Third, we opportunistically buy back shares when market conditions are favorable. Year-to-date, through August 2, we have repurchased approximately 231,000 shares at a cost of \$7.7 million. We have about \$28 million remaining on our current share repurchase authorization.

In closing, Horace Mann has a clear line of sight to target profitability across our segments, a strong balance sheet, and solid growth momentum. With these pieces in place, we are well positioned to expand our market share and achieve a 10% shareholder return on equity in 2025. Thank you.

Operator, we're ready for questions.

Question and Answer

Operator

[Operator Instructions] And our first question will come from Meyer Shields with KBW.

Meyer Shields

Keefe, Bruyette, & Woods, Inc., Research Division

I wanted to ask a question based on Bret's comments, because when we look at, I guess, the rate of earned rate increase or the pace of earned rate increase and what seems to be decelerating severity trends, I guess I would have expected the underlying accident year loss ratio in auto to improve by a little bit more than it had. I was hoping you could talk through, I think it's the frequency issue that probably opposed that. I was hoping you could add a little detail to what's going on there.

Mark Richard Desrochers

Chief Corporate Actuary & SVP of Property and Casualty

Sure, Meyer. This is Mark. I'll take that question. When we look at auto frequency, the accident frequency in the quarter was a bit elevated compared to 2023. I think it's primarily attributable to the fact that spring break across much of the country was a little bit later this year. So some of what would normally come as accident frequency in the first quarter leaked into the second quarter. I think that's a little bit exacerbated by the fact that we have our educator niche.

But if you look at the first half of the year in aggregate, accident frequency is pretty much flat year-over-year. And if we look at severity, the metal coverages are definitely coming down. I think on the bodily injury [and UM side], we continue to see trends in the kind of mid-to high single digits, somewhat a function of continued social inflation. But in the aggregate, auto loss costs for the first half of the year, about 5% over where they were in 2023, which is pretty much dead on to what we expected.

Meyer Shields

Keefe, Bruyette, & Woods, Inc., Research Division

Okay. That's very helpful. I guess a follow-up question on that. Is the filed -- I guess, the delta between filed rate increases on the liability side and on the metal side or the physical damage side, is that changing as we see the physical damage trends abate?

Mark Richard Desrochers

Chief Corporate Actuary & SVP of Property and Casualty

I think it likely will, Meyer, but right now, I mean, most of our rate has been primarily across the board, across all coverages. There are some differences, but not material differences as of yet. But I think as we get into next year and we feel strong about our profitability trajectory and you get to more kind of inflationary type rate changes, you'll see it match up, I think, much more closely with the underlying coverage inflation.

Marita Zuraitis

President, CEO & Director

Certainly, as this year's data gets worked into the pipes, yes.

Ryan Edward Greenier

Deputy Chief Financial Officer & Chief Investment Officer

Go ahead, Meyer.

Meyer Shields

Keefe, Bruyette, & Woods, Inc., Research Division

A timeline of the mark-to-market accreting back to par, I guess, maybe the right way to ask is the duration of the real estate portfolio?

Ryan Edward Greenier

Deputy Chief Financial Officer & Chief Investment Officer

Sure, Meyer. This is Ryan. I think you're asking about the timeline of when we think we're going to see some of that recovery in the unrealized. We put a little more detail on the investor presentation on the commercial mortgage loan portfolio this quarter. It's on

slides 36 and 37. And you can see that about 2/3 of our CML portfolio will mature over the next 18 months. So as a reminder, with equity method of accounting, we've taken a valuation adjustment real-time, 1 quarter lag to every single loan in that limited mortgage loan fund portfolio, that's 249 of them.

And clearly, many of them, the vast majority, continue to perform well. And you can see that in the cash yield statistics that we put out on that slide for you, there's a significant delta between the cash yield and the net investment income. The net investment income reflects those unrealized adjustments. So with 2/3 of them maturing over the next 18 months, we feel good that there's a tailwind there that will play in. Our estimate for second half is conservative. And so I think you're going to see more of that in 2025 or later. But we feel confident about the trajectory.

Meyer Shields

Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And I apologize for my phone.

Ryan Edward Greenier

Deputy Chief Financial Officer & Chief Investment Officer

No problem.

Operator

And our next question will come from Wilma Burdis with Raymond James.

Wilma Carter Jackson Burdis

Raymond James & Associates, Inc., Research Division

Could you just talk about the -- can you guys hear me?

Ryan Edward Greenier

Deputy Chief Financial Officer & Chief Investment Officer

Yes.

Wilma Carter Jackson Burdis

Raymond James & Associates, Inc., Research Division

Could you just talk about the trajectory of the interest rates that are factored into the current CML portfolio valuation? And maybe just talk about the expectation for rate cuts that's baked into that assumption?

Ryan Edward Greenier

Deputy Chief Financial Officer & Chief Investment Officer

Sure, Wilma. This is Ryan. Thanks again for the question. Our commercial mortgage loan portfolio is primarily floating rate exposure. Over 80% of the loans, close to 85% are floating rate. And that has certainly helped cash yields. But the inverse of that is it puts pressure on the valuation, on cap rates of the underlying portfolio, the underlying loans, the properties supporting the loans.

As we move into what will likely be a moderating interest rate environment, that will be a tailwind for the commercial real estate market. It will provide some relief on the debt service coverage numbers as well as help support cap rates for the underlying properties. So we're not necessarily counting on that. We have a lot of confidence in the underlying fundamentals of the properties. And as I just said to Meyer, we expect a lot of this unrealized marks to come back as they mature, which is over the next -- 2/3 of the portfolio matures over the next 18 months.

Wilma Carter Jackson Burdis

Raymond James & Associates, Inc., Research Division

Okay. And then could you talk about what drove the favorable prior year developments? And is that something that we could see continuing into the second half of the year?

Bret Alan Conklin

Executive VP & CFO

Sure, Wilma. This is Bret. And as usual, let me just start out by as it relates to the P&C reserves. I think most know that we take a very conservative stance as it relates to our P&C reserving, withholding our reserves at the upper half of the actuarial range. I would also add that we remain very comfortable with our aggregate reserve levels. And to your point, on the PYD that we recorded in the second quarter, obviously, we were encouraged by the emerging favorable trends that we're beginning to see. And I think it was in my prepared remarks in the auto claims development pattern, specifically in the auto physical damage coverage.

So with that, let me turn it over to Mark who can kind of talk about the -- more specifically about the trends that we're seeing.

Mark Richard Desrochers
Chief Corporate Actuary & SVP of Property and Casualty

Yes. Absolutely. I mean, all that development essentially came out of essentially collision and auto property damage, which are short-tailed lines. And the -- as those claims are closing, what we're finding is the severity on them has dropped precipitously from where we thought it was at the time when reserves were set. So at that time, we were still dealing with the tail end of mid-to high single-digit severity trends. And now as they're settling out, we're seeing trends that are more in the very low single digits and that's really what's driving that prior year development. So we have a very high level of confidence that we're right on these numbers.

Bret Alan Conklin
Executive VP & CFO

Yes. And I can't sit here and guarantee what's going to happen in the second half of this year. But I would just say this, if the trends continue to be favorable, as Mark just described, it would not surprise me if we would have development. But to say that we will or we won't, I can't do that. But we feel very good about where we're at currently and the trends that we're seeing.

Wilma Carter Jackson Burdis
Raymond James & Associates, Inc., Research Division

And if I could sneak one more in. Could you just talk a little bit about share repurchases? They were a bit higher in the quarter. Cat came in line. But just maybe talk about that and what we could see in the second half of the year and maybe even '25 as P&C operations normalize.

Marita Zuraitis
President, CEO & Director

Yes. I'll let Ryan go through the details. But as we always say, share repurchase is just one piece of a very thoughtful capital management strategy. Ryan, you want to take it?

Ryan Edward Greenier
Deputy Chief Financial Officer & Chief Investment Officer

Sure. Thanks for the question, Wilma. As we have a clear line of sight to returning to target profitability in 2025, that translates into about \$50 million of excess capital production and that's on top of the interest expense and a pretty compelling dividend. Our capital management priorities are, number one, to fund profitable growth. Number two, to support that dividend. We've got a bit over 4% right now of the dividend yield, and we've increased that annually over the past 16 years.

Our approach to buybacks has historically been opportunistic and will continue to be. Like I said, we have a clear line of sight to target profitability. We feel confident in our excess capital production capabilities. And we clearly feel shares are undervalued. And through yesterday, on a year-to-date basis, we bought back \$7.7 million at an average price of \$33.30. So pretty opportunistic approach to what we feel is an undervalued stock price.

Operator

[Operator Instructions] And with no further questions, this will conclude our question-and-answer session. I'd like to turn the conference back over to Brendan Dawal for any closing remarks.

Brendan Dawal

We'd like to thank you for joining our call today. Please reach out if there are any additional questions and have a great day. Thank you.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.

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