EVOLUTION PETROLEUM CORP. (NYSE: EPM)

Financial Strength—A Critical Component of Evolution's Business Model

June 13, 2022
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KEY POINTS

- We hosted a fireside chat on May 18, 2022, with Ryan Stash of Evolution Petroleum. Ryan serves as Evolution's Senior Vice President, CFO, and Treasurer.
- Evolution has integrated the Williston Basin acquisition, which closed in January 2022, and the Jonah Field acquisition, which closed in April 2022 into the asset base. To accommodate the increased scale, management expanded the organization's financial team. Management believes additional assets could be layered in with minimal incremental costs thereby increasing the free cash flow on acquired assets.
- Evolution's model concentrates on non-operated working interest properties. Management seeks to forge strong working relationships with the asset operators and to be involved with their technical teams on field-level decisions. Evolution works with its operators on field optimization projects based on its own technical interpretations of what's best for the producing assets.
- The Jonah Field assets provide exposure to premium west coast natural gas markets. Marketing agreements for those assets provide some flexibility for Evolution to seek out optimal pricing.
- Maintaining a conservative financial posture is critical to Evolution's business strategy. The strategy aims to grow the business through mature non-operated working interest asset acquisitions that generate free cash flow to support a sustainable dividend. The current pricing environment could allow for rapid deleveraging following the two most recent acquisitions.
- The 3QFY22 dividend paid on March 31, 2022, restored the quarterly payout to the pre-pandemic level of $0.10 per share. Future dividend increases are likely to be a discussion topic as a competing use of free cash.

KEY STATISTICS

Price	$7.55
52-Week Range	$3.60 - $8.17
Avg. Daily Vol. (30 day)	165,833
Shares Out (MM)	33.7
Market Cap (MM)	$254.6
Enterprise Value ($MM)	$261.2
Revenue TTM (MM)	$80.6
Annual Dividend/Yield	$0.40/5.3%
Fiscal Year End	June

Source: YCharts, as of June 10, 2022

THE COMPANY

Evolution Petroleum Corporation is an oil and natural gas company focused on delivering a sustainable dividend yield to its shareholders through the ownership, management, and development of producing oil and natural gas properties onshore in the United States. The company's long-term goal is to build a diversified portfolio of oil and natural gas assets primarily through acquisitions, while seeking opportunities to maintain and increase production through selective development, production enhancement, and other exploitation efforts on its properties.

Evolution's asset base consists of a diverse mix of producing assets across five operating areas. The company owns non-operated interests in the Barnett Shale in North Texas, Jonah Field in Wyoming's Green River Basin, Delhi Field, a CO_2 enhanced oil recovery project in northeast Louisiana, North Dakota's Williston Basin, and Hamilton Dome Field in Wyoming's Big Horn Basin. Evolution closed its latest property acquisition, non-operated properties in the Jonah Field, on April 1, 2022, for $27.5 million, before closing adjustments. The company's homepage is www.evolutionpetroleum.com.

ABOUT THE EXECUTIVE

Ryan Stash
Senior Vice President, CFO, and Treasurer

Evolution Petroleum

Ryan Stash has served as the Senior Vice President, Chief Financial Officer, and Treasurer for Evolution Petroleum since November 18, 2020. He has over 20 years of experience in the oil and gas industry focused on capital raising, mergers and acquisitions, and accounting and financial reporting. Before joining Evolution, Mr. Stash served as Vice President and Chief Financial Officer of Harvest Oil & Gas Corporation from October 2018 to November 2020.

Prior to joining Harvest, he served as a managing director at Regions Securities focused on the energy sector. Before his time at Regions, Mr. Stash spent 11 years in the energy investment banking group for Wells Fargo Securities in Houston, rising to the level of director. He began his career as an auditor and spent five years working at Hewlett-Packard and Ernst & Young, LLP.

Mr. Stash is a Certified Public Accountant in the State of Texas. He received an MBA, a Masters in Professional Accounting, and a Bachelor of Business Administration, all from the McCombs School of Business at the University of Texas at Austin.

EXECUTIVE DISCUSSION

Jeff Robertson: Good afternoon. I would like to welcome everyone to our fireside chat today with Ryan Stash. Ryan is the Senior Vice President, Chief Financial Officer, and Treasurer of Evolution Petroleum. Ryan, I would like to take the opportunity to thank you for joining us today. Before we get started, I would like to mention that we will reference forward-looking statements during today's discussion. Viewers can review Evolution's disclosures around forward-looking statements and its latest corporate presentation, which can be found on the Investor Relations section of the company's website. Ryan, let's get started. We are pleased to have you join us today.

Ryan Stash: I appreciate it, Jeff. We had a lot of fun on the last fireside chat and are looking forward to this one as well.

Jeff Robertson: We hosted a fireside chat on April 20, 2022, with both Jason Brown, Evolution's President and CEO and Ryan. The May 9, 2022 Management Series Report for that call is accessible here. Today's discussion will build on the last and focus on the financial integration of recently closed acquisitions.

Since the beginning of January, Evolution has closed two significant acquisitions. One in January in the Williston Basin for ~$25.9 million and one in early April in the Jonah Field in southwestern Wyoming for ~$27.5 million. Both acquisitions added new operating areas, relationships with new operators, and new opportunities for the company.

The Williston Basin acquisition added a sizable inventory of proved undeveloped drilling locations, which can be used to augment Evolution's capital program over the next several years at least. The Jonah Field acquisition was essentially a proved developed producing (PDP) natural gas-based asset that is effectively fully developed.

Ryan, I would like to start with your CFO role and managing the integration of assets into Evolution. Can you talk a little bit about how the company approaches integrating non-operated assets into the asset base?

Ryan Stash: Sure. Honestly, integration is one of those words where the answer is always "it depends". Integration depends on the asset location and the type of records systems maintained by the sellers.

Integration really starts with the back-office accounting piece and making sure it is all in check. We make sure we can receive revenue from the operators and pay expenses we are invoiced for. Once the basic receivables and payables accounting is confirmed, we are ready to go. That is the beauty of the non-operating model; there is not a lot of complicated back-office work that we really need to do.

We do like to contact the various accounting teams at the asset operators. We have been deliberate to make sure we have good relationships there. As you are aware, especially in the non-op piece, we are on a one- to two-month lag when we receive actual revenues and expenses. So, it is important to be able to get real-time information. We generally do that by fostering good relationships with the operators and making sure that we have good communication protocols in place as well.

Jeff Robertson: Evolution's asset base now includes producing assets in five operating areas with five different primary operators. How did you become familiar with Foundation Energy Management, the operator of the Williston Basin properties, and Jonah Energy, the operator of the Jonah Field properties?

Ryan Stash: The Foundation situation was an interesting one. The Williston Basin assets were not sold through a marketed process. Our CEO was introduced to their principals by one of Foundation's investors. Also, it just so happens one of our board members had a prior relationship with Foundation's CEO. We built a relationship with them over several months before we committed to the transaction. They owned an asset in the Williston Basin that they had just acquired, and we ended up buying a non-operated 50% share of their position. So, that deal was sourced from prior relationships. By the time we bought the asset, we felt like we knew Foundation well after months of relationship building.

The Jonah Field assets were sold through a marketed process. We were contacted early on by the brokers, who we have done several deals with. We knew Jonah Energy by reputation. It has a great reputation in the industry for being a very responsible operator. Jonah Field is in a sensitive area and Jonah Energy has made ESG a significant focus. Interestingly, I covered Jonah Energy when I was a banker at Wells Fargo, so I got to know the CEO and CFO. So, I had familiarity with them as well. Obviously, it does not always work that way but, in those two instances, we were familiar with the operators.

Jeff Robertson: You mentioned working with the accounting teams at the asset operators. How does Evolution go about building relationships with operators' technical teams to get integrated into the workflow for field-level operational plans, capital allocation, and project selection?

Ryan Stash: We focused on making the relationship collaborative. I think, we have done a very good job there. We generally schedule monthly operations meetings with the operators of all our assets. We plan to meet with Jonah Energy monthly. The meetings allow the group to talk about what is going on in the field with respect to production and any other issues and allow us to better understand whether there might be any planned or unexpected capital expenses.

We also hold annual working interest owner meetings, which include all asset stakeholders. In March, we held meetings with Foundation, Diversified, and Merit, who operate the Williston Basin, Barnett Shale, and Hamilton Dome, respectively. We had previously met with Denbury, the operator at Delhi. We expect to meet annually with Jonah Energy after closing that acquisition in early April. The annual meetings are an opportunity to meet everyone face to face for a deep dive into all aspects of the field-level operations. We get real-time information about what to expect so we can approve authorizations for expenditure (AFE) faster. Operators know who to call if they have an AFE that needs to be dealt with or if they have an emergency workover to perform. From our standpoint, we can act quickly because we already know the people involved and are up to speed on field activity.

On our April fireside chat, Jason described our ability to propose drilling new wells in the Williston Basin through a joint operating agreement we put in place with Foundation. If Foundation elects not to participate for its working interest share in a well, it still must operate the well for us. That provision is unique to the Williston Basin across our asset base. Our other assets have agreements that are protective of our interests as well. In Delhi, for example, the operator needs our consent to undertake most any capital project. Good working relationships with our asset operators are important to be able to get things done in the field.

Jeff Robertson: Evolution develops its own technical understanding of the assets in the portfolio. Is it fair to say that when an operator suggests certain workovers or other projects to enhance production, Evolution has its own independent view of the merits of the proposed work?

Ryan Stash: That is 100% correct. We do take the time to do our own deep dive on all the operations and geology of any asset we acquire. As you mentioned earlier, we acquired the Jonah Field assets solely on their PDP production profile. But as I mentioned on the May 11 earnings call, we have been pleasantly surprised to receive some AFEs from Jonah Energy to recomplete some wells in that field.

To your point, if something comes from one of our operators, we can make our own independent decision about the cost/benefit of the proposed work. We receive some AFEs for workover projects but not many new drill wells right now. We run our own economic model and will make our consent decision based on our own assessment. We need to be able to understand the asset to make those decisions for our shareholders.

Jeff Robertson: Evolution has added scale to the company's asset base with the Williston Basin and Jonah Field acquisitions. Has that scale put any strain on the organization as Evolution has integrated the assets operationally and financially?

Ryan Stash: Jason discussed this on the recent earnings call. We recently hired an experienced accounting team to build out that function with the intent to bolster the organization for the recent acquisitions and for future acquisitions. We want to position the company to have operating leverage and to grow the business. As we have discussed previously, the non-operated asset business model allows us to acquire assets with minimal incremental overhead. We are also looking at strategies to optimize our accounting systems to efficiently add new assets onto the platform. The team is in place to manage a growing asset base.

Jeff Robertson: Let's talk about Evolution's preference for non-operated assets and the company's ability to improve the marketing arrangements for its share of oil and natural gas production. The company's asset base spans five geographic areas from an enhanced oil recovery project at the Delhi Field in northeast Louisiana, to the Barnet Shale in north Texas, to Hamilton Dome in northeast Wyoming and, with the two latest acquisitions, the Williston Basin in southwest North Dakota and the Jonah Field in southwest Wyoming.

How much control does Evolution have over the ability to improve margins by seeking the most advantageous realized prices across the asset base?

Ryan Stash: It varies asset by asset. Our assets are governed by a joint operating agreement. Non-operated working interest owners do have the ability to take their gas in kind like we do at the Jonah Field as the prior owner did. We can then market the natural gas ourselves.

Another option is to allow operators to sell the gas for us. They are bound to sell our production on no worse terms than they receive for their own share. If we decide to take our gas in kind, like we do at Jonah, we can choose which market to sell into.

In the Barnett Shale, Diversified markets our natural gas production on our behalf. We have considered marketing our gas ourselves like what the prior owner, Tokyo Gas, did. However, we have some remaining time on the existing contracts, and we should have more flexibility with our Barnett production in a few years after existing contracts roll off.

Overall, our marketing arrangements vary asset to asset with some flexibility to seek the best arrangement for us and I would not want to give the impression we have zero control over how our production is marketed.

Jeff Robertson: Do you see many asset packages in the acquisition market where Evolution might be able to add some value through a different approach to marketing from the sellers?

Ryan Stash: We have started thinking about that quite a bit more recently. Especially with the natural gas assets we have evaluated. I think we discussed on our last fireside chat that the Jonah Field assets opened our eyes to the strength in western US gas markets. Moving gas to premium west coast gas markets makes the Rocky Mountains an attractive region to look for incremental gas-producing assets.

Recently, we have looked at some acquisition opportunities in the Rockies where we have asked our marketing experts whether they think we can enhance the economics by approaching marketing differently than the sellers. Can we move gas to the west coast or some other market to realize higher prices than the sellers? It is certainly something we are taking a much closer look at.

Jeff Robertson: Evolution released fiscal third-quarter results on May 10. The quarter included a contribution from the Williston Basin for most of the period but zero for Jonah, which closed in early April. Your fourth fiscal quarter ending June 30 will include nearly a full period impact from the Jonah Field. How will the inclusion of the Williston and Jonah Field assets affect production costs moving forward?

Ryan Stash: Natural gas assets carry lower lifting costs than oil-producing assets. Our overall lifting costs should edge lower on a unit-of-production basis. The offset is that lease-level margins are generally not as robust on natural gas assets as oil. Although, I will note, at current strip, the margin on our gas assets is going to compare very favorably to our oil assets.

The answer to your question is that we would hope to see overall LOE per barrel drop from the level reported in our fiscal third quarter. The impact could be as much as ~20% reduction on a unit basis.

We are hoping for a drop in our corporate operating expenses due to the impact of lower lifting costs at the Jonah Field. Lifting costs on our gas assets are roughly half of those in our legacy oil assets at Delhi and Hamilton Dome. Delhi, a CO_2 enhanced oil recovery project, and

Hamilton Dome, a mature waterflood, are probably on the high side for oil assets. Our Williston assets are going to be a little bit lower on the lifting costs than Delhi and Hamilton Dome, but clearly higher than the Barnett and Jonah.

Jeff Robertson: You mentioned the positive impact current strip pricing is having on margins, especially on your natural gas assets. Commodity prices have risen sharply since acquisition terms were finalized on the Williston Basin and Jonah Field deals. Can you talk about the incremental return and/or the accelerated ability to deleverage the balance sheet at today's prices compared with where they were when the acquisitions were announced?

Ryan Stash: Sometimes it is nice to get lucky in terms of timing of a commodity cycle in the context of acquisitions. The Barnett Shale deal we closed in May 2021 just paid out in May 2022. We certainly had not modeled a 12-month payout for that deal. So, that was a great result for us. I would say the Williston Basin and Jonah Field deals are looking like they might pay out in about half the time we originally modeled. So, high prices are certainly making their timing look very good.

With respect to the balance sheet, assuming we do not find another use for cash, we are paying down debt with cash flow. As you know, our board is very focused on maintaining a clean balance sheet. We expect to fully repay our borrowings by the end of calendar 2022 and potentially well before then at current strip. So, our balance sheet and liquidity will be in very good shape in short order.

Jeff Robertson: Can you share any guidance return hurdle rates Evolution is looking for in the current PDP acquisition market against a high commodity price backdrop? Is there a level that leaves upside for further positive surprises and some protection from unpleasant surprises?

Ryan Stash: That is good question and one that we have a healthy debate about at the board and management level. How should we really be thinking about acquisitions and value? I would say we generally focus on accreting cash flow per share and whether a deal will support our dividend coverage. If a potential deal cannot check those two primary boxes, it is not something we will spend time on.

Once those criteria are satisfied, we look at all the relevant metrics such as expected PV rate of return, payback period, and what we are paying for production and cash flow. Obviously, asset characteristics are a big influence on shaping our valuation view. In general, we might pay somewhere between PV-15 and PV-20. Or potentially, it could be closer PV-10 for the right kind of long-life very low decline high-margin type assets. We do not apply a rigid discount rate framework. Rather, it comes down to the asset characteristics and accretion.

To protect ourselves, we certainly look at downside pricing scenarios to make sure that we are not overpaying.

Jeff Robertson: Evolution's capital discipline business model aims to reinvest ~50% of cash flow into the asset base through a combination of acquisitions and capital projects and dedicate the balance to maintaining conservative financial leverage and supporting a sustainable dividend. Does the inclusion of the Williston Basin development inventory affect how management and the board think about capital allocation?

Ryan Stash: Capital allocation is a real-time topic for us. As we noted earlier, we can reduce borrowings related to our two recent acquisitions rapidly in the current price environment. We are committed to sustaining an attractive dividend for shareholders. The allocation question comes down to the fact that our asset base has a natural decline, so we want to look for opportunities to grow and remain opportunistic in the acquisition market. Conservative leverage is one element of being able to be opportunistic.

We are currently evaluating potential Williston Basin development opportunities, which could add a drilling element to the capital budget. We also must remain flexible to fund the recompletion projects that have arisen in Jonah Field. As noted earlier, those AFEs were a pleasant surprise as we modeled a PDP production profile without much incremental capital.

You are right from a general framework perspective. We are looking at a reinvestment rate of less than 50% of our cash flow for some combination of potential development drilling in the Williston Basin, workover activity in Jonah and other areas, and acquisitions. To the extent we cannot acquire assets on attractive terms, we will consider other ways to potentially return cash to shareholders. The board is weighing those allocation decisions right now as we prepare for fiscal 2023.

The industry has a high-class cash problem now. A lot of companies are generating significant free cash and trying the determine the most efficient allocation framework.

Jeff Robertson: Evolution has closed two acquisitions since January 2022, adding meaningful scale to the asset base and balance sheet. Scale manifests in the amount of cash flow generated by the asset base. We have talked about the deleveraging pace in the current price environment. How should investors think about Evolution's capacity to fund incremental acquisitions and possibly larger deals as it gains scale?

Ryan Stash: We certainly expect to repay our borrowings and build cash late in calendar 2022 absent an incremental acquisition. Our strong balance sheet has been a competitive advantage and allowed us to acquire three asset packages going back to May 2021. We currently have a $50 million RBL credit facility with a single bank MidFirst, which has been a great partner.

Our current asset base could support a much higher borrowing base based on some collateral value analysis performed to set our hedging covenant.

In fact, we can probably support a borrowing base in excess of $150 million today. So, there is clearly some incremental capacity out there. I have kept my ear to the ground and talked to various other banks in the market and feel good that if we could find the right kind of acquisition, we could certainly find adequate liquidity on the debt side to execute on a transaction.

Equity is also an option as a component of acquisition funding. For equity, a deal would have to be accretive on a long-term basis. The board and management view our equity as a very valuable currency, especially factoring in the dividend. Consequently, we would only consider equity in certain situations. An acquisition would need to have a high-return element, like the low-risk development drilling locations that came with the Williston Basin, or an attractive merger. We have considered mergers in the past and will do so in the future if the valuation metrics between the two companies are attractive on a long-term basis for our shareholders.

Jeff Robertson: You spoke earlier about Evolution's increased scale and adding the Williston Basin and Jonah Field assets with some incremental costs to build out the organization. Moving forward, the company is positioned to fold in incremental acquisitions without a lot of incremental costs thereby improving the free cash flow profile of those assets. Which brings us back to the allocation question between a consistent sustainable dividend. Evolution has paid a quarterly dividend since the end of calendar 2013. How do you think about dividend sustainability and the duration of that coverage when Evolution evaluates acquisitions?

Ryan Stash: We have talked extensively in the past and Jason has frequently indicated that a major focus for the board was to return the quarterly dividend to the pre-pandemic level of $0.10/share ($0.40/share annualized). The company had historically paid a dividend at that level, and we felt it was important for our legacy shareholders to get back there.

We have restored the dividend and proven that we can successfully integrate acquisitions while maintaining conservative leverage. Now, we are back to that high-class problem we discussed of how to allocate free cash flow.

Clearly, we are going to pay down some debt. The board wants to keep debt very low so we can maintain the flexibility to act opportunistically in the acquisition market.

Beyond that, the board and management consider the appropriate dividend policy. We evaluate our business over multiple years on a mid-cycle price deck ($60/bbl for oil and $3.50/Mcf for natural gas) to think about dividend policy. Our mid-cycle deck is up a bit from $55/bbl and $3.00/Mcf. Our goal is a sustainable level that we can pay over several years without needing to reduce it unless there is some market shock like the COVID-19 pandemic. We use a lower mid-cycle price deck because dividend sustainability is very important to us.

Jeff Robertson: If I remember correctly, you mentioned a five- to seven-year time horizon that the board wants to keep in front of Evolution in terms of dividend duration on the May 11 earnings call. Am I remembering that right?

Ryan Stash: Actually, we model the business out at least 10 years. Ideally, we would like to sustain at least seven to 10 years. The five- to seven-year time frame is a good way to think about sustainability using our mid-cycle price deck.

Jeff Robertson: Does the board think about the dividend in terms of a target yield or is the goal to deliver a combination of a growing asset base combined with growing EBITDA along with an attractive dividend yield as the value proposition for investors?

Ryan Stash: There is not necessarily a threshold where if the yield is a certain level, we would raise the dividend. The calculus is balancing what dividend we can sustain versus the growth opportunities we see while maintaining a strong balance sheet position. Conversations focus more on achieving the optimal balance. The dividend was increased as we were busy integrating the new assets.

We think the yield will be a function of how well we execute on the business strategy and overall valuation in the energy sector. If we can raise the dividend because the business is growing and generating incremental free cash flow, we believe the stock should react favorably. The yield becomes a product of successful execution rather than a driver.

Jeff Robertson: Just to wrap up on circumstances that could lead to a further dividend increase, which was a hot discussion topic on the May 11 earnings call, if we fast forward to early calendar 2023 and finding attractive acquisition opportunities is difficult, how would a dividend increase compete for cash flow with Williston Basin development?

Ryan Stash: That is a good question to ask. I think the board will consider a dividend increase if the cash flow outlook remains strong. However, we are going to take a very thoughtful and measured approach to the dividend. As you know, the last thing we would want to do is put ourselves in a position where we might need to lower the dividend because we raised it too fast. Again, sustainability is paramount to us. Investors can understand market dislocations caused by events like COVID-19 and commodity price crashes. Still, we do not want to raise it too high too fast.

If we get through the rest of calendar 2022 and the acquisition market just isn't there, shareholder returns, and dividends could move higher on our priority list along with Williston development. Jason has talked about those issues at length.

One aspect of the Williston Basin assets we really like is the ability to put capital to work and grow the business if the acquisition market is not there for us. We are evaluating some drilling opportunities to include in our fiscal 2023 capital program. The dividend is one important lever in our business and ensuring its sustainability helps drive other decisions surrounding our capital and balance sheet.

Jeff Robertson: We have covered a lot of ground today about asset integration, scaling the business, capital allocation, and the dividend. I would like to thank you for joining us today. We appreciate your time.

Ryan Stash: I appreciate it, Jeff. And thanks everybody for listening in. As always, management is always open for discussions with investors.

Jeff Robertson: Thank you. We'll look forward to hosting another fireside chat with you soon.

Ryan Stash: Look forward to it. Thanks, Jeff.

Jeff Robertson: Thank you.

ABOUT THE ANALYST

Jeff Robertson
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Prior to Water Tower Research, Jeff was an 18-year equity research veteran at Lehman Brothers / Barclays where his coverage concentrated on mid- and small-capitalization companies in the oil & gas exploration and production sectors, and he also covered master limited partnerships (MLPs) and royalty companies.

Previously, Jeff worked in similar industry roles at Salomon Smith Barney and Wasserstein Perella. Jeff has worked on the sell-side for 28 years, gaining exposure to all facets of the oil & gas industry, and his tenure spans multiple industry cycles.

Jeff holds a BS degree in Geology from Centenary College of Louisiana, an MS degree in Geology from Texas A&M University, and an MBA from Southern Methodist University.

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