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BA - Q3 2013 The Boeing Company Earnings Conference Call

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OVERVIEW:

Boeing announced 3Q13 revenue of \$22.1b. Management raised 2013 core EPS guidance to \$6.50-6.65.



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PRESENTATION

Operator

Good day, everyone and welcome to the Boeing Company's third-quarter 2013 earnings conference call. Today's call is being recorded. The management discussion and slide presentation, plus the analyst and media question-and-answer sessions, are being broadcast live over the Internet. At this time for opening remarks and introductions, I'm turning the call over to Mr. Troy Lahr, Vice President of Investor Relations for the Boeing Company. Mr. Lahr, please go ahead.

Troy Lahr - The Boeing Company - VP IR

Thank you and good morning. Welcome to Boeing's third-quarter 2013 earnings call. I am Troy Lahr and with me today are Jim McNerney, Boeing's Chairman, President and Chief Executive Officer; and Greg Smith, Boeing's Chief Financial Officer. After comments by Jim and Greg we will take your questions. In fairness to others on the call we ask that you please limit yourself to one question. As always we've provided detailed financial information in our press release issued earlier today and you can follow this broadcast and slide presentation through our website at www.boeing.com.

Before we begin, I need to remind you that any projections and goals included in our discussions this morning are likely to involve risks which is detailed in our news release and our various SEC filings and in the forward-looking statements disclaimer at the end of this web presentation. In



addition we refer you to our earnings release and presentation for disclosures and reconciliation of non-GAAP measures we use when discussing our results and outlook.

Now I'll turn the call over to Jim McNerney.

Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Thank you, Troy, and good morning, everyone. Let me begin today with an overview of our business environment and some thoughts on another strong quarter of operating performance. After that, Greg will walk you through our financial results and outlook.

With that let's turn to slide 2. Our overall view of the business environment remains strongly positive given the depth and breadth of our record \$415 billion Company backlog and our customers continued demand for our efficient and value creating products and services. During the third quarter commercial airplanes booked 200 net orders that increased our backlog to nearly 4,800 airplanes, worth a record \$345 billion. Airline customers continued to replace older airplanes in favor of new ones that offer compelling operating economics and increased fuel efficiency. In addition, many airlines around the world are expanding their fleets to support growth in passenger traffic, which further strengthened in recent months. As a result of this continued strong demand deferral requests from customers are running well below the historical average and requests to accelerate airplane deliveries continue at a healthy pace.

The air cargo traffic market, however, remains under pressure and has not improved as quickly as expected. Softness in this market contributed to steps we took last week to adjust the 747 production rate to 1.5 per month from 1.75 per month beginning in early 2014 and continuing at that rate through 2015. As the only large freighter on the market, the fuel-efficient 747-8 remains well-positioned to benefit our customers once air cargo traffic conditions improve. Overall, commercial aviation remains a very attractive near and long-term growth market and our strategies have positioned us for significant and sustained growth in the years ahead.

In addition to affirming our product strategies, strong customer interest in our current and future airplane families is driving our planned production rate increases. On the strength of the growing 90 airplane order book for the new 787-10 that is expected to enter service in 2018, along with continued demand for the 787-8 and 787-9, this morning we announced plans to increase 787 production beyond the 10 per month we're on track to achieve this year to 12 per month in 2016 and then 14 per month before the end of the decade. The steady, deliberate pace of these planned rate breaks builds in stabilization periods that are designed to reduce supply chain risks, capture productivity and learning, improve profitability, and help minimize the investment required to meet the high customer demand for the 787.

On the 777X, Lufthansa's announced intent to place a substantial order for the airplane upon launch illustrates the extensive and growing customer interest in the performance and economic advantages the 777X will offer. We continue to anticipate market launch of the 777-8X and 777-9X this year, the latter of which will be the only twin aisle, twin engine airplane available in the 400 seat market. Together, our twin aisle 777X and 787 families will provide customers with more choices that will deliver greater value through market-leading innovation and performance than anything the competition is offering. In the single aisle market, airline interest in our new fuel-efficient 737 MAX also remains high with nearly 1,600 cumulative orders to date and our demand forecast continues to place upward pressure on the 737 production rates. As we assess the optimum path forward to meet that demand our teams relentless focus on additional production system productivity improvements continues unabated.

Turning to defense, space and security. The contingency plans we activated during the federal government shutdown were successful in minimizing the impact on our daily operations. Nevertheless, we are hopeful that the fiscal 2014 budget process will be resolved without further disruption in the weeks ahead. The congressional mark-ups completed prior to the hiatus were relatively favorable to Boeing and our key programs. However, as you may recall, neither the President's budget request nor congressional efforts fully reflect sequestration level spending caps. We do remain concerned about the impact that sequestration targets will have on our customers with regards to both military readiness and the industrial base in 2014 and beyond.

Notwithstanding these budget uncertainties, our defense space and security portfolio is optimized for the current environment with reliable, proven, affordable systems and services that are being delivered on budget and on schedule. We are targeting our investments in technology and innovation in areas where growth is occurring such as commercial derivatives, space, unmanned systems, intelligent surveillance and reconnaissance,



cyber security, and the few but critical future large-scale programs identified as priorities by our customer like long-range strike, UCLASS class and the T-X Trainer. Fueled by our productivity gains, these investments are strengthening our position for the long-term and differentiating us from our competitors, many of whom have scaled back R&D in this difficult environment. Capturing a disproportionate share of growing international markets including leveraging our unique one-Boeing global advantage, is an equal emphasis in our efforts to mitigate domestic market pressures. International defense space and security business represented 20% of our BDS revenue during the quarter and remains approximately 40% of our current backlog.

We also continue to strengthen our competitive position in all markets by driving further efficiency, quality and productivity improvements through our long-running, market-based affordability effort and our partnering for success initiative launched last year. As many of you recall, partnering for success is a long-term effort designed to achieve double-digit improvement in total costs across our supply chain. It is a collaborative approach. We're unlocking opportunities in design, production and support to drive significant gains in quality, flow and efficiencies. While we are still at the very early stages of this effort, we are making good progress as many of our suppliers recognize the exciting growth opportunity that's available to those who choose to work with us in providing customers' greater value at increasingly lower costs.

Now let's move to a summary of the third quarter on slide 3. Our business and core functions delivered yet another strong quarter of financial performance as we reported double-digit revenue growth, healthy operating margins and substantial operating cash flow. Revenue at commercial airplanes was \$14 billion and operating margins grew to 11.6% resulting from higher volume and strong operating performance. We delivered 170 commercial airplanes in the third quarter, including 23 787's. 787 production is operating as planned at a rate of 7 per month with increasing efficiencies and as we approach 10 per month by year-end. Including October deliveries to date, we have delivered 96 787's to 16 customers. The fleet is flying an average of 200 flights per day and had nearly 43,000 revenue flights since entering service.

Improving dispatch reliability of the 787 is at the top of our priorities. While we're seeing more customer-by-customer variation than we'd like, the 787 is -- we're making good progress at reducing those dispatch reliability issues. And we're working very closely with each and every customer to do that. While we are not yet satisfied with our fleet wide performance, even though it is at around 97% on average, we have made some progress implementing a series of component, software and spare parts placement improvements but we still have more work to do. While we are otherwise pleased with the feedback we are receiving from customers about the airplane's fuel efficiency and other features, we will not be satisfied until we are meeting our customers' expectations across-the-board.

Progress with development of the 787-9 continues on track. In September we completed a very successful five hour first flight and the flight test program is well underway. 787-9 production is also progressing nicely with meaningful productivity gains being achieved as we prepare the second aircraft for its first flight and the third and fourth airplane move through productions. As we shared in the second quarter call, the 737 MAX reached firm configuration on schedule in July, signaling the start of the program's detailed design phase. Since that time, we have completed an assessment of the final configuration, which indicates that the MAX will deliver efficiencies and operating economics that exceed our earlier high expectations, making it an even stronger competitor in the marketplace.

Now let's turn to the defense business. Defense, space and security increased revenue in the third quarter by 3% to \$8 billion and reported healthy operating margins. Numerous key contract awards were captured, including a \$2 billion order from US Navy for 13 P-8A Poseidon aircraft and order from Satmex for a second 702 SP satellite and an order from the US Army for 36 Apache helicopters for South Korea. Noteworthy program milestones included the successful first flight of the unmanned QF-16 full-scale aerial target delivery to the US Air Force of the fourth GPS IIF Satellite, the start of flight tests on 2 Boeing EMARSS aircraft and receiving commercial certification of the ScanEagle unmanned aircraft system.

Also, after successfully finalizing the KC-46 tanker design with the Air Force in September, the first three aircraft are in production at our Everett factory. We also completed 21 flight tests since August on our advanced Super Hornet fighter as we demonstrated significant stealth and range improvements. On a bittersweet note, I must admit during the quarter we delivered the third C-17 to India and the 223rd and final C-17 to the US Air Force. While we made the tough but necessary decision to end the C-17 production line in 2015, the program continues to prove itself a strong financial contributor and a model of operational consistency as we shift our focus to deliver the remaining production airplanes to the international market.



In summary, our team is executing to our business strategies and achieving desired outcomes. We delivered a strong quarter of financial results in both businesses, reached major program milestones and captured orders totaling \$27 billion. We also returned cash and increased value to shareholders, which Greg will discuss in just a moment.

Now I will turn it over to Greg for our financial results and our updated guidance. Greg?

Greg Smith - *The Boeing Company* - CFO

Thanks, Jim, and good morning. Let's turn to slide 4 and we'll will discuss our results for the quarter. Third quarter revenue increased 11% to \$22.1 billion, driven by strong commercial airplane deliveries and solid growth in our defense business. Core operating margins increased to 9.7% in the quarter, primarily driven by higher commercial airplane deliveries, lower R&D and solid productivity gains at both businesses. Core earnings per share increased 16% to \$1.80 in the quarter on higher revenue and continued strong operating performance in both commercial airplanes and defense space and security business.

Let's discuss commercial airplanes on slide 5. For the third quarter, our commercial airplane business increased revenue 15% to \$14 billion on 170 airplane deliveries and produced solid operating margins of 11.6%. Higher commercial airplane operating margins were driven by delivery volume and strong core operating performance across the business. Gross inventory for the Company included \$31.5 billion related to the 787 program, an increase in the third quarter of approximately \$1.2 billion. This increase was primarily driven by higher inventory in support of the planned production rate increases later in the year and the introduction of the 787-9 program. Included in the work in process inventory are the deferred production costs. The deferred balance for the 787 program was \$20.2 billion at the end of the third quarter and includes approximately 58 airplanes still in process. Since the fourth quarter of last year we've seen roughly 50% to 60% improvement in deferred production costs associated with the 787-8 and we anticipate further improvement in unit cost through our continued focus on driving productivity.

As I've previously stated, assessing the 787 progress by analyzing deferred production on a per-unit basis was useful and informative early on in the program. However, now given the different stages of the program maturity, learning, increased flow with 787-9 production and investments now to support the higher production rates, as well as the inclusion of the 787-10, this quarter metric at a summary level is no longer a good reflection of the overall program performance. Obviously we remain focused on the progress on a daily basis, model-by-model and unit-by-unit and we will continue to discuss our key relative performance indicators that do reflect productivity and overall program performance such as improvements in flow time, traveled work, and unit hours as well as progress on upcoming rate breaks and deliveries.

Due to the successful launch of the 787-10 program with 90 firm orders and consistent with accounting guidelines, we extended the accounting quantity of the 787 program by 200 units to 1,300 airplanes in total. Program margins now include investments to support the 787-10 introduction and production rates of 12 per month in 2016 and then 14 per month before the end of the decade. Despite these investments and considerations for risks, the 787 program is capturing value, which is reflected in the improved program gross margin. We now anticipate deferred production to peak at approximately \$25 billion by 2014 and then moderate at that level before beginning to decline shortly after we complete the transition to 12 per month.

The higher deferred balance -- production balance is driven by the additional flow and learning associated with the 787-10 introduction and additional rate increases as well as investments to further optimize the production system improving flow and increasing long-term program profitability. The deferred production balance is now expected to decline at a faster pace, given the higher production rates, as we capture efficiencies by optimizing our production system. We continue to remain focused on driving 787 productivity and successfully achieving our planned rate breaks, which will ultimately drive value for all stakeholders. Commercial airplanes captured \$20 billion in orders during the quarter and increased backlog to a new record of \$345 billion, or 4,787 aircraft. Customer demand for a game-changing, fuel-efficient airplanes remains strong as illustrated by the additional 136, 737 MAX orders and 49, 787 orders in the quarter.

Now let's turn to defense, space and security results on slide 6. Third quarter revenue at our defense business increased 3% to \$8 billion and operating margins were 8.4% driven by mix and one-time charges on the F-15 program and for cost associated with the C-17 planned shutdown. Defense segment operating margins were 9.4%, excluding these charges. International customers accounted for 20% of our defense revenue in the third quarter and we continue to drive towards our goal of 30% of revenue going forward. As a result of our continued focus on productivity



and driving market-based affordability, we've reduced our cost structure at BDS by an additional \$1 billion, now bringing the total reduction to approximately \$4 billion. We're also on track for further reductions at an effort to increase productivity and strengthen our competitive position in this challenging environment.

Revenue at Boeing Military Aircraft was \$3.5 billion in the third quarter, primarily driven by lower volume and timing on C-17 and F-15 programs. Operating margins were 6.2% due to the mix and the one-time charges on the F-15 and C-17 program. Network and space systems revenue of \$2.2 billion increased 9%, primarily driven by higher sales of Delta inventory and revenue on space launch systems programs. Operating margins were 8.7% in the quarter. Global services and support had third quarter revenues of \$2.3 billion and solid operating margins of 11.4%. Defense space and security reported a solid backlog of \$70 billion and international business was 38% of our current backlog, representing customers outside the United States.

Turning now to slide 7. Boeing capital net financing portfolio remained unchanged at \$4.1 billion. Other segment income improved by \$118 million, primarily driven due to an insurance recovery settlement. Unallocated expense from core operations of \$226 million was higher, primarily due to an increase in deferred compensation expense driven by higher stock price and overall stock market performance.

Now turning to cash flow on slide 8. Operating cash flow before pension contributions for the third quarter was \$4.3 billion. The strength of our cash flow was driven by higher volumes, strong operating performance and favorable timing of receipts and expenditures. While we aggressively look for opportunities to reduce future pension liabilities, we continue to be proactive and manage the funded status as we've made a planned \$1.5 billion discretionary pension contribution in the quarter. As a result of our strong performance in execution of our balanced cash deployment strategy, we paid a \$400 million dividend to shareholders and repurchased 7.6 million shares for \$800 million in the third quarter, bringing year-to-date repurchases to \$1.8 billion and we now expect 2013 share repurchase will exceed \$2 billion.

Moving onto cash and debt balances on slide 9. We ended the quarter with \$15.9 billion of cash and marketable securities and our cash position continues to provide a solid liquidity and positions us well going forward. Our financial strength allows us to continue to invest in key growth areas of the business, return cash to shareholders and execute our balanced cash deployment strategy.

Let's now turn to slide 10 and I'll discuss our outlook for 2013. Due to the strong performance through the first 3 quarters and improved outlook for the balance of the year, we're increasing our 2013 core earnings per share guidance to now be between \$6.50 and \$6.65 per share. Revenue guidance for the year is unchanged at between \$83 billion and \$86 billion and we still expect 787 deliveries to be greater than 60 this year. Commercial airplane operating margin guidance is increased to be greater than 10% on improved operating performance and lower R&D. We expect fourth quarter margins to be influenced by dilution from the 787 deliveries, higher R&D primarily associated with the 737 MAX and timing of supplier payments along with increased investments associated with higher deliveries and production rates. With our continued focus on development program execution, we now expect total research and development spending for 2013 to be approximately \$3.2 billion, \$100 million lower than our previous guidance. Operating cash flow before pension contributions guidance for the year is increased \$500 million to now be greater than \$8.5 billion.

Overall, third quarter performance continued to deliver strong results as we remained focused on production program execution and profitability, rate ramp up and ongoing productivity improvements in both commercial and the defense business. And as we look ahead to 2014 we expect this strong core operating performance to continue.

Now I'll turn it back over to Jim for some final thoughts.

Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Thank you, Greg. With three strong quarters behind us we remain committed to the goals we initially set for 2013. This includes the continued conversion of our record backlog into deliveries through strong core operating performance that allows us to return cash to shareholders while investing wisely in our products, technologies and people to sustain our growth and competitiveness. Our priorities going forward remain clear. The profitable ramp up in production on our commercial airplane programs; executing on our commercial and defense development programs;



driving productivity and affordability throughout the enterprise; continuing to strengthen and reposition our defense business with investments in growth areas amid further international expansion; and importantly, providing increasing value to both our customers and our shareholders.

With that said, we'd now be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Carter Copeland, Barclays.

Carter Copeland - Barclays Capital - Analyst

Good morning, gentlemen, and good quarter. I'll apologize in advance for what might be a complex question, but, Greg, I was hoping you could help me clarify some of the moving pieces you talked about on the 87, the \$25-billion production -- deferred production peak that then declines at a faster pace. Maybe if you could help clarify what's driving the near-term costs up and the long-term costs down -- presumably that's higher rate and mix on the long-term stuff?

And then related -- if you can just verify for me the pieces of the program accounting that got influenced in the block and influenced the gross margin in the quarter. I think it's rate changes, the inclusion of the -10 and the mix. And then if you could clarify -- did you extend the block at all? Any help on any of those would be great.

Greg Smith - The Boeing Company - CFO

Sounds good. So, on the higher deferred balance, as I mentioned, the increase you're seeing there is really the additional flow time as you bring in the -10, as well as learning associated with that. And then, as well as investments that we're making to further optimize the production system and improve the flow, and obviously, improve the long-term profitability. So, just a couple of examples there.

In Charleston, our [aft] facility -- you see we've reconfigured the entire flow there, or we're in the middle of doing that. And that will, again, drive profitability, increase flow, and allow us to get to these higher rates in a much more efficient manner.

On the final line in Everett, same thing. We've added another line -- or sorry -- a position within the line where we're doing the wing body joint earlier in the process. And this is through experience. After 134 airplanes, the teams are really coming up with better ideas or improvements on how to increase flow, and that's going to require some upfront investment. But obviously, in the units to come after, we'll see that improvement again in flow and productivity.

So, that's kind of what you're seeing in the increase in the near-term deferred production. The burn off is just what you said -- it's really driven by the improvement in adding the -- certainly adding in the -10, the rate on the 12 and the 14. And that's what's allowing us to burn that off at a faster pace on the back end.

Carter Copeland - Barclays Capital - Analyst

And on the things that changed in the block?



Greg Smith - *The Boeing Company - CFO*

The things that changed in the block -- you added in the 200 units. Obviously, the -10 coming in there, as well as the investments to build the -10 are also included in that. And then, net-net, that was an improvement in the overall gross margin of the program.

Carter Copeland - *Barclays Capital - Analyst*

Okay. Thank you.

Greg Smith - *The Boeing Company - CFO*

You're welcome.

Operator

Howard Rubel, Jefferies.

Howard Rubel - *Jefferies & Company - Analyst*

I bet you thought you were done with 787 questions.

Greg Smith - *The Boeing Company - CFO*

(laughter) I knew I wasn't done, Howard. Not with you on the line, Howard.

Howard Rubel - *Jefferies & Company - Analyst*

In any event, just to follow partly on that -- and it's more to Jim's point -- can you talk a little bit more about the initiatives that you've undertaken to improve dispatch reliability? First, I noticed the reliability's ticked up a bit. And then, second, how are you incorporating those improvements into the line?

And then related to that, as we look forward, there's clearly some costs this year that should go away next year. Can you ballpark that, please?

Jim McNerney - *The Boeing Company - Chairman, President & CEO*

I'll let Greg answer the costs, but I'll answer all the rest. Yes, we are seeing improvement. I mentioned the fleet average of 97% or so dispatch reliability. But while we're seeing improvement, we're not pleased yet. Number one, we want to go higher.

And number two, we still have some customers that aren't at that level. And so, we're worried about them. We know that we have a lot to do to help them improve. And it's on us to help them improve.

So, to your point, we're putting people, we're putting spares, we're doing some engineering changes at the component level to increase reliability. We've addressed some software issues. Software false messaging is roughly a third of the issue here. And that is frustrating for us, and very frustrating for our customers. So, there's some software, as well as hardware component issues.

And it's an all hands on deck customer by customer -- working very closely with our customers to drive the fleet average even higher, but, more importantly, to get those customers who are below the average up to the average and higher. So, we want to get everybody higher, and it's a big effort. But when you add it all up, steady improvement.

And then, costs that will go away and I think --

Greg Smith - *The Boeing Company - CFO*

Yes, Howard, I think when you look at the fleet support associated with this -- and going into next year -- you kind of see it a little bit flattish. We'll have more customers, obviously, introduced on the 787, and we'll continue to provide the support at the levels that Jim just described.

Having said that, we'll offset some of that with some of the other areas of fleet support. So, net-net, as I see it today, it's kind of flattish going into next year, but something where, obviously, we remain very focused on, and, as I said, trying to offset some of the maybe increases we may have on 87 with some of the other programs across the board.

Howard Rubel - *Jefferies & Company - Analyst*

Thank you very much.

Operator

Doug Harned, Sanford Bernstein.

Doug Harned - *Sanford C. Bernstein & Company, Inc. - Analyst*

I'd like to shift gears a little bit, and get to the partnering-for-success initiative. And I'd like to understand how it's progressing. And particularly, if you look across the supply chain, whether it's US, Japan, Europe, you've got a number of suppliers that I would say are pretty much locked in -- or may view it that way -- locked in on your programs and for many years to come. And so when you look at this now, how do you prevent a situation where they feel they are locked in and they could raise prices or just not lower them? How do you get leverage over them? And if you do make progress, is that still incremental upside to the margins that you're talking about today?

Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Well, Doug, I think this program does have potential to increase our margins. And leverage comes in a lot of different ways. The biggest way is joint success. I think as long as we do our job, which is to build and design the right airplanes, and market them effectively, and our winning in the marketplace, which is what we're trying to do in each and every campaign. And if our suppliers have faith in that, which is really fundamental here, then the tactics of coming in-house with something or switching suppliers if someone doesn't want to work with us -- the tactics become less important.

There's plenty of work to re-compete with all these new models, Doug. So, those tactics are available to us. But I think a lot of them see the increased business we can do together if we -- if they drive as hard on productivity and cost reduction as we are.

We are trying to lead by example here. We're -- the flow time reductions we've had in our factories, the hours per unit, the productivity per whatever, are increasing significantly on all of our programs. It is a major priority for us. Market-based affordability within the defense business is a superstar example of dealing with a very, very difficult situation. And we're absolutely committed to that. We're just asking our suppliers to work with us on the same basis.



And by the way, I made the point in my remarks that we're still in early days, but I'd say the majority of our suppliers are working with us. They see this big opportunity, if we can get the product right and the costs right in a more-for-less world.

Doug Harned - *Sanford C. Bernstein & Company, Inc. - Analyst*

And is the effort you've got underway now -- is that still incremental to the margins, say, the 11% type margin that you have today?

Jim McNerney - *The Boeing Company - Chairman, President & CEO*

I think the -- it will be -- our margins in the future will be a lot better than they would have been if we hadn't embarked on this program. Let's start with that. Now, a more-for-less world is going to demand increasingly lower prices from us. So, exactly how this economic gain gets used to make us more competitive in the marketplace, whether it is -- I doubt whether it will be all margins or all price. But I feel confident, and it's our objective, to have the best margins of -- and for our suppliers to have the best margins of anyone in the marketplace. Now, whether we can achieve that objective remains to be seen, but that's the objective we have in front of us.

Doug Harned - *Sanford C. Bernstein & Company, Inc. - Analyst*

Okay. Thank you.

Operator

Rob Spingarn, Credit Suisse.

Rob Spingarn - *Credit Suisse - Analyst*

So, a quick question as well on BCA margins, going back to what Jim just said, but I want to start with Greg. Greg, on the gross margin for 787, you'd been, I guess, just above the zero level. That's been the long-standing margin assumption. We'd always know that you'd address that. So, that apparently happened here. Can you give us some sense -- can you quantify where you are on the margin now, post the block extension and the latest learning curve assumptions?

Greg Smith - *The Boeing Company - CFO*

I'll tell you that, obviously, extending this block, as I said earlier, did improve the overall gross margin. We're still at very low single digit, and what we're looking to drive that is obviously continued making progress internally on productivity. But obviously a big priority of partnering for success is 787. So, working our way through that and trying to drive that gross margin up even higher. But net-net -- we included the investments of the -10 and, with the extension, ended up in a net-net improvement overall on gross margin.

Rob Spingarn - *Credit Suisse - Analyst*

So, that segues into what I wanted to ask Jim, which is -- at what point -- at what inning are we in partnering for success? And at what future inning would you be able to readdress the gross margin on 787?



Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Well, it's early innings. Whether it's the second inning or the third inning, I can't tell you. And we'll play extra innings if we have to, just to keep it in perspective. (laughter)

Listen, I think the margin improvement is not just on the 87, although, obviously, that is where a lot of our effort is focused. But this effort is focused on every program we have in the Company -- on every service we have in the Company. It's focused on non-production procurement. In other words, the \$12 billion or \$13 billion of stuff we buy that doesn't go into our products, that goes into G&A budget someplace -- there's a huge opportunity there. So, I think this is -- the point would be, across the board -- the point would be second or third inning.

I think also the point would be where it's already beginning to impact some 787 costs, as well as those in other programs. But we still have a long way to go here. And so, declaring any form of victory at this stage would not be appropriate. I think displaying to you confidence that we're off to a good start is appropriate. And that's the way we feel, and that's what we're seeing.

Rob Spingarn - *Credit Suisse - Analyst*

Greg, is there a moment in time, though, in the future where you would readdress the margins?

Greg Smith - *The Boeing Company - CFO*

I think what you're going to see, Rob, is you're just going to see this come in gradually over time as we work our way through these with some of our suppliers. As Jim noted, some of these may take a little bit longer. But that's really working along with that supplier and finding an ultimate solution for both of us that provides the profitability or the meeting our target objectives that we laid out for them, at the same time allowing them to become more efficient. So, that may be that you want them to build a few more units and come down the learning curve and us work with them.

So, I think you're just going to see it gradually come in. You've seen some of that benefit in the results today, particularly on some of the defense programs and around 37 and 777. So, this is kind of gradual as we go through each one of these, but we've got a good cadence and pace. And we just had the top 20 in here again a couple of weeks ago, and continue to work through the operating rhythm. And it's all about us working together to become more efficient and more effective on all of our programs within the supply chain and, obviously, at the core here. So, we're continuing to march along, and I think you'll see that, again, over time.

Rob Spingarn - *Credit Suisse - Analyst*

Thank you.

Operator

Joe Nadol, JPMorgan.

Joe Nadol - *JPMorgan Chase & Co. - Analyst*

Just on the margins real quick -- you noted that 787 was up a little bit. Is partnering for success having any positive impact yet on either 37 or 777 gross margin?

And then just secondly, Greg, on the deferred production, I hear you in that there is a lot of other moving parts and it's harder to gauge on a unit basis what's going on now. But this is a very, very important metric, and transparency here is important for us all to understand how you're doing. And so, if we can't use that, what can we use to track your progress?



Greg Smith - *The Boeing Company* - CFO

Okay. Let me answer your last question first. You're right -- it's absolutely important, and it's something that we're very focused on. As I said, on a day-to-day basis, model by model, we track our performance against what we have in our plan. But when you look at an aggregate level, as you know, now with the mix of -9 in there, investments for -10 and so on, when you're looking at a deferred per unit, it's not an accurate depiction. And it was when you were just building -8.

So, as far as looking from the outside in, again, we're going to continue to give you some clarity on where we are making operational improvements on the program that ultimately affect deferred production and overall performance of the program. Certainly deliveries -- watching our deliveries, and we give you good guidance on that -- our rate breaks. And then as well as flow time and unit cost projection. And that in combination -- again, that really ends up driving that deferred. So, that's kind of what we'll continue to do, Joe. And I think those are very good, solid indicators of progress.

On partnering for success, the short answer is, yes. You've seen on the 37 and 777, in particular, improvements brought into those as we've increased the profitability in there or offset some initial pricing on MAX or end-of-line NGs. That's being offset by partnering for success. That was our objective.

But as Jim said, we're still in the second or third inning, so we've got still a long way to go. But you are starting to see progress there. And again, I think you'll see that over time as we make progress with each one of our suppliers by program.

Joe Nadol - *JPMorgan Chase & Co.* - Analyst

Greg, I hate to do it, but on the \$25 billion, is it possible to quantify how much of that is -- I mean, -10's -- we're so many years way. I know you guys are busy at work, but it's so many years away from really putting a lot of money into the production of that aircraft. How much of the \$25 billion -- the increase here really is -10 versus the other investments you mentioned?

Greg Smith - *The Boeing Company* - CFO

Yes, well, certainly getting rate to 12 is a big part of that investment, as well as the optimization in some of the other areas of the factory I talked about. That's certainly a bigger element of it. And then, as we go further on, that's where you'll start to see -10. But as we're looking at rate going to 12, we're obviously making investments for 14 at the same time.

So, we're trying to be very efficient with our resources inside and with the supply chain to make sure we're making the right strategic investments on the program, and make sure we're fully utilizing our resources as we build our way into 10. So, if there's opportunities to minimize some of that investment going from 12 to 14, we're going to do that. So, we're pretty active, obviously, internally and working with our suppliers. And then, again, you're going to see the deferred coming down at, I'll say, a steeper decline than you would have prior. And that's all driven by the higher deliveries and improved unit costs in the outter years.

Joe Nadol - *JPMorgan Chase & Co.* - Analyst

Okay. Thank you.

Greg Smith - *The Boeing Company* - CFO

You're welcome.

Operator

Rob Stallard, RBC Capital Markets.

Rob Stallard - RBC Capital Markets - Analyst

Greg, I was wondering if I could ask you a couple questions on the BCA margin. Your guidance suggests that it's going to step down quite significantly in the fourth quarter. You gave some factors behind that. I was wondering if you could help us out maybe in sizing what these issues could be in the fourth quarter. And perhaps also maybe if there was some one-off positives in the third quarter that's making that comparison sequentially tough?

Greg Smith - The Boeing Company - CFO

Yes, I think, what you'll see in the fourth quarter is we are expecting R&D to tick up a little bit there, [all around] 737 MAX and some supplier payments that you didn't see in the third quarter. Obviously, on a margin basis, we'll have more dilution on the deliveries. And then, some higher period expense really driven by investments in some productivity tools for us to become more efficient near term and long term.

And then a little bit more on the fleet support side. As we have more airplanes and new customers going into service, we'll ensure that we've got the right amount of people and parts and components in place to focus on the reliability that Jim talked about earlier. But that's primarily what's driving that. But we're going to continue to, obviously, manage those costs very tightly as we move into the fourth quarter. But that's what we're seeing as I sit here today.

Rob Stallard - RBC Capital Markets - Analyst

Were there any one-off positives in the third quarter that won't be repeating themselves?

Greg Smith - The Boeing Company - CFO

No, nothing that really stands out.

Rob Stallard - RBC Capital Markets - Analyst

Okay. Thanks very much.

Operator

Cai Von Rumohr, Cowen & Company.

Cai Von Rumohr - Cowen and Company - Analyst

Yes. Good performance.

Jim McNerney - The Boeing Company - Chairman, President & CEO

Thank you, Cai.



Cai Von Rumohr - *Cowen and Company - Analyst*

So, it looks like the margin before R&D and period expense improved pretty nicely versus the second quarter. You mentioned the 787 as higher gross margins. Were the gross margins on the 37 and the 777 higher sequentially?

Greg Smith - *The Boeing Company - CFO*

Yes, we had improvements on the 737. I'd say 777 was about flat. And then a slight improvement on the 87, as I talked about. And then, of course, the lower R&D. That was really the big drivers, Cai.

Cai Von Rumohr - *Cowen and Company - Analyst*

Okay. And then, you mentioned this \$25 billion. Do you reach that early in the year or late in the year? And what are the implications for cash flow? You've had this massive increase in excess advances. Everyone has kind of thought cash flow gets better as we move forward. Do you have a pause in cash flow next year as the deferreds go up, and maybe the excess advances don't build as dramatically?

Greg Smith - *The Boeing Company - CFO*

Yes, I think, Cai, you're going to continue to see strong cash flow. And that's, obviously, driven by the higher deliveries and the advances associated with that as you look further out on the 37 or even on the 787. So, we still expect strong cash flow.

On the deferred, I talked about what's driving that. And we'll continue to manage that. But that's all really preparing us for growth going forward, and doing that in the most efficient way possible. And we'll continue to, again, optimize our capital and tooling and resources required to do that. But I still expect strong cash flow for the Company and from BCA as a result of some of the earlier things I mentioned.

Cai Von Rumohr - *Cowen and Company - Analyst*

And then to the question when you're going to peak at the \$25 billion? Is that early or late in the year?

Greg Smith - *The Boeing Company - CFO*

It's kind of tied to the 12 per month, so we kind of hit around \$25 billion in the 2015 time frame. And then we kind of moderate. And then as we get to 12 a month is when you start to see that come down, and that's in 2016.

Cai Von Rumohr - *Cowen and Company - Analyst*

Thank you.

Operator

Peter Arment, Sterne Agee.



Peter Arment - *Sterne, Agee & Leach, Inc. - Analyst*

Just a follow-up on the cash flow. A question, really, Greg, on talking about capital deployment. You brought back another, close to \$800 million in this quarter, and you've kind of already achieved your commitment for this year and you haven't exceeded \$2 billion. How do we think about the continuation of that -- sizing it, or how you're thinking about capital deployment going forward?

Greg Smith - *The Boeing Company - CFO*

Yes. Well, as you know, we were out of the market in the first quarter, so we got back in, in the second quarter and third quarter. So, year to date at that \$1.8 billion. And we're going to continue to execute our balanced cash deployment strategy as we continue to perform and reach our milestones in the Company. So, you'll continue to see us make progress in that area going forward.

Peter Arment - *Sterne, Agee & Leach, Inc. - Analyst*

Should we expect a similar kind of path that you did last year, establishing it before the end of the year for next year, or are you waiting until the year end?

Greg Smith - *The Boeing Company - CFO*

We'll give you more clarity on next year as we close out the fourth quarter -- on the fourth-quarter call.

Peter Arment - *Sterne, Agee & Leach, Inc. - Analyst*

Okay. Thank you.

Greg Smith - *The Boeing Company - CFO*

But it's a big priority for us, and we're staying focused on deploying cash to shareholders.

Operator

Myles Walton, Deutsche Bank.

Myles Walton - *Deutsche Bank - Analyst*

Jim, I was hoping you could talk a bit about your vision for where after market could be in terms of Boeing's ability to capture more of the value -- the lifecycle tail of the products. And maybe in particular, what kind of hooks you're implanting on the 777X so that that could be realized? Obviously, you're doing a couple things in the 37 MAX. And then also an update on GoldCare?

Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Yes, we have two big -- I guess your question more relates to the commercial side of our Business.

Myles Walton - *Deutsche Bank - Analyst*

It does, yes.



Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Yes. Okay. We are mindful of the lifecycle costs and revenues associated with decisions we make on these programs. And I think you're right on both the 37 MAX and the 777 X. We are thinking harder about that issue, and leaning forward more than perhaps we did on the 87 on -- to use your characterization -- some hooks and handles. And we're doing that primarily to serve our customers better. I think more integrated solutions, either at the technical level or at the commercial level, which would be GoldCare, which I'll get to in a second -- are increasingly in demand by our customers. So, we're trying to respond to that.

GoldCare -- we're off to a start with GoldCare. We have a number of our customers that we now have on the program, and others we're in discussions with. And we're trying to be sure that we execute well with GoldCare. So, we're going one customer at a time, as they need it. We're trying to keep our feet underneath us with the partners associated with us at GoldCare, as well as our own technology. But I'd characterize it as off to a good start.

Myles Walton - *Deutsche Bank - Analyst*

Did you characterize your after-market exposure able to grow in line with your sales growth?

Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Yes, I think -- I didn't comment on the kinds of information-based technology and other technology that we want to invest in, in concert with the kind of spares volume that your question more alluded to. I think when you combine that with the increased investment in technical solutions for our customers that are more helping them operate the planes, in real time, more efficiently, I think the combination of those two over the long term will have us growing at at least the rate of our base business, and hopefully more.

Myles Walton - *Deutsche Bank - Analyst*

Great. Thanks.

Operator

Jason Gursky, Citi.

Jason Gursky - *Citi - Analyst*

Greg, just a quick clarification, and one for Jim. On the clarification question -- the deferred production -- it builds to \$25 billion until 2015. Then we get to cash flow breakeven at some point in the back half of the year, and it starts to wind down, and we burn through the deferred inventory starting in 2016. I just want to make sure that cadence is really clear.

Greg Smith - *The Boeing Company - CFO*

Yes, that's right.

Jason Gursky - *Citi - Analyst*

And then, for Jim -- okay, great. And then, Jim, on the tanker, you mentioned that the design's locked down. Can you give us an update on your comfort now that that design is locked down with that program, and what you view to be the key risks now that you have that design locked down?



Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Let me answer that while you take a look at the numbers. I think -- obviously, I'll use our customers' words, which is that they have great confidence in both the design review we recently had with them over the summer and the follow-on review that we had. And I feel exactly the same way. I think we're in good shape with configuration and design. I think, like in all programs when you get into the detailed design of a couple of the systems, there's still some issues to wrestle through. And I would characterize that as highly normal. I would not characterize it as abnormal.

And I think the real risk -- if I were looking at this from your perspective, the real risk now shifts from design to production, and the integration associated with production. And as I mentioned, we've got the first three airplanes in work. And we will see early any issues that are associated with production and integration. So, I think we're -- you compare this to many other programs, this one is in very good shape.

Jason Gursky - *Citi - Analyst*

Okay. And then, Greg, you confirmed that at some point in 2015 we're at breakeven for a couple of quarters before winding down, right?

Greg Smith - *The Boeing Company - CFO*

Yes, that's exactly it. It will start to -- it will moderate, and then start to come down in late 2015, early 2016 -- really driven by the higher production rates.

Jason Gursky - *Citi - Analyst*

Okay. Thanks.

Greg Smith - *The Boeing Company - CFO*

You're welcome.

Operator

Ladies and gentlemen, that completes the analyst question-and-answer session. Program for the media.

(Operator Instructions)

I will now return you to the Boeing Company for introductory remarks by Mr. Tom Downey, Senior Vice President of Corporate Communications. Mr. Downey, please go ahead.

Tom Downey - *The Boeing Company - SVP of Corporate Communications*

Thank you. We will continue with the questions for Jim and Greg. If you have any questions after the session ends, please call our media relations team at 312-544-2002.

Operator, we're ready for the first question, and, in the interest of time, we ask that you limit everyone to just one question, please.



Operator

Doug Cameron, The Wall Street Journal.

Doug Cameron - *The Wall Street Journal* - Media

Jim, obviously, commercial orders stretching into the far blue yonder. And a bit of a different story if you looked at parts of BDS, and particularly on the attack aircraft side where there's a lot of if's and but's and maybe's about keeping something like the F-18 line going. When do you start having to be more proactive with the Pentagon and saying and basically asking them -- if they want to keep competition in US attack aircraft, they have to give you something, if not at least more clarity about orders going forward. I've also got a follow-up.

Jim McNerney - *The Boeing Company* - Chairman, President & CEO

Sure. I think -- I don't want to speak for our customer, but I think it's fair to say that our Pentagon customer would also like more clarity. We are in daily discussions with them about requirements associated with our technology and others. And I think until the whole budget situation clarifies, and I think the Pentagon is not clear either on exactly how that's going to sort out, and that's because it is largely in the hands of the legislature right now. I think it's unclear. But I am confident that, given a reasonable solution to the budget environment, that the technology we've got will continue to be in demand.

Now, could there be a draconian budget outcome that impacts Boeing, and many others, by the way? I don't think it would disproportionately impact Boeing. But that is -- you've seen the perils of Pauline in Washington. So, there could be an outcome that is much more difficult. But I think reasonable outcomes that the pundits predict would suggest continued demand for most of our products.

Doug Cameron - *The Wall Street Journal* - Media

Given the uncertainty on the defense side and what's happening on the commercial side, when do you start to get uncomfortable about the relative shares of BDS versus commercial?

Jim McNerney - *The Boeing Company* - Chairman, President & CEO

Well, I think the fact that commercial is growing faster than BDS right now is a good thing. It reflects that our strategy of diverse market positions in both the commercial, defense and space arenas underpinned by technical, geographic and other kinds of synergies across all of the businesses -- it says that it's working. I think I am less concerned about commercial growing too fast. (laughter)

And so, I think the basis of synergies, which is what makes the business model work, is still intact, even if one side, for an extended period of time, grows a lot faster than the other side. It was only eight years ago that the defense space and security side of our Business was growing much faster than the commercial side, and I was getting questions the other way. So, I mean, it's -- I don't think we're anywhere near the point where I think the business model is called into question.

Operator

Julie Johnsson, Bloomberg.

Julie Johnsson - *Bloomberg* - Media

Just to follow-up on that last line of questioning, I'm just curious what your thinking is with regards to mergers, potentially to offset some of the programs like C-17 that are in sort of the twilight years?



Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Yes, I think we are a Company that has, and continues to rely on organic growth for its long-term sustainment. Which is not to say that we don't entertain acquisitions from time to time. We've made a number of small ones in the services area and in the vertical areas in our defense business that we've called out as needing some supplementation. And you'll continue to see that.

But I think the answer to our future more lies in our ability to grow ourselves than anything else. And fortunately, we have a broad enough business model, as was surfaced in the last question, that when parts of our Business are flat or down, other parts of our Business are growing. And that's by design.

Operator

Dominic Gates, The Seattle Times.

Dominic Gates - *The Seattle Times - Media*

You spoke about the investments by Boeing that are baked into that \$25 billion of deferred production to support the rate increases to 12 and 14 on the 87. But you guys are holding the strings of a huge global partnership, so your partners in Italy, Japan, and also Spirit in Kansas also have to increase their production rates.

Tom Downey - *The Boeing Company - SVP of Corporate Communications*

Dominic, you're cutting out really badly. Can you come back at that again?

Dominic Gates - *The Seattle Times - Media*

All right. Can you hear me any better now?

Jim McNerney - *The Boeing Company - Chairman, President & CEO*

There we go. Would you mind starting again, Dominic? We couldn't hear you.

Dominic Gates - *The Seattle Times - Media*

Well, I was asking about -- Boeing has baked into its \$25 billion deferred production number the investments you need to increase the rate on 787 to 12 and then 14. But you also -- I just want to ask about the situation with your partners around the world in Japan, in Italy, in Kansas with Spirit -- they also must invest to increase the rate. So, have you nailed down the investments from your partners? Is there any Boeing support involved there? And also, has partnering for success allowed you, when you reach this stage of increasing the rates, to improve the contract terms with those partners?

Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Yes, I think, yes, we are working very closely with our partners as we take up rate. And I think we probably would not announce that we're taking up rate unless we had a high degree of confidence that our business arrangements would be at least as good with them as they are now. And quite



frankly, we have a lot of growth to offer them. And so, as I mentioned earlier, that's the basis of the partnering for success program. And that is the success of Boeing products and services.

So, it's not that we're jamming something down their throats. It's that we are offering them growth, and together we should search for productivity to take advantage of that growth. That's the spirit with which we're approaching our partners. And so, I think that gets at the spirit of your question.

Operator

Jon Ostrower, The Wall Street Journal.

Jon Ostrower - The Wall Street Journal - Media

Question for Greg on the \$25 billion deferred production figure. Just thinking about all the changes that you've made in your factories over, really, the last 18 months or so (technical difficulty) a month -- the expansion of Charleston aft fuselage, the new positions in Everett, what you mentioned earlier. But those are really designed, as far as I understand it, to get to 10 per month.

And obviously, a \$5-billion increase in deferred production is pretty significant jump when you think about that. Can you break through what that additional \$5 billion is in terms of your overall cost? It seems like that jump is most related to just building more units over a constant period of time.

Greg Smith - The Boeing Company - CFO

There's certainly that; that is part of it. But the optimization -- some of the points I made -- were not just solely reflected on getting to 10 a month. There was a headset, certainly because of our backlog and the demand of the airplane and the anticipation of a -10 launch to -- how do we fully optimize that even beyond 10? So, that's where you're seeing investments maybe near term on going to 10, but with a headset of more looking at improving flow at any rate, 12 or 14. So, that's primarily what you're seeing there.

But you're right, there's certainly the upfront investments to, again, further optimize the current production system in anticipation, but also the investments to get to 12 a month are another increase in there. So, that's really the biggest drivers in the deferred production. And as I said, we're optimizing those investments, and continue to refine them, but it's obviously -- net-net, it's a good thing because we're supporting a higher production rate and strong demand for this airplane. And we're continuing to focus on productivity and efficiency at the same time.

Tom Downey - The Boeing Company - SVP of Corporate Communications

Operator, we have time for one last question from the media, please.

Operator

Andrew Parker, Financial Times.

Andrew Parker - Financial Times - Media

Couple of questions, please. Just a clarification on your shareholder remuneration -- I think you said on the call with the analysts that you're going to exceed the \$2 billion for your buyback in 2013. You've got a large cash balance. So, can you give any insight into what your thinking is for next year?



And then, secondly, Airbus had this notable contract win with Japan Airlines with the A350. Mr. McNerney, what sort of lessons have you learned from that? And do you think -- because they've obviously broken into the market in a significant way for the first time in Japan. And in particular, whether you think the Airbus success was at least partly to do with the issues you've had with the Dreamliner?

Jim McNerney - *The Boeing Company - Chairman, President & CEO*

Well, as to JAL, I'll answer that one first, and then you can answer the numbers question. I think, obviously, that's a campaign that we did not want to lose. We fought hard. Airbus fought hard.

I can't speak for them on -- for JAL on why they chose the other airplane. Knowing the JAL folks, I'm sure the reasons were good ones. This is a customer that we have served for many, many years, and we'll continue to serve for many, many more. I think we will take this as a sign to redouble our efforts.

I would note, during the time of this loss, that we made some major progress in Europe with Lufthansa with the 777X. Which, in the minds of some, is an analogous situation. But back to JAL, we will take it as a sign to do better and work harder with one of our great customers.

Greg Smith - *The Boeing Company - CFO*

On the share repurchase -- obviously this -- deploying our cash is a top priority for us, and returning cash to shareholders. And we're -- as you think about us going forward, we're going to continue to have a balanced approach. And as we continue to perform and reduce risk, we're going to continue to deploy our cash accordingly. Plus or minus, on an annual basis, we've kind of targeted 80% of our free cash flow returning to shareholders. And I think that's probably a good barometer to think about as you look at us executing on our cash flow going forward.

Tom Downey - *The Boeing Company - SVP of Corporate Communications*

That concludes our earnings call. Again, for members of the media, if you have further questions, please call our media relations team at 312-544-2002. Thank you.

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