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RAD - Q4 2019 Rite Aid Corp Earnings Call

EVENT DATE/TIME: APRIL 11, 2019 / 12:30PM GMT

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CORPORATE PARTICIPANTS

Benjamin E. Bulkley Envision Rx Options Holdings, Inc. - CEO

Bryan B. Everett Rite Aid Corporation - COO

Byron Purcell

John T. Standley Rite Aid Corporation - CEO & Director

Matthew Schroeder Rite Aid Corporation - CFO

CONFERENCE CALL PARTICIPANTS

Bryan Cecil Hunt Wells Fargo Securities, LLC, Research Division - MD & Senior Analyst

John Edward Heinbockel Guggenheim Securities, LLC, Research Division - Analyst

Karru Martinson Jefferies LLC, Research Division - Analyst

Kevin Hartman Goldman Sachs Group Inc., Research Division - Business Analyst

Michael Roman Minchak JP Morgan Chase & Co, Research Division - Analyst

William Michael Reuter BofA Merrill Lynch, Research Division - MD

PRESENTATION

Operator

Good morning, and welcome to the Rite Aid Fiscal 2019 Fourth Quarter Earnings Release. I would now like to turn today's program over to Byron Purcell. Byron, you may begin.

Byron Purcell

Thank you, and good morning, everyone. We welcome you to our fourth quarter earnings conference call. On the call with me today are John Standley, Chief Executive Officer; Bryan Everett, Chief Operating Officer; Ben Bulkley, Chief Executive Officer EnvisionRxOptions; and Matt Schroeder, Chief Financial Officer. On today's call, John, Bryan, and Ben will provide an update on the business. Matt will provide an update on our fourth quarter results and provide guidance for fiscal 2020 and then we will take questions. As we mentioned in our release, we're providing slides related to the material we will be discussing today. These slides are provided on our website www.riteaid.com under the Investor Relations information tab. We will not be referring to them in our remarks, but hope you'll find them helpful as they summarize some of the key points made on the call. Before we start, I'd like to remind you that today's conference call includes certain forward-looking statements. These forward-looking statements are presented in the context of certain risks and uncertainties that can cause actual results to differ. These risks and uncertainties are described in our press release, in item 1A of our most recent annual report on Form 10-K and another documents that we file or furnish to the Securities and Exchange Commission. Also, we will be using certain non-GAAP measures in our release and in the accompanying slides. The definition of the non-GAAP measures along with the reconciliation to the related GAAP measure are described in our press release and slides. With these remarks, I'd like to now to turn it over to John.

John T. Standley - Rite Aid Corporation - CEO & Director

Thanks, Byron, and thanks to everyone for joining us on the call today. During the fourth quarter, we continued generating critical momentum in key areas of our business while also taking important steps to position Rite Aid for future success. To help us build on this momentum, we've also developed a comprehensive business strategy that specifically defines our top priorities and provides Rite Aid with a clear path to the future for long-term sustainable growth. I'll be discussing this strategy in more detail later on today's call.

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As you know, operational efficiency has been one of our top priorities. To that end, we recently took an important step forward by announcing a restructuring to right size our organization as the TSA with WBA winds down. As announced, we're reducing managerial layers and consolidating roles throughout our organization to align current operations with our new footprint. We expect annual cost savings of about $55 million from the restructuring with approximately $42 million to be realized in fiscal year '20. This is important because we expect TSA revenue to be lower by approximately $40 million this year. As we complete this restructuring, we're also implementing a leadership transition. The board has initiated a search for a new CEO, and I will stay throughout that process to ensure a smooth transition.

While changes like these are never easy, this restructuring represents a critical step in becoming a more-efficient company that is better positioned to deliver value. In addition, as previously announced, Rite Aid stockholders have approved a reverse stock split of the company's outstanding shares and common stock. Our Board of Directors has now approved the implementation of the reverse stock split at a ratio of 1:20. Rite's common stock will begin trading on a split adjusted basis on New York Stock Exchange at the market open on April 22, 2019. Implementation of the reverse stocks split should enable us to regain compliance with the New York Stock exchange listing environments. In terms of our results for the quarter while adjusted EBITDA met our expectations, we're still not where we want to be in terms of performance. There's no doubt that we're dealing with a very challenging environment for retail and pharmacy reimbursement rates and that these trends affected our results. At the same time, we also generated positive results in critical areas of our business. In the Retail Pharmacy Segment, in addition to our success with our very script growth initiatives over the past few quarters, we also administered a record number of flu shot and drove strong growth in the ancillary immunizations. And despite a mild cough, cold and flu season, we increased same-store pharmacy sales and prescription count for the third consecutive quarter.

In our Pharmacy Services Segment, increased Medicare Part D enrollment helped drive a 1.2% increase in revenue for the quarter and a $4.5 million increase in adjusted EBITDA. As you know, we recently announced the addition of Ben Bulkley to our team as CEO of EnvisionRxOptions. Ben is an outstanding leader with a proven track record for driving results through innovation and operational excellence. We're excited to have him as part of our team, and he will be joining us later in the call to provide additional details on EnvisionRxOptions business. While we know there are opportunities for organic growth within our business, we also know the dynamics of retail and healthcare are changing rapidly. And that it's critical to develop a strong plan for a long-term future. As I alluded to earlier, we spent significant time over the past several months taking a close look at our go-forward strategy. We've analyzed all aspects of our business, including engaging with outside consultants to ensure that Rite Aid has the best possible strategy for achieving long-term sustainable growth.

This included a thorough analysis of the marketplace so that we could better understand the needs of pharmacy customers and tailor our mix of services and products to deliver an even higher level of convenience and care. As a result, we have developed a clear path to the future that will position Rite Aid to capitalize on its strongest capabilities and core competencies to help improve health outcomes for more patients. Our strategy focuses on 3 top priorities: first, we will leverage and more clearly align our unique capabilities, like the expertise of our pharmacists, Health Dialog, RediClinic and EnvisionRxOptions that help payers in delivering a higher level of care to patients.

Specifically, we know there's more that we can do to work with payers to drive positive health outcomes for chronic and polychronic patients. We already have related experience in this area following our pilot of Rite Aid Health Alliance, which saw us partner with local physicians and hospitals. Our Health Alliance pilot provided us with some key learnings that we can now apply as we look to make a stronger play in the value-based care market: second, we are reimagining our front-end offer to capture right selection of products and services, to meet the needs of our target consumers. This will include executing a full SKU optimization program that continued migration of our product mix to have a greater emphasis on health and wellness and the identification of new services we can offer at the store level: third, we are continuing our efforts to fundamentally transform our processes and procedures to ensure strong cost discipline, unlock capacity and achieve peak operational efficiency.

In addition to the organizational restructure -- restructuring, I mentioned earlier, we've identified specific expense reduction initiatives in areas such as store operating expenses, advertising and non-head count back office expenses. While we have always been focused on these areas, our thorough review process identified further opportunities to reduce complexity in our business and drive efficiency. We have also identified opportunities to improve working capital. These efforts will drive additional savings that we will use to make critical strategic investments for future growth. With our strategy in place, we're excited to be fully focused on building momentum for our business going forward. We're also excited to have a number of dynamic and talented leaders taking on new roles within our organization that help us execute and strengthen our go-forward strategy. Matt Schroeder who you will hear from later on this call is our new Chief Financial Officer. He is an experienced member of our team who knows our business and will do a great job of putting Rite Aid in the best possible financial position to succeed. Jocelyn Konrad is our new Executive

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Vice President of Pharmacy and Retail Operations. Jocelyn is a licensed pharmacist with a significant experience in clinical service and value-based care initiatives. With her additional front-end responsibilities, Jocelyn will be an excellent leader to further strengthen our one-store, one-team culture in the field and stores. And finally, Bryan Everett has been named Rite Aid's new Chief Operating Officer. Bryan's leadership has been critical in keeping our team focused on operational priorities over the past several years. His passion for our business and vision for our future have earned him the trust and respect of our Rite Aid team. I'm excited to see him take on additional responsibilities in his new role and look forward to working with him as we focus on positioning Rite Aid to deliver value over the long term. With that, at this time I'd like to introduce Bryan to provide an update on our key initiatives and further details about our go-forward initiatives. Bryan?

Bryan B. Everett - Rite Aid Corporation - COO

Thank you, John, and good morning, everyone. I'll start by saying that I'm very excited for the opportunity to take on additional responsibilities and lead in this new role. As a team, we have made some good progress in improving our business. And while we still have work to do heading forward, I'm confident in our Rite Aid team and strategy and optimistic about our future as an organization. In terms of our key initiatives, as John said, we've driven same-store pharmacy sales and prescription count growth for 3 consecutive quarters. A key factor has been our success with immunizations as we delivered a record of more than 2.3 million flu shots and growth of 78% in the ancillary immunizations.

In FY '19, we also ramped up our investment in prescription file buys by spending a total of $45 million compared to $29 million in the prior year. For this year, we have allocated $60 million for prescription file buy opportunities. Also during the year, we completed 134 wellness remodels and this highly successful format now represents nearly 72% of our chain. The wellness stores continued to outperform the rest of the chain in terms of both same-store front-end sales and prescription count. And they will continue to play a key role as we aggressively test innovation to drive even better customer experiences. Our wellness+ rewards program also continue to play a key role in delivering value to our customers. We have over 13 million active wellness+ rewards members, and we will continue leveraging this very popular program to provide a higher level of personalized marketing that drive sales and customer loyalty. The key initiatives, I've mentioned, provide a strong foundation from which to build as we focus on accelerating our transformation in FY '20.

To support these efforts, we have identified several key areas of opportunity. We understand that providing best-in-class clinical pharmacy services represents a critical opportunity to deliver a higher level of care to our customers, while also positioning Rite Aid for sustainable growth in the emerging value-based healthcare marketplace. A great example is our launch of Rite Care in FY'19. Rite Care is a state-of-the-art tool that provides our pharmacists with real-time alerts for clinical service opportunities without having to access a separate application. To position us in delivering a higher level of care, we must continue finding ways to operate more efficiently so that we can free up additional time for our pharmacist to provide personalized services to our patients. This includes a continued focus on increasing predictive refills through a program like Automated Courtesy Refill and OneTripRefills and other workflow improvements to reduce our cost to fill. We will also expand on our essential fill capabilities throughout the year.

Tools like these will help us continue to execute our aim strategy. Aim stands for adherence, immunization and medication therapy management, or MTM. And these services represent our gateway into value-based care and in recent years we've made significant progress in expanding these offerings. By gaining efficiencies in the pharmacy and providing best-in-class services through aim, we will be in an even better position to further expand our offering and begin working with key payer partners to close gaps in care. We must also deliver on our priority to be a low-cost provider. That's why it was so critical to lock in the best possible drug cost, which we have accomplished through our recent 10-year agreement with McKesson.

We will also continue working with payer partners to manage reimbursement rate pressure with a focus on gaining access to additional limited networks heading forward. In the front end, we are completing a comprehensive evaluation of our business to better support our target consumer. This includes completing a SKU optimization and re-merchandising key categories to better meet the needs of our customers. It also includes introducing additional better-for-you items, especially in consumables and beauty. One of our biggest areas of focus will be growing our own-brand penetration over the next few years. We believe this area presents enormous potential and our go-forward plan includes introducing new items, enhancing our product mix and additional consideration to how we market and promote these items. Early this fiscal year, we'll be relaunching our bestselling own brand of OTC products Rite Aid pharmacy. And we're also in the final stages of repositioning the Thrifty Ice Cream brand and expanding sales to additional states. In addition, we've heard from many customers about their interest in purchasing CBD products. In response to this interest, this month, we will begin piloting the sale of CBD creams, lotions and lip balms at Rite Aid stores in Oregon and Washington to

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better meet the needs and preferences of our customers in those communities. As we analyze and evolve our front-end business, we'll also be examining our marketing to make sure that we are targeting the right opportunities to grow our business. At the same time, we know that today's retail consumer is looking to shop and engage with brand in a number of different ways. And as a team, we're highly focused on meeting these needs and are exploring various options to further enhance our omni-channel capabilities, including making key strategic investments. We will significantly grow our e-commerce business again this year. We will continue developing our mobile capabilities and further expand our self checkout pilot. Expect to see more self-checkouts at Rite Aid stores in the coming year.

Additionally, we are also exploring mobile checkout solutions. We continue to offer same-day prescription home delivery in the majority of our markets at no charge for our wellness+ gold and silver members. This service has been very well received and continues to grow. We see further expanding home delivery as a key opportunity, which is why we're also partnering with Instacart, a technology-driven on-demand service to pilot another convenient option for home delivery. We will continue to refine and enhance our home delivery capability in the months to come. We're also excited to be partnering with Amazon to introduce Amazon Lockers to more than 900 Rite Aid stores over the next few months to give customers another option to pick up or return their Amazon packages. This effort will bring additional traffic into our Rite Aid stores. Heading forward, we'll continue to look for new ways to engage with customers both in-store and online to create a seamlessly connected customer experience. Finally, it's really important that we continue to thoroughly understand current trends and how they relate to the products that we sell. To that end, we're concerned about some of the alarming statistics regarding the use of e-cigarettes and vaping products by children and teens. According to the Centers for Disease Control and Prevention, tobacco use among our nation's youth grew nearly 38% between 2017 and 2018. This has been driven largely by an increase of e-cigarette use which over the past year has increased 78% in the high school demographic and 48% for middle-school aged children. While many feel these products are beneficial to those of legal age who're trying to quit the use of tobacco. We have made the decision to remove all electronic cigarettes and vaping products from our offering at all Rite Aid stores. We will remove this product over the next 90 days. In addition, we will continue to rigorously enforce our chain wide ID-all policy that requires identification to purchase any age-restricted item. We will also continue evaluating our entire front-end offering to ensure that we're meeting both the needs and the expectations of our customers. Before I conclude, I wanted to take a moment to sincerely thank our Rite Aid store associates, our field leaders, our distribution center partners and corporate team members for all they've done this year. I can't say enough about how our team has been able to stay focused and providing great service to our customers as we've navigated through some significant challenges. It's truly an honor to be taking on a new leadership role as part of this extraordinary team. As I said earlier, our team recognizes that we have important work ahead of us in order to continue positioning our company for sustainable long-term growth. At the same time, we're ready to do this important work and to continue delivering great experience -- experiences to our valued customers. I believe in our team, I believe and our brand and I'm excited about our company's future. I'm also looking forward to working with the other leaders who are taking on new roles within our organization. And this includes Ben Bulkley, our new CEO of EnvisionRxOptions. As John said, Ben is an outstanding leader, and we welcome him to our team. At this time, I'd like to introduce Ben for an update on the Pharmacy Services segment. Ben?

Benjamin E. Bulkley - Envision Rx Options Holdings, Inc. - CEO

Thank you, Bryan. I'm pleased to be part of the Envision and Rite Aid teams and feel strongly about our opportunity to grow in a market increasingly hungry for our mix of solutions. The transparent PBM model is an important option right now and no organization has more experience with it than Envision. This was a big draw for me to join the team. And since I've started, I visited our offices around the country, led numerous round table discussions, chatted with customer care and clinical associates and have engaged teams throughout the company. It's a team that is very motivated to do the important work of supporting clients and their members. It's also a team that has a grit to grow in a competitive market. I've been impressed by the team's talent and enthusiasm and their desire to make a difference.

The conversations with clients have been upbeat and forward looking. They would like working with Envision. In fact, every client, everyone has made clear how much they appreciate the support they get from the great people they work with from Envision. There's also a refreshing level of candor about the things we can do better. Clients want to innovate with us. Because of the assets we have, they see the potential to deliver new value not only in clinical capability but in financial arrangements too. Consultants and brokers appreciate having flexible solutions not only the transparent pricing model and point-of-sale rebate capability but also our traditional model at MedTrak as well. Our Part D brokers were clear, they appreciate the clear consistent pricing as well as being easy to work with. Our growth will always be based on providing better and better levels of service, delivering innovative products and, of course, disciplined execution. I would like to provide some additional details to the results on the quarter which include $4.5 million increase in adjusted EBITDA, primarily driven by continued growth in Medicare Part D enrollment. We're very

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pleased with the growth of our Med D business and all told we now have roughly 635,000 enrolled Part D members for plan year 2019. In terms of open enrollment for the plan year of 2019, we added 95,000 new lives puts our larger-than-expected disenrollment in geographies where Rite Aid divested stores resulting in approximately 22,000 net new Med D members. We expect Med D membership to grow over 10% for the planned year 2019. The strategic decisions over the last few years are beginning to pay off. Most notably, our number of chooser members in our plans has increased from 77,000 in calendar 2016 to 352,000 today. We're also excited about the progress in the current year 2020 commercial selling season with several regional and health plan RFPs in-house, a number finalist opportunities and a new regional health plan alliance already in place. Also, we have won new commercial clients during the 2020 selling season that add over 220,000 lives and have several exciting prospects in the pipeline. Envision is well positioned to take advantage of the consolidation that is occurring in the marketplace. In addition, we're also excited about how Envision can play a key role in defining an integrated value proposition for payers as Rite Aid positions its unique assets to drive the greatest value to the enterprise. We look forward in working together and bringing this vision to light by driving positive patient health outcomes and creating even greater value in today's healthcare marketplace. Thank you for your time. Now I'll turn it over to Matt Schroeder for more information on our financial results. Matt?

Matthew Schroeder - Rite Aid Corporation - CFO

Thanks, Ben. And thanks, everyone for joining us today. On this morning's call, I'll provide a recap of the refinancing of our credit facility that we completed in December, walk through our fourth quarter results and review our fiscal 2020 guidance. On December 20, 2018, we completed the refinancing of our senior secured credit facility. As a result of this refinancing, we replaced our $2.7 billion revolving credit facility with the new facility that includes a $2.7 billion revolving credit facility and a $450 million term loan. These new credit facilities were scheduled to mature in December of 2023 with a springing maturity at December 31, 2022, if we have not repaid or refinanced our 6 1/8% notes due in April of 2023 before that date. The interest rate on the revolver has improved by 25 basis points over the old revolving credit facility. Our covenants under the new senior secured credit facility remains substantially unchanged. This refinancing pushes our debt maturities until 2023 and increases our current liquidity to $1.7 billion. This important refinancing strengthens our balance sheet and gives us the flexibility to make investments necessary to execute our growth plan as well as provide the time needed to execute on our strategy.

Now I'll turn to review of our fourth quarter results. Revenues for the quarter were $5.4 billion which were essentially flat to the prior year's results. Net loss from continuing operations was $255.6 million, or $0.24 per share, versus a net loss of $483.7 million, or $0.46 per share in the prior year's quarter. Current year net loss was impacted by a charge to income tax expense to report a $197 million increase in our valuation allowance against our deferred tax assets. I'll point out that our current federal tax affected NOL carryforward is $225 million. And with none of our federal NOLs expiring until fiscal 2029, this represents a valuable shield against future federal cash taxes. Adjusted net loss in the current quarter was $13.3 million or $0.01 per share versus adjusted net loss of $7.8 million or $0.01 per share in the prior year quarter. Our decline in adjusted net loss was primarily due to a decline in adjusted EBITDA which was a $134.1 million in the current quarter compared to $154.8 million in the prior year quarter. Retail Pharmacy Segment revenue for the quarter was $3.97 billion, which was $28 million lower than last year's fourth quarter. Our increase in comparable store sales was more than offset by the impact of the 82 underperforming stores that we have closed since the end of last year. Same-store sales increased 70 basis points in the quarter. Front-end same-store sales were down 1.9% but pharmacy same-store sales increased 2.1% with same-store script count up 80 basis points on a 30-day adjusted basis. The increase in script count reflects the continuing impact of our pharmacy initiatives, including our immunization program and our focus on improving clinical capabilities. We're pleased that we were able to grow scripts this quarter despite cycling a very strong flu season in the prior year's fourth quarter. Front-end sales were negatively impacted by soft performance in tobacco due to regulation changes that prohibited the sale of tobacco in certain New York stores beginning January 1 and in over-the-counter cough, cold and flu products due to cycling last year's strong flu season. Total Retail Pharmacy Segment gross profit dollars in the quarter were a $111 million lower than last year's fourth quarter and gross margin was 259 basis points lower as a percent of revenues.

LIFO expense increased $53.2 million, due to higher levels of pharmacy inflation in the current year. Adjusted EBITDA gross profit was unfavorable to last year's fourth quarter by $54.5 million and a 117 basis points worse as a percent of revenues. Pharmacy gross profit was worse than prior year's fourth quarter on a dollar and rate basis due to reimbursement rate pressure that we were not able to offset with generic drug purchasing efficiencies and comparable store prescription growth. Distribution expenses were unfavorable due partially to the realignment of stores within our distribution network. Front-end gross profit was worse than the prior year's fourth quarter due to decreases in front-end sales but front-end margin improved due to good marked down management and favorable shrink results. Retail Pharmacy Segment SG&A expenses for the quarter were $37.8 million lower than last year's fourth quarter, while SG&A rate as a percent of revenues improved by 76 basis points. Adjusted EBITDA

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SG&A was $29.1 million better than the prior year fourth quarter and 55 basis points better as a percent of revenue. Our SG&A improvement was driven by an increase in TSA fee income from WBA and lower payroll and advertising expense. Our Pharmacy Services Segment have revenues of $1.5 billion, which was an increase of $18 million or 1.2%, primarily due to an increase in our Medicare Part D membership.

Adjusted EBITDA for the Pharmacy Services Segment of $37.8 million was $4.5 million higher than last year's fourth quarter adjusted EBITDA of $33.3 million. The increase in revenue was partially offset by increases in SG&A expense as we invest for current year and future growth. Our cash flow statement for the quarter shows a use of cash from operating activities of $216 million. During the fourth quarter, we remitted a $180 million of the payment for our 2017 plan year CMS receivable to the reinsurer, which had a negative impact on our working capital. We did not utilize reinsurance for the CMS receivable in 2018. We also saw a decrease in accrued interest due to the payoff of several of our debt instruments with proceeds from the WBA asset sale during the year. Other differences were due to timing and receivables and payables. Our debt balance net of cash was approximately $3.3 billion at year-end and our leverage ratio was 5.7x adjusted EBITDA which takes into account the pro forma impact of the sale of the remaining distribution centers to WBA.

Now let's turn to our fiscal 2020 guidance. Similar to others in the retail pharmacy space, we are facing significant pharmacy margin headwinds as the lack of new generics in the break-open period and market conditions with regards to generics supply are expected to negatively impact our ability to offset reimbursement rate pressures with drug cost savings. These industry headwinds will more than offset the benefits we receive from the extension of our supply agreement with McKesson. We expect total sales to be between $21.5 billion and $21.9 billion and same-store sales to be in a range of flat to an increase of 1%. We expect to have positive script count growth through a continued focus on our clinical capabilities and prescription file buys and we'll be looking to expand into additional preferred networks in calendar 2020. At Envision, we expect additional commercial Med D business to offset some client losses that we will be cycling during fiscal 2020 as we turn our focus to the 2020 selling season. We expect adjusted EBITDA to between $500 million and $560 million. In addition to the pharmacy headwinds noted above, we expect to offset the loss of TSA income in fiscal 2020 with the impact of the headcount reductions that we announced last month. We also expect rent expense to increase by $11 million as a result of the adoption of the new lease accounting standard. We have identified further cost reduction opportunities that we will be aggressively pursuing which we expect to offset the impact of wage and benefit inflation. Our net loss guidance includes an estimate of $55 million for restructuring expenses, related to the rightsizing of our organization that we announced last month and the initiatives that John and Bryan discussed earlier on the call. I expect the restructuring expense estimate to be refined in future quarters as we further develop these initiatives. Keep in mind that this restructuring expense is not part of adjusted EBITDA or adjusted net income. We expect adjusted net income to be in a range of a loss of $7 million to income of $36 million, or a range of a loss of $0.01 to income of $0.04 per share. Our fiscal 2020 capital expenditure plan is to spend $250 million, which includes $60 million for script file buys and investments in technology design to accelerate our digital and omni-channel offering. We are planning to open or relocate 8 stores and remodel 70 stores in fiscal 2020. This completes my portion of the presentation. And now I'll turn it back to John.

John T. Standley - Rite Aid Corporation - CEO & Director

Thank you, Matt. Before we open the lines for questions, I just like to state that despite a challenging environment for pharmacy reimbursement rates, we're well positioned to build on our strengths and capitalize on our best opportunities for future growth. We have important momentum in key areas such as same-store pharmacy sales and script count, cost control and our Pharmacy Services Segment. Based upon our analysis of the marketplace and a thorough understanding of our target customer's needs, we also have a clear strategy for our path to the future that will leverage our core competencies and unique capabilities in delivering improved patient care, see us reimagining our front-end business and drive further efficiency to fuel strategic investment. And finally, we also have ample liquidity and a stronger balance sheet which gives us the time and flexibility we need to execute our strategy for growth. While we have some critical work ahead of us, we also have full confidence in our team, our strategy and our company to succeed as we build momentum for the future. That concludes our prepared remarks for the call. We will now open up the phone lines for your questions.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of John Heinbockel from Guggenheim Securities.

John Edward Heinbockel - Guggenheim Securities, LLC, Research Division - Analyst

John, 2 things. Number one, if we think about the decline in adjusted EBITDA in 2020, that is entirely concentrated in the retail segment. Is that fair? And then secondly, it sounds like you still believe the retail business can grow EBITDA long term. What does it take -- what's the most important prerequisite to get there? Is it to have a significant improvement in reimbursement pressure, is that the most important thing?

John T. Standley - Rite Aid Corporation - CEO & Director

Well, I guess the first -- to the first part of the question, yes, it's really -- it's the -- the decline in adjusted EBITDA is focused on the retail side of the business. I do -- I'm a believer on the retail business, John, I really do think this thing can grow over time. I mean I think if you -- I know we're a little negative here on the comps, but if you, kind of, look at where we've been through the last few years, I think we're still in a really great position here. And we've done a lot of work here on this business over the last several months, while not obviously huge impact on fiscal year '20. I think we build the plan here with a lot of great initiatives and activities in it that we think is going to really reinvigorate this business in moving forward. And so while -- maybe there's a little bit upside to what we've got in the guidance here, we think there's a big impact for us in fiscal year '21. So we've got a lot of good things working behind the scenes here. Reimbursement rate obviously is a little bit of the limiter on our results. It's going to depend on how that kind of plays out over time. From where reimbursement rates were honestly 2 years ago to where they are today, it has gotten a little bit better for us. But obviously, we've seen some tightening on the generic market as well. So we continue to work with payer partners to try and find solutions that work for both of us, that allow them to be competitive in the marketplace but also allow us to make appropriate returns in our investments to do -- to deliver the services that we're delivering. And the other thing I would just say on the reimbursement rate side, John, is that we I think have a lot of our core capabilities here to really drive better outcomes -- health outcomes in the marketplace. And I think a key part of where we're going is to really leverage those capabilities. That should make us a better partner, more valued partner as we go forward. And so I think it all, sort of, fits together for us. We think it all comes together in a singular way that takes us forward. So we're going to fight the reimbursement rate. It's going to be a challenge, but there's a lot of -- there's enough opportunity here with improvements to the business and we think additional revenue streams that we can access, that we can actually grow this business overtime.

John Edward Heinbockel - Guggenheim Securities, LLC, Research Division - Analyst

And then 2 quick things. The -- if I think about the cost inflation on the retail side of the business, right? Labor, rent, et cetera. Is that in the 2%, 2.5% range? Is that about right. And then secondly, when you think about your vision for the front end and SKU optimization, so I take it that is not OTC/HBA, that is more food and consumables. What do you think -- when you think about revitalizing the front end? And I still think wellness+ is a key part of that. But is it assortment? Is it that the value proposition has gotten stale? How do you assess that?

John T. Standley - Rite Aid Corporation - CEO & Director

I think -- I would just say and I'll kick it over to Bryan. I think assortment is a piece of the puzzle for us. We've got to continue to evolve the merchandising inside the store. We made a lot of progress when we went to the wellness format, but I think we have another opportunity, another, kind of, turn of the wheel here to take the merchandising forward. Own brand is a huge opportunity for us. There's so much more that we can do in that space as we push forward here and kind of getting the noise of the past behind us. So I think it's opening some doors for us. Again, to gain additional access to things it'll really I think help us, kind of, push forward there. And I do think there are some additional services that we can do inside the box. You talked about wellness+ but tying that in with the wellness ambassadors and other things we can do with our pharmacists, those are all going to be big parts of how this kind of plays out. I don't know Bryan, you want to...?

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Bryan B. Everett - Rite Aid Corporation - COO

John, it's Bryan. To answer the first question, I think that's probably a fair range. Although, we work to offset these additional expense challenges just through operating efficiencies and technologies. So we feel pretty good about that. Just to build on John's comments, we've really identified beauty, health, vitamins and consumables as the 4 categories in the front end of the store that we will continue to invest in, in terms of differentiation. And we will edit the assortment, but it's also an introduction of cleaner products, more better-for-you products, as John mentioned, a huge effort around own brand. We have a lot of opportunities there. And it's actually pretty exciting. And then we're also looking at our marketing as we shift some of these dollars to more personalized, more digital, more relevant offers that we have access to through our -- again our loyalty program in just moving away a little bit from the mass message to a more personalized message. Lot of work in the pipeline you bet.

Operator

Our next question comes from the line of Lisa Gill from JPMorgan.

Michael Roman Minchak - JP Morgan Chase & Co, Research Division - Analyst

It's actually Mike Minchak in for Lisa this morning. First question, you guys talked about the focus on gaining access to limited networks going forward. We've seen significant traction in the Part D market. But what are you seeing in the commercial market? Has there been increased uptake of preferred or narrow networks there? And then you also highlighted the emerging value-based care marketplace. So you're starting to see interest from payers or PBMs around high-performance networks or outcome-based reimbursements and if so, is that discussion that you're having for calendar 2020? Or is that, sort of, more of longer-term opportunity at this point?

John T. Standley - Rite Aid Corporation - CEO & Director

I think, it's probably both. In terms of the commercial marketplace, it's still I'd like to stay, kind of, a gradual uptake in terms of narrow preferred networks there. There's still -- there's interest in it, but it's not moving at the speed that Part D has. We think there's a unique opportunity for us. We build some care models in the past. We were, kind of, connected more at the provider level where we really drove some improved health outcomes. We think there's a real opportunity for us to connect deeper at the payer level, particularly in working with EnvisionRxOptions here as there's a lot of interest that we, kind of, been out and surveyed the marketplace a little bit. There's a lot of interest particularly in the retail health plan space. Our folks who're really looking in terms of how they're going to compete with these bigger vertically integrated, sort of, health care models. We think there's some exciting opportunities for us potentially in that space and others as they, kind of, dig in here with the, kind of, things that we can do with the core competencies that we have. So that's where we think a lot of the opportunity is. There's been a lot of action over obviously in the Part D space. And even some in the commercial space with some of our reimbursement being tied to outcomes in terms of how -- what we deliver on various key metrics in the pharmacy. So that's, kind of, an ongoing trend I would say.

Michael Roman Minchak - JP Morgan Chase & Co, Research Division - Analyst

Got it. And then you've talked about opportunities around prescription file buys. Can you talk about what that pipeline looks like at this point with the ongoing reimbursement pressure that you and your larger competitors have been discussing? Are you seeing an increase in number of opportunities for file buys? And can you talk about whether there's been any changes in terms, sort of, the relative historical valuations on the script files?

Matthew Schroeder - Rite Aid Corporation - CFO

Yes, Mike, it's Matt. I'll jump in and tackle this one. I think from the standpoint of either there's always been, kind of, a pretty robust pipeline. There's a surprising level of churn in this business. When you get pass, kind of, the some of the -- get down into the independent level, there's quite a few

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independence but there's a lot churn in the business. And the other thing is, I think, you are seeing some competitors probably more on the big box and grocery level who are looking to scale back their pharmacy -- have looked to scale back their pharmacy offer and that's put some stuff in the pipeline as well. It's competitive. It's competitive on a, kind of, deal-by-deal basis. So it all depends on who's in the marketplace. As far as the valuations, I think, in the past we've used a range of $10 to $20 per script, and I'd say that range still holds.

Michael Roman Minchak - JP Morgan Chase & Co, Research Division - Analyst

Got it, that's helpful. And then if I could ...

John T. Standley - Rite Aid Corporation - CEO & Director

I would just throw one more thing on to that. We talk buying files, we talk about preferred networks and things, I mean, a big opportunity for us is really about the capacity we have in this business today. I mean, we have the ability to add a lot of script volume here. There's a high component of fixed cost in operating our retail pharmacies. So between that -- those kinds of opportunities and, again, trying to build relationships with payer partners on outcomes and using that to bring more foot traffic into the stores as well, we think there's a lot of value that we can create here. And those file buys and preferred networks have a low incremental cost to fill. So we can afford to make some investments there.

Michael Roman Minchak - JP Morgan Chase & Co, Research Division - Analyst

Got it. That's helpful. And if I could squeeze one more in on the PBM side. As we think about the proposed HHS rebate rule on rebates at the point-of-sale. As it relates to your PBM business, how can -- can you talk about the potential impact to your business if that were to go in place as proposed? And if we're ultimately to see a shift away from rebates in the commercial market, can you talk about how much of your profit is driven by retained rebates and, sort of, what the impact would be on your business going forward if rebates were to go away?

Benjamin E. Bulkley - Envision Rx Options Holdings, Inc. - CEO

So right now -- Mike, it's Ben. We retained no rebates in our Medicare Medicaid lines. To our commercial clients, we passed all the year-end rebates in our transparent model. So the key question with the proposed ruling is one on timing, given as we move into our bids coming up and having a stable set of rules. Our expectation is we'll be bidding off of the rules that are in place at that time, and we hope to do well with that.

Operator

Our next question comes from the line of Robert Jones from Goldman Sachs.

Kevin Hartman - Goldman Sachs Group Inc., Research Division - Business Analyst

This is Kevin on for Bob this morning. So first, obviously, reimbursement pressure seems to be having a meaningful impact on you guys and your competitors this upcoming year. I was just wondering if there's any detail you can give around expectations or cadence for the retail gross margin through fiscal '20. And whether you expect we should see any improvement in margins off of the fiscal 4Q level?

John T. Standley - Rite Aid Corporation - CEO & Director

Sure, that's -- I think that's a great question. Again, I think for us when we look at just overall the cadence of reimbursement rate, I think this last year and this coming year fiscal year '20, they are at reduced levels from where they were just the 2 years prior to that. We've actually saw much deeper declines. And the issue for us this coming year is a little bit probably more on the purchasing side. Having said that, we're actually not quite yet buttoned down. For fiscal year '20 we still have an open contract that we're working through. So our guidance is based on the best information

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we have right now based on where we think rates are going to land. In terms of cadence, I think you're right. Generally the fourth quarter, even into the first quarter here, it takes us a little bit of time to get the generic savings through our various bids and also little bit of timing on how some LOEs are coming to market in the year. So a little bit more pressure early. And then as those savings and some of the LOEs kick in the back half that really pushes us along.

Kevin Hartman - Goldman Sachs Group Inc., Research Division - Business Analyst

Awesome, thanks. And then one quick one on cash flow. So if I look at the fiscal '20 guidance for EBITDA and, kind of, factor out interest, CapEx and some of the restructuring, it's getting me to roughly break even for cash flow for next year. So when is that like roughly correct and would you expect net working capital to be a meaningful swing factor one way or other next year?

Matthew Schroeder - Rite Aid Corporation - CFO

Yes. First of all, your math is correct. You, kind of, walked the EBITDA down to the cash interest and debt rent and CapEx, you get to a flat cash flow. I would say some of the initiatives we're focusing on could have a working capital impact, we're going to be pushing hard on those. I don't want to -- meaningful, it's probably a big numbers, but I think my expectation would be we have some possible working capital benefit coming through this year.

Operator

Our next question comes from the line of William Reuter from Bank of America Merrill Lynch.

William Michael Reuter - BofA Merrill Lynch, Research Division - MD

In your guidance, you talked about reimbursement rate pressure and '20 being similar to '19. Can you tell us what the reimbursement rate pressure would have been on a dollar basis in '19? And I think there's a lot of commentary in the industry that these reimbursement rates pressures are accelerating. So I guess it was little surprising that you said it was similar, so if you could comment on that as well?

John T. Standley - Rite Aid Corporation - CEO & Director

Well, I mean, I think we all have different contract renewal dates and cadences. We never -- I don't think it's appropriate for us to give that out because it starts to get where our actual rates are. So I don't think that's the right thing to do. But because of timing of renewals and we took a lot of rate declines a couple of years ago that when we were working through some of our merger activity. So it does show up at different times in different places I think. I don't think we all have to be in exactly the same spot at any given moment. We do still have an open contract work to do for the current year. So we got to get that finalized. But our comments are accurate, our rate pressure is probably very -- going to be we think based on what we know so far. It's going to be pretty similar for our fiscal year '20 as well as for fiscal year '19.

Matthew Schroeder - Rite Aid Corporation - CFO

The only thing I would add is I think the commentary around the generic market between the, kind of, introductions that are single source and the supplier are things that some of our competitors have been saying as well that, that's putting a big factor on pharmacy margin.

John T. Standley - Rite Aid Corporation - CEO & Director

Yes, for sure.

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William Michael Reuter - BofA Merrill Lynch, Research Division - MD

That make sense. And then, I don't think if I remember that you have ever quantified the new McKesson agreement in terms of the tailwind there. Is there anything you can provide there because I think it becomes effective in March or, I guess, a month ago?

John T. Standley - Rite Aid Corporation - CEO & Director

Now, it actually kicked back in the fourth quarter.

Matthew Schroeder - Rite Aid Corporation - CFO

It's already effective. We have never given, kind of, the number. So again, it's in the guidance. We don't break out all the various components of pharmacy margins.

William Michael Reuter - BofA Merrill Lynch, Research Division - MD

Okay. And then just lastly for me. It would seem to me that given the transparency of the EnvisionRx business model, it would be a little better position given a lot of these, I guess, headlines that are coming out in the market. I guess, do you think that is the case? And do you think that this is going to allow you to win additional Medicare Part D in those 2020 negotiations for bidding?

Benjamin E. Bulkley - Envision Rx Options Holdings, Inc. - CEO

Yes. Well, and there's been -- we do -- we're seeing a really nice uptick in the health of our funnel. We're off to a great start already this year. So we're very positive on the progress we're making. And clients are indicating a real hunger for this option as they consider their buying decision.

Operator

Our next question comes from the line of Ross Muken from Evercore.

Unidentified Analyst

This is [Susie] on for Ross. I think most of my questions have been asked. But you mentioned you've initiated the search for a new CEO. Could you just provide us with an update on management plans and what the timeline looks like for the CEO, CFO and COO hiring?

John T. Standley - Rite Aid Corporation - CEO & Director

Well, we've got a CFO. Matt Schroeder is here and he is our CFO. So that's a good news. We have a COO, Bryan Everett's here. I'm the guy on the bubble, and I know the board is actively working on search. So did I answer that question, I'm not sure.

Operator

Your next question comes from the line of of Karru Martinson from Jefferies.

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Karru Martinson - Jefferies LLC, Research Division - Analyst

In terms of TSA wind down, you talked about $42 million of savings coming through this year being realized. What's the cadence of those savings? And what's your level of confidence on offsetting that full $96 million?

Matthew Schroeder - Rite Aid Corporation - CFO

First of all, the cadence of the savings is pretty much starting right away and going through the year. I mean, the restructuring announced last month is being actioned very quickly. So I would say that's pretty evenly spread through the year.

John T. Standley - Rite Aid Corporation - CEO & Director

I mean probably a little bit less than the first quarter and more in back, but yes.

Matthew Schroeder - Rite Aid Corporation - CFO

On the $96 million, Karru, I think as we moved along here through the TSA wind down, I think, we've done actually a pretty good job of not leaving stranded cost in the business for that. And we talked about how this $40 million is going to almost directly offset the reduction in TSA fees that we are expecting for this year. I think between the other initiatives we have out there, plus, kind of, the rest of the run rate impact of the restructuring that we've already announced, I'm very confident we'll offset that $96 million.

Karru Martinson - Jefferies LLC, Research Division - Analyst

Okay. And then in terms of the pro forma leverage here, that's assuming that the $160 million or so comes in from Walgreens' excess proceeds and those would go to the 2023, that's correct?

Matthew Schroeder - Rite Aid Corporation - CFO

Yes, it assumes that the $160 million is a reduction in our debt. I think we still have some limited excess proceeds offer we need to make on the 2023 notes. I don't know if it lines up dollar per dollar, but there is a little bit more we need to do there.

Karru Martinson - Jefferies LLC, Research Division - Analyst

Okay. And then lastly, as you guys talked about looking at your front end and aligning with your customer needs. We've seen some talk about looking at the card sections to bringing in the CBD oils and things of that nature. How do you look at transforming? What parts of your business do you feel are lagging? And what parts have traction with the consumer today?

Bryan B. Everett - Rite Aid Corporation - COO

Karru, it's Bryan. I'll just kind of reiterate the overall SKU optimization project. So really try to identify SKUs that are unproductive, get those out, reallocate that space for more better-for-you cleaner products, natural organic, and then the own brand. It's probably the one -- to answer the last part of the question, it's probably the one that where we have the most opportunity to make up ground on.

Operator

And we have a time for one more question. Our final question today will come from the line of Bryan Hunt from Wells Fargo Securities.

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Bryan Cecil Hunt - Wells Fargo Securities, LLC, Research Division - MD & Senior Analyst

Just sticking with Karru's questioning. Have you all done any initial reset testing on the front end? And what type of reactions are you getting from sales and margin improvements on those resets?

Bryan B. Everett - Rite Aid Corporation - COO

Bryan, it's Bryan. We have experiment with a number of different we call them innovation sets both in grocery, healthcare. But we've got a lot more work to do. So the new wellness remodel, we still believe is a very shoppable and easy-to-navigate experience. We believe the layout in that format is still very good. But when you start digging into the item selection within the departments, we again, think there's some opportunity to, sort of, edit what we have itself. The new grocery innovation that we worked on, that we talked about a little bit last quarter, I think we have this in about 150 stores. We're getting very good feedback from consumers about the expanded assortment of healthy offerings, that easier-to-navigate aisles, et cetera. So I guess the short answer is yes, we have quite a few of those different tests out there in the field. And we will continue to do so.

John T. Standley - Rite Aid Corporation - CEO & Director

And I would just add, we're working through a process that will go through a good part of this fiscal year. That -- again, as we think about the pharmacy side of the business and really some core customers that drive both the pharmacy and the front end and how we could better meet their needs, we're also looking at what kind of disease [dates] are we talking about. We're looking at a little bit more locally and regionally about how these stores should be merchandised. And trying to get all those pieces of puzzle really to fit together as we go forward.

Bryan Cecil Hunt - Wells Fargo Securities, LLC, Research Division - MD & Senior Analyst

And when you look at all the tests whether it's on the pharmacy side and the additional services you may add, or on the front-end in terms of merchandising, do you all expect to have some type of more formalized plan that can be rolled out next year? Or do you feel like ...

John T. Standley - Rite Aid Corporation - CEO & Director

Yes. That's exactly right. We got a ton of work going on behind the scenes here. So we've got parts out being testing and what not. But it's going to come together in a more formal way for fiscal year '21 and we'll be talking about it each quarters as it develops here.

Bryan Cecil Hunt - Wells Fargo Securities, LLC, Research Division - MD & Senior Analyst

Great. Just a couple of more questions. One, you look at Amazon lockers. Can you talk about stores where you have Amazon lockers today? And may be, how the performance of those fronts ends may differ relative to stores that don't?

Bryan B. Everett - Rite Aid Corporation - COO

Bryan, we have these lockers in a few stores. And I would say, just generally, we see some traffic generated from these lockers. We will be expanding this over the next few months to an additional 900 stores. We're actually 900 in total. So we are excited to move forward with that partnership.

Bryan Cecil Hunt - Wells Fargo Securities, LLC, Research Division - MD & Senior Analyst

If you look at the CBD opportunity, I know you're rolling it out in a few states, it seems like there's a lot of noise in that category in terms of product purity. Is there any way you could communicate to us which brand or brands you're rolling out?

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Bryan B. Everett - Rite Aid Corporation - COO

What I can say Bryan is we have 2 vendors that we have been working with for several months actually. And like any product we put in the store there is a pretty rigorous betting process to make sure we have the best offering available. The other comment I would make is at this point in time, we're only offering the topical solutions of creams, lip balms, lotions and we won't be carrying any of the injectables at any of stores as part of the pilot.

Bryan Cecil Hunt - Wells Fargo Securities, LLC, Research Division - MD & Senior Analyst

And then my last question. I know there's a measles scare in various parts of the country, you have stores in those areas. Are those vaccinations that you all can provide? Are you staying in any difference of performance, I guess, in certain parts of the country given the various scares on measles and maybe other viruses currently?

John T. Standley - Rite Aid Corporation - CEO & Director

Okay. It's a short answer. The answer is yes. We do provide these vaccinations. And yes, we're seeing an increase in the administration of these immunizations. And we have supply to do so.

Operator

And there are no further questions.

John T. Standley - Rite Aid Corporation - CEO & Director

Okay, great. We appreciate everybody's time today. And look forward to talking to you in the future.

Operator

Thanks to all of our participants for joining us today. We hope you found this webcast presentation informative. This concludes our call. You may now disconnect. Have a great day.

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