



Nanotech Security Corp.

Second Quarter 2019 Results Conference Call

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C O R P O R A T E P A R T I C I P A N T S

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C O N F E R E N C E C A L L P A R T I C I P A N T S

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Anthony Prost, *GMP Securities*

P R E S E N T A T I O N

Operator:

Good afternoon, and thank you for joining us to discuss Nanotech Security Corp.'s Second Quarter 2019 results. Today's call is being recorded. On the call today we have Troy Bullock, Nanotech's President and CEO, and Monika Russell, Nanotech's acting CFO. At this time, all participants are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session, and instructions will be provided at that time for you to queue up.

I will now turn the call over to Monika Russell.

Monika Russell:

Good afternoon, and thank you for attending our Second Quarter 2019 Conference Call. Troy Bullock will begin the call today with an overview of our Q2 results and operational highlights. I will then provide a detailed review of our financial performance for the quarter. Following the financial review, Troy will provide an outlook and a discussion of our goals and expectations for Fiscal 2019. Following the formal presentation, we would be pleased to take questions.

However, before we talk about results, I'd like to remind everyone that certain statements in this call may be forward-looking in nature. These include statements involving known and unknown risks, uncertainties, and other factors that could cause actual results to differ materially from those expressed or implied in our forward-looking statements. For caveats about forward-looking statements and risk factors, please see our MD&A for the year ended September 30, 2018, which can be found on our Company profile at sedar.com.

Also, as part of the Company's business involves dealing with security features for banknotes, you will appreciate that we are quite limited in our ability to provide details about specific customers and prospects. That said, we will do our best to provide investors with general feedback we are receiving from our customers, the industry, new opportunities that we are pursuing, and give some general parameters

on how these development contracts normally advance into full deployment as security features on banknotes.

I will now pass the call over to Troy for an overview of our second quarter. Troy?

Troy Bullock:

Thanks, Monika, and good afternoon, everyone. Thank you for taking the time to attend our conference call for the second quarter of fiscal 2019. Our second quarter ended March 31, 2019 was a good quarter for the Company.

Financially, we saw revenue increase 3% year-over-year to \$1.9 million and although Adjusted EBITDA decreased \$88,000 year-over-year to \$45,000, I am pleased that Nanotech achieved its eighth consecutive quarter of positive Adjusted EBITDA. Gross margins remain strong at 69% and we exited the quarter with a very solid cash position of \$10.1 million. Financially, the Company remains in a very strong position.

As many of you know, Nanotech currently generates most of its revenue from development contracts with a single customer, with the goal of incorporating a Nanotech security feature on their bank note. We continue to anticipate that we will generate most of our Fiscal 2019 revenue from this customer. As we shared on our Q1 conference call, at the current stage of development contract, the customer is narrowing the scope of development activities with an intention to select a final security feature. This selection could see us move to delivering production volume samples in Fiscal 2020. We continue to operate under the agreement with this customer to provide up to \$30 million in research and development services. As of March 31, 2019, we recognized \$13.4 million of this revenue.

I am also pleased to share that Nanotech not only delivered its first products for the commercial brand protection market during the quarter, but we also completed our first sale in the commercial market. We developed two brand protection products around interest from this customer and we were able to prove out the manufacturing process as we successfully fulfilled the order.

According to Marcus & Marcus, the global anti-counterfeiting packaging market was estimated at \$106 billion in 2019 with healthy growth rates. We feel we are putting in place the right products and go-to-market strategies to take advantage of this market opportunity, though it may take some time to generate additional sales and reference customers. That concludes my initial comments on the second quarter of Fiscal 2019 and I will now pass the call back to Monika to discuss the detailed financial results for the quarter. Monika?

Monika Russell:

Thank you, Troy. Before I begin, I would like to mention that all of the dollar amounts I refer to are in Canadian dollars unless otherwise stated.

Starting with our quarterly results, revenue for the second quarter of 2019 was \$1.9 million, up 3% from the second quarter of Fiscal 2018. This year-over-year increase was primarily due to revenue from products and services while development contract revenue was largely flat year-over-year.

Gross margin for the second quarter was 69% versus 74% in the second quarter of 2018 due to a lower proportion of development revenue in our revenue mix. We continue to contain our operating cost. For the second quarter of 2019, operating costs were \$1.9 million compared to \$2 million in the second quarter of Fiscal 2018.

Net loss for the second quarter of 2019 was \$477,000 versus \$285,000 in the second quarter of 2018. The difference was primarily due to the higher foreign exchange losses in the current quarter. Adjusted EBITDA for the second quarter of 2019 was \$45,000 compared to \$133,000 in the same period of 2018. As Troy mentioned, this was our eighth consecutive quarter of positive Adjusted EBITDA. The decrease from the prior period was primarily due to reduced margins in the current period.

Moving on to our year-to-date results, revenue for the first half of 2019 was \$3.6 million, down 10% from 2018. This year-over-year decrease was primarily due to the timing and scope of development contracts.

Gross margin for the year-to-date was 70% versus 74% in 2018 due to a lower proportion of development revenue in our revenue mix. Operating costs were \$4.4 million in the first six months of 2019 compared to \$3.6 million in 2018. This increase reflects the investment we have made in our sales and marketing efforts and in our people as we have increased head count year-over-year.

Net loss for the first half of 2019 was \$1.6 million versus \$189,000 in 2018. The difference was primarily due to restructuring cost associated with the executive transition in the current year in combination with decreased revenue. Adjusted EBITDA for the year-to-date was \$163,000 compared to \$593,000 in the same period of 2018. The decrease from the prior period was primarily due to reduced revenue and margins in the current period.

The Company remains debt free, and we ended the quarter with a strong cash position of \$10.1 million, a decrease from the \$10.9 million reported at December 31, 2018. Our operations consumed \$809,000 and we made capital investments of \$22,000 during the quarter.

This concludes my comments on our results for the second quarter. I will now turn the call back to Troy to provide an update on our outlook for 2019. Troy?

Troy Bullock:

Thanks, Monika. When I assumed the role of CEO in January, I established goals for our Fiscal 2019 and I want to take the remaining part of the call to update you on how we are tracking after four months.

The banknote market continues to be Nanotech's primary market and the Company has two areas of focus in the banknote market. The first is contract development activities. As I mentioned previously, Nanotech currently generates most of its revenue from development contracts with a single customer with a goal of incorporating a Nanotech security feature on their bank note. I am happy with our progress in the contract development work, which is progressing very well. The second area of focus for developing our banknote market is to expand our banknote product line. Development efforts for a new and innovative banknote product are underway with an expected launch in 2019.

In addition, we are making investments in our internal manufacturing capabilities, which will enable us to increase our optical thin film offering over time, enabling us to produce and fulfill security feature for bank notes for commercial customers in the future as well.

Another pillar of growing and diversifying our revenue base is in the launch of products targeting specifically for the commercial markets. On April 2, 2019, the Company successfully launched two products specifically targeted for the commercial brand protection market, LiveLogo™ and Dynamic Portrait™. These products will allow customers to showcase their logo, tag line, and products using our unique and compelling KolourOptik® technology. You can view more details about LiveLogo and Dynamic Portrait in the product section of Nanotech's website.

To support the launch, we have completed extensive effort on our North American supply chain development and vendor qualification. These efforts ensure that live logo and dynamic portrait can be produced and delivered to customers within short lead times and in commercial volumes ranging from thousands to millions. I am very pleased that the Company completed its first sale in the brand protection market this quarter, which as I discussed in my opening remarks.

We are now marketing these products both directly to companies as well as to established packaging OEMs that can broaden our reach. While it is too early to provide much detail at this point, we are encouraged in the early days of our new commercial activities and initiatives.

On the sales side, we would like to create a direct sales force in 2019. In January, Brian Donnelly joined the company as Vice President of Sales. In a short timeframe, Brian has reached out to all of our existing customers and several new prospective clients in the commercial market. We will continue to focus on building out Nanotech's sales team and growing the sales pipeline. You can expect to see an announcement shortly about a new addition to our sales team as we are adding an experienced brand protection sales executive to Brian's team to focus specifically on the commercial market in North America.

Moving onto our Fiscal 2019 guidance: while in the first half of the year, we are tracking at or ahead of our guidance, we have decided to leave our initial guidance unchanged. On revenue based on our current visibility and conservatively assuming no additional contracts that we would win during the year Fiscal 2019, revenue is expected to be between \$7.4 million and \$8.3 million. As I mentioned earlier in the call, our development contract customer has narrowed the scope of development activity as they moved towards collecting a final security feature. While focusing on one security feature is a positive development, overall 2019 revenues may still be negatively impacted as seen in the first quarter.

For the first six months of 2019, revenues tracking in line with the higher end of our guidance. Although we have seen growth in the most recent quarter, we have not changed our guidance for the year as the timing and scope of development contracts may still be negatively impacted in the second half of 2019.

On the earnings side, as we previously stated that our Adjusted EBITDA loss could approximate \$1 million in 2019. Potential declining revenue and increased investment in the Company's sales efforts and product offerings could reduce near term profitability. For the first six months of 2019 Adjusted EBITDA was positive at \$163,000. At this time, we have decided not to change our guidance as there continues to be uncertainty due to the timing of revenue related to our development contracts in our fourth quarter.

Looking into the future, Nanotech's KolourOptik nano-graphic display technology offers unprecedented live content, visual effect, and high-definition color that redefine conventional print image. As we continue down the path to fully commercialize our technology, we are well-positioned with our secure production facility to deliver highly differentiated products to both the banknote and commercial markets. We are already well into advancement of our commercialization strategies and in the coming quarters, we will continue to make significant investment in our sales and marketing efforts as we continue to pursue both the banknote and commercial markets.

With that, I will now pass the call back to the Operator to open up the call for questions. Jessica?

Operator:

Thank you. If you would like to ask a question, please signal by pressing star, one on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star, one to ask a question.

We will go first to Gianluca Tucci with Echellon Wealth Partners.

Gianluca Tucci:

Hi Troy, good afternoon.

Troy Bullock:

Hi Gianluca, how are you?

Gianluca Tucci:

I am well, thanks. Yourself?

Troy Bullock:

Very well.

Gianluca Tucci:

You signed or had your first sale in the commercial pros (phon) market there, so congratulations. Of the \$1.9 million that you did in the quarter, how much came from the development contract?

Troy Bullock:

Yes. You have switched on the end, going to ask it the other way around. No, you are correct, so we did have our first sale in the commercial market, or commercial sale in the branding market.

First, let me just provide a little bit of color on that because we are quite excited about that sale. That is a customer that we have been working on for the better part of I would say six to nine months leading into that and in that process, we had a pretty good sense from them as to what they were looking for in a product and a lot of the discussions we had with that initial customer went into the design characteristics of our product launch, particularly LiveLogo and so we were using that initial lead customer to develop a great product that we launched and that came out in April. We did successfully get that product launched, but we were working on that customer opportunity beforehand and that particular customer opportunity was about a \$50,000 sale.

In regards to the product development contract work, we actually fully disclose that now in our financial statements so we did \$1.5 million in development contracts, which is on Note 11 of our financial statements.

Gianluca Tucci:

Okay, thanks for that color there. Into Q3 and Q4 of your fiscal year, do you have any visibility on if that development work is going to be increasing or hovering around the same, what kind of color can you give us there?

Troy Bullock:

Yes, it is a difficult one for me to answer and that is why we held back on revising any of our guidance going forward. We are making really good progress on the development contract. We've had a number of great meetings with the customer. As we go through Q3, we do anticipate that revenue staying at or

above where it is now. As we enter Q4, that is the next stage, where we are still in the process of finalizing the size of what that contract will be with this customer, which will be typically a 12-month contract and obviously that will impact my fourth quarter revenue. There is risk that it could be delayed in signing and it may not get signed until September timeframe, which would mean an impact on my Q4; however, there is also upside opportunity for us that is significantly higher than what we did last year.

I am really left with a bit of an uncertainty there. I know we are progressing well and I do expect us to move to the next level, but I just don't know the timing yet of the execution of that contract and whether it is going to have growth or significant growth to it. Our Q3, we've got pretty good visibility, but our Q4 is a little bit up in the air for us right now and that is why our guidance is kind of at that lower end where we are kind of conservatively looking at what would happen.

Gianluca Tucci:

I understand, okay, thanks. You mentioned previously that your development customer, they're going to be making a decision in Fiscal 2020 about if you are going to be added to the banknote and delivering at scale volume, so did they tell you if you are going to be added to that banknote in December or in the fourth quarter of this year?

Troy Bullock:

No, I would put the milestones more like this, Gianluca. The first stage is this summer through to September, we would like to see ourselves transition into a production proof of concept phase, which would last for about 12 months and that phase, as I just described, could see us with a lift in revenue, it could see us, depending on the timing, whether it closes in August, September or October, it could be a reduction, just depending on when that happens.

The overall scope of work should be significantly larger than what we have seen to this point. That project should last for about a year, at which stage we would move into integrating into their production facility, I guess, if you will. That is when we would start to see a real lift in our revenue as we would start to be producing fairly significant volumes for them. It wouldn't necessarily be at a stage where we are announcing we are on the banknote or anything like that, but we would be generating and benefitting from some pretty significant revenue at that point because effectively we would be producing full volumes for them.

Gianluca Tucci:

Okay, I appreciate the color, thanks, Troy. You didn't mention tax stamps at all, is it safe to assume that NTS is foregoing that opportunity in India?

Troy Bullock:

I wouldn't go quite that far. I think we do have a couple of good partners in India and we have also got some good opportunities with other banknote OEMs that also sell into the tax stamp market, so we are pretty well positioned with respect to partners that have existing business in tax stamps. As it relates to India though, I have had an opportunity to review the progress of sort of where they are at and at this point, I can't see that they are that far along. They've invested quite a bit in their sales and marketing activity, but I haven't seen them get a lot of traction yet, so as it relates to 2019, I don't have anything in our forecast or in our funnel that relates to that. I think it is still early for them there, but that said, they are coming out here in June and we plan to do a workshop with them to maybe provide a little bit more education, perhaps solve a couple of issues that they may have and like to see them get back on track because they are very excited and still prepared and are spending money behind our product to their

customers, but when I review their progress to this point, I still think there is some help we need to give them before they sort of get over the line where I can start forecasting and counting on revenue there. I haven't given up on it by any means, but I think we have some work to do there yet.

Gianluca Tucci:

Okay, and if I could just focus on the commercial markets for a minute, so you launched your two new products in April and you signed a brand protection customer thereafter, can you add some more color on what types of customers you are targeting for the commercial space and the types of opportunities that are, if not in your funnel now, soon to be in your funnel?

Troy Bullock:

Good question. We are just early into that space and so when we look at the brand protection market, we are seeing, again, the same partners that are selling into the banknote space that are also selling into this space and typical customers there—and so when I think of those sorts of OEM, some of the bigger players in this space are companies like OpSec or De La Rue or Kurz, CCL is a big player. When I look at those sorts of OEMs that have significant customer bases, there is opportunity for us to partner with them, to help provide a different solution for their customers. At the same time, we are also looking at going directly to end customers to find solutions or provide solutions.

When we look at some of the types of customer sales, there are everything from customers that would put a security feature on a printer cartridge or on some software to demonstrate that it is an authentic product and those volumes can be quite ranging. They can be customer opportunities where the volumes might be 5 million to 10 million units a year, they might even be less than a million units a year, upwards of—we have seen opportunities where they were upwards of 800 million to a billion units, and so it is a pretty ranging scope of different opportunities, so our approach to market is really to go after the OEMs as well as to sell direct and one of the things that I hope we will be announcing in short order, likely towards some point next week, towards the end of the week, is that we are in the process of bringing on a sales executive that has been selling in that market for 15-plus years, specifically selling into the commercial market, selling security features to the customers like this.

We are pretty excited about having this fellow join us, I do not want to say too much because once we get all the details and finalize things we will put that out in our news release and announce the individual's name and you will have much more color around it, but it is a pretty big opportunity and I think the amount of go-to-market work that we need to do is, to a large extent, going to be leveraging our existing relationships.

Gianluca Tucci:

Okay, that is great color. Thanks. I will re-queue.

Troy Bullock:

Thank you.

Operator:

We will now take a question from Anthony Prost with GMP Securities.

Anthony Prost:

Good afternoon.

Troy Bullock:

Hi, Anthony.

Anthony Prost:

Just following up on some of Gianluca's questions, are you at liberty to divulge not necessarily the name of the customer, but maybe what market they are in, this new commercial customer?

Troy Bullock:

I can't say the name yet. I still hope to. At some point in the next probably month, I would like to have it written up as a case study and have it up on our website and I am just working through some of that with the customer right now as to making sure they are comfortable putting that up as well.

What I would characterize it is a company that is a leading edge company, that is kind of in the insurance /block chain market that was using this as a differentiator to identify products that were unique and have a specific security label on it that they could verify and we have a unique QR code for each product that would in turn be able for them to identify and track the product.

Anthony Prost:

Okay, great, thank you. Taking one step back, I assume that you are getting some good feedback and positive reception from other commercial leads on these new products, LiveLogo and the Dynamic Portrait?

Troy Bullock:

We are, and I do not want to get too far ahead of ourselves. We have had these out now for about four weeks, we have done a few email campaigns and obviously we have done some news releases and we are fortunate that we got picked up in three or four different magazine articles, so we are getting some good press around them. The feedback we are getting is quite positive and we are just now starting to get in front of these people and work the sales opportunities, if you will. I think having this new individual join the team that, frankly, comes up with a very thick rolodex that is full of people that he has worked with over the last 15, 20 years and that is going to be a good next step for us.

I think the feedback we are receiving has been quite good, but we are four weeks in and so it is time now to begin to have the sales guys do what they do and start to work on building out our pipeline.

Anthony Prost:

All right, I can appreciate that. With this new individual joining your sales team, will that be effectively—will your sales force be built out at that point or you are thinking you are making further additions as we move further into the fiscal year?

Troy Bullock:

Yes. What the sales team would look like at that stage is Brian Donnelly, kind of being our lead and sort of overseeing both banknote and commercial, and Igi LeRoux who has got a tremendous amount of experience in the banknote space and we are extremely lucky to have him, he would continue to focus

and allow him to focus more just on the banknote space and with the new individual coming in focusing on the commercial space. I think over the next three or four months certainly as I look to fiscal '19, that probably positions us pretty well at this stage.

I think as we go beyond that, we are going to start to look at agents, perhaps not agents, but other partners. If we can start to partner with some of these OEMs, I think our ability to get to a broader reach of customers easier is going to be kind of the next wave of activity, but depending on the market segments and the pickup that we are seeing, we may still look to add more sales people, I don't want to get too far ahead of ourselves. I want to make sure that we are getting the traction, we are servicing the customers that we're targeting now well before we start bringing too many opportunities to the table and may be underperforming for them.

It's a roll out. We are into week four, if you will, and we will see how that progresses before we start committing to adding more sales resources.

Anthony Prost:

Okay, perfect. Over the last year we have seen quite a few initiatives to sort of bring yourselves up the speed, as far as having the infrastructure in place for you to see higher volumes. You have launched these new commercial products, you are expanding your sales force, your production capacity is being improved as well. Are you at a stage now where you feel comfortable with— that any new contracts, you are able to handle them or is there anything else that you would like to—any other things that you would like to shore up before these real volumes pick up in the coming years?

Troy Bullock:

Yes, it is a great question, Anthony. I think when I look at sort of the goals that we set out at the beginning of the year, what the first thing for me and the biggest priority was really focused around largely putting a sales team in place and having something to sell. Previously, we were in a position where we had some great technology, we were able to show great samples to customers and we were searching out partners that would have interest in purchasing this, selling this for us and together we would figure out how to make it in the right level of volumes and that strategy still is sound with these OEMs; however, we also need the ability to go in and make a sale, show a product, have a manufacturing solution in place, whether it is internally or externally, with a partner, so that we can take orders and commit to deliveries within weeks and not quarters.

I am comfortable, and I think we have done a lot of work in three or four very short months, to launch a product and put a supply chain in place, in particular around that product, and the sales resources now started so that they can go out and begin to sell, so very comfortable that we can produce this particular product in volumes ranging from 5,000 or 10,000 up to tens of millions. I think that solution is in place now, but I still think we have got a lot of work to do. Where I would like to see us have more capability is different application types. Right now, we are selling products that are easily sold as a PSA label and in the future having the ability to expand that into something that either can be a hot stamp application or stripe application.

We proved that out that we know how to do it in sort of more of a lab setting, but finding the right partner that can put that in place and so when I look at the next wave of commercialization, if you will, I think we can broaden our capabilities to have more product offerings based on widening out our manufacturing capability by working with partners that can manufacture product for us in volumes, in different application types, so that our sales people can take a single product and sell it in different formats to different customers and I think once we have that in place, we will have way more opportunities in front of us that can provide a better, wider ranging solution for our customers.

In two parts, I am pleased and excited where we got to in four short months. We do have something now that we can do in volume as it relates to this particular product. I think our next phase for us is going to be to have a wider product offering that has more applications and we are going to do that with partners.

Anthony Prost:

Right, very insightful, thank you. My last question is a bit more of a nitty gritty one. It appears, based on disclosures in your financials, that you have not applied IFRS-16 as of yet. Is that the case and what impact do you think it may have when you finally roll out?

Monika Russell:

Sure, Anthony, this is Monika. IFRS-16 is actually not applicable for us until our next fiscal year and at this point, we haven't done the full analysis to see what all the impacts are on us. That should be completed within the next quarter or so and we will have more information in the financial statement notes as we get that information.

Anthony Prost:

All right, that's all from me, thank you so much.

Monika Russell:

Yes, sorry, just to clarify that was the lease accounting.

Anthony Prost:

That is great, thank you.

Operator:

We will now take question from Gianluca Tucci with Echelon Wealth Partners.

Gianluca Tucci:

Hi guys, just a follow-up on the commercial side. The first part is, are these generally one-time in nature or are there any recurring elements to a commercial sale? The second part is what are the typical gross margins that can be expected on the commercial sale versus a development contract gross margin?

Troy Bullock:

Yes, thanks, Gianluca. In general terms, what I can say in the marketplace for the commercial brand protection market is very much they are recurring and so once you get sort of selected to be put on a piece of software box or a printer cartridge, you go into their production cycle and as they sell printer cartridges for the next four or five, six, seven years, that is the security label that is going to on that cartridge and so it would be very much recurring.

At this stage, I don't want to talk specifically about gross margins on a new customer segment on a new product that we are just launching today. I think there is a number of competitive reasons around that. As we start to develop and see broader revenue streams there, I'd be more comfortable talking about it as a

collective group, but as you can imagine, that is not going to help my sales team out very much if I am announcing what our margins are when they are trying to close on sales.

Gianluca Tucci:

Okay, no, great. Just lastly here and I will hop off. How far along the transformation or pivot of your sales force are you today and how much more work is there to do and how soon do you think that will be done?

Troy Bullock:

I think as I'm bringing on this new commercial person, again, it will be described in some more details in our news release coming out. I think that is a big milestone for us. I think now having a team of three people as opposed to, in the years past we had really one person that was tasked with running around, chasing a lot of different opportunities, so now we are up to three. I think they are highly focused, they have the processes and systems in place and now we have some product offerings in our hand, so I like where we sit right now as far as the team and I like where we sit as far as the strategy around it.

I think that we can further build that out with more developed product offering, better and wider manufacturing solutions and to start to engage with and find deeper, stronger partnerships with OEMs that we can partner with to get into their customer channels. Certainly, selling direct is great and it gets us some good initial accounts, but we also need to, and it is very important part of our strategy to, find partnerships and develop those with some significant OEMs so we can get more people selling our offering and that is a big part and we are in the early stages of that. Over the next year, we are going to continue to focus on all of those areas, to build that out so we have much more opportunities to grow our sales funnel as opposed to just one or two people doing it on their own.

Gianluca Tucci:

Okay, thanks, Troy. Have a good evening. Thank you.

Troy Bullock:

Thank you, Gianluca.

Operator:

That will conclude today's question-and-answer session. I will now turn the conference over to Mr. Bullock for any additional or closing comments.

Troy Bullock:

Thank you. I would like to thank everyone for your questions and for joining our second quarter conference call. I am pleased with our progress since January and I feel confident in our go forward strategy to expand our sales team, launch new products and diversify beyond banknotes. I look forward to updating everybody on our continued progress on our next conference call. Let me please pass the call back over to the Operator for her closing comments. Thank you.

Operator:

This concludes Nanotech Security's Second Quarter Conference Call. A replay of this call is available at 1-844-512-2921 for callers in Canada and the U.S. The PIN number to access this call is 8155235. The replay will be available until Sunday, June 9, 2019. Thank you, and have a wonderful evening.