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Company Conference Presentation
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Call Participants

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Presentation

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

Good morning, everyone. I'm Sebastiano Petti, and I cover the telecom, cable and satellite space at JPMorgan. I'd like to welcome Chris Stansbury, CFO of Lumen Technologies. Chris, thanks for being here today.

Christopher David Stansbury

Executive VP & CFO

Great to be here.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

So Chris, you joined Lumen in March 2022 just over 3 years ago, and alongside Kate have instituted several strategic changes over that time while repositioning the company for growth. Take us through your 3 company-wide priorities, how some of those changes you've implemented have set the business up to return to long-term growth.

Christopher David Stansbury

Executive VP & CFO

Yes. The first would really be building the backbone for AI. And when we arrived at Lumen, one of the things that attracted us was this tremendous asset base that was underutilized, which was the network and not just the existing network, but the conduit and the availability to expand that network.

And so with the explosion of AI, the data needs for the hyperscalers to train their models and then ultimately, as large enterprise starts to consume it, there was a tremendous opportunity to monetize those assets. And that really culminated in the \$8.5 billion of deals that we signed last year. And there's conversations that continue around that as we've discussed in the past. So that's really the first one.

But what ultimately changes the landscape and is very disruptive for the space is really the cloudification of telecom. And what that means more simply is the ability to deliver services digitally. And telecom, particularly in the enterprise space, has been known for a long time at being slow. It takes months to get services lit up. It's truck rolls. It's very slow. It's also infrastructure heavy. It's -- every service has its own infrastructure, its own set of ports. And so it's really difficult to scale. And so the economics of enterprise telecom have never been that attractive because it's really about putting in a new technology and then keeping customers on that technology for as long as you can, right? And what that does is it really stifles innovation.

Where we are today is in a position through an IT layer, a control center, where customers will be able to add services to what we call a fabric port. And all that is, is it's one port for many services. And so that's the innovation that we're bringing. The services that will come will vary greatly. It will be everything from direct cloud on-ramps, which we can get into to security services, to edge compute, et cetera, et cetera. It also allows us, frankly, to bring in services for others and lay those on top of those ports. So it's a much more scalable model. It's a much more customer-friendly model, where they can order and effectively provision on their own, fewer truck rolls, faster to service and very scalable.

And then the last is really driving operational excellence. And that's primarily around managing the big legacy base that we have. There's things that we can do even for businesses that are in decline to help manage those declines, things like renewal motions and migration motions. And the reality is that declining base of revenue is actually in itself a tremendous asset because that's an installed base of customers that as we start to light up new digital services, we can migrate them.

So those are the big 3, but there really is a fourth, Sebastiano, which is the modernization and simplification efforts and part of what unlocks our ability to do these things is finally integrating a set of networks that were never integrated. All across the enterprise telecom landscape, there's been a history of M&A. And the efficiency that came from that was really just collapsing spans and layers. It was never a full IT integration.

Today, Lumen runs 4 different networks that we plug together and customers buy a little bit of each network as they're expanding their footprint. By the end of this year, it will be one network. And that starts to unlock a lot of value as we go forward. So that's the \$1 billion of exit run rate savings that we expect by 2027, and we're off to a great start there.

Question and Answer

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

Great. And I think that's a great intro as we cover a lot of those topics here in a moment. So starting with the PCF AI deals, no update on the remaining \$3.5 billion tranche in the pipeline on the most recent earnings call. Just help us think about whether or not this is indicative of slower demand, given all the noise around cooling AI, data center demand? Or does it just speak to the complexity of the deals?

Christopher David Stansbury

Executive VP & CFO

It really is the latter. I mean, the conversations that are taking place today are around new routes where I think it's a real tell to what AI requires and what large enterprise will require. It's not so much about filling in gaps in the network, it's about taking nodes out of current pathways between city pairs. So today, we may be able to -- we can get from city A to city B, but we might have to go through a third destination to get there. AI hates latency. And that really is important when we talk about direct cloud connect, because as enterprise starts to use AI to run their businesses, and that's starting to happen now in a much broader basis. When you think about the amount of AI that's being used, for example, to write code, it's significant. So latency kills that. And so these are complex deals because they're new routes, and it requires a lot of planning and alignment with the customers around that.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

Great. And so I thought one of the bright spots from the first quarter call was the pretty significant EBITDA, right, in the quarter. So you reiterated the 2025 guide and expectations for continued margin expansion over time, just given the core connectivity business as that scales and the modernization and simplification efforts that you just touched upon. So while you did note that there could be some upside to guidance, you also commented that you're watching the macro environment. So I guess help us think about what's driving the strong start to EBITDA this year? What's coming in better than planned, I guess? Is it organic declines?

Christopher David Stansbury

Executive VP & CFO

A few things. I mean I would say that on the modernization and simplification, we're off to a great start and we've got to continue to push that, test it and make sure that we're comfortable with what we're seeing on that side. But again, off to a great start.

The other thing is, is in the core business, we're seeing real improvements in churn. And some of that is because of the things that I think we've done as it relates to again, back to that driving operational excellence, putting processes in place to try to create more customer stickiness so they're not leaving us, and I think that's working. I also think there's some external factors. There's obviously been a real drive to return to office, particularly in places like public sector. And that is driving needs to maintain services rather than disconnecting them. And I think that's helped as well.

But we've also seen really strong performance in waves growth, and that's something that's obviously industry-wide, but we are a big player there, and we should continue to outpace the growth of the market. So that's a factor as well.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

And as you think about the cloud economics, has that also helped? Or is it still kind of early?

Christopher David Stansbury

Executive VP & CFO

It's still early. And again, I think that's where when we look at our economic modeling, we love the PCF deals. Again, it allows us to monetize an asset that has literally been dormant for 25 years since that conduit was put in the ground. And it's given us really much needed cash flow at a time in our transformation when it matters most, but it's not how we save the company. The part that ultimately, I think, really propels our growth and our financial future is this cloudification of telecom, but we're really at the early edges of that.

And so as we start to talk more about things like cloud on-ramps, there's an enormous amount of interest and the questions that we're getting from enterprise is how fast can I get it. Now we're obviously still building that out, but that's where we'll start to see that growth impact us. And later this year, we're having an Analyst Day, it will be in September, and we're going to unveil a lot more of that with the economic modeling around it in terms of when we expect that to happen. But there's a lot going on inside the company, and we're really excited about it.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

Great. And I think cost-cutting program, you talked about maybe a good strong start there. So you expect to achieve run rate cost savings of \$250 million in year building over -- building to \$1 billion exiting 2027. So I guess it's tracking ahead of plan, but help remind us of some of the major efforts above and beyond the network side. There's also simplification efforts, right, if you're not mistaken.

Christopher David Stansbury

Executive VP & CFO

Yes. So I mean, again, there's product simplification. If you think about some of the opening comments I made were historically, every service required its own set of technologies, that's complexity. That's cost. That's real estate. It's power. It's a whole bunch of things. And our ability to save on all of those buckets of cost, as we simplify the product line and start to pivot to more of a digital portfolio, that starts to unlock a lot of that. There's a lot of IT backbone, right, that drives all these different systems. And it's the most tangled pot of spaghetti you've ever seen in your life. And I think it would be true if you looked inside of any enterprise telecom provider, and we're untangling it. So it's in that we find a lot.

The thing that I think I'm most excited about is the rigor that is going into this. I've been part of a lot of cost programs over the course of my career, and I've never seen anything like this where literally, every project has got enormous rigor around what is driving the savings? What is the connectivity across projects? Does one impact another positively or negatively?

And so we did a review with the Board this week of where we were on that time line. And the reality is the makeup of what we showed them a quarter or 2 ago versus the makeup of what's in there today continues to change because we continue to learn more. And as we learn more, we find more. And so it's a really rewarding process, and the team is just doing a tremendous job.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

Great. You did touch on the better-than-expected disconnects and maybe some of the reasons why there. But do you think -- so you talked about maybe return to office is one thing, right, so maybe services are a little bit more sticky than they probably would have been otherwise. But do you think this pace or this level of improvement can persist, just kind of given...

Christopher David Stansbury

Executive VP & CFO

Cautiously optimistic. You never want to declare victory on something like that. But if we look at those trends over the last number of quarters, they've continued to improve. So that's encouraging. But I think we need a little more time to make sure that, that can stick. But again, even just engaging with the customer because it's -- I got asked when I first came into this role, what's different in telecom. And this is a truth, which is once you had a customer connected to a legacy service, the rule was to never speak to them again, right? Because if you spoke to them, they might wake up and turn it off. And that is exactly the wrong mindset because cannibalization on a flat business, you could argue, is that a good thing or a bad thing. If it's going to drive growth, it's a good thing. But cannibalization on a business that's in decline is nothing but goodness, right, because it's declining. It's going to zero.

And if you don't innovate and you don't create a pathway for customers to consume the next generation of products, you're just opening the door for everybody else to come after those customers and pick that up. And so we are very aggressive in our mindset about how we can create those migration pathways for customers, retain those customers and ultimately, upsell them with more new services. And that's really where the fabric ports and the digitization of our portfolio will take us.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

Got it. So the public sector was very strong in the first quarter, growing 15% year-over-year, driven by large bookings in the quarter. So I guess help us think about what's driving that strength and whether it's durable. I think on the call, you talked about waves, right, is a big piece of that.

Christopher David Stansbury
Executive VP & CFO

Yes. There's a lot -- so there's a lot of activity going on, on the selling side right now. And if we look at just opportunity sets, I would say that the opportunity sets in the public sector space have grown over the last 6 months. And that's a real positive for us.

There was some installs that impacted revenue because of the State of California PCF deal that we announced a while ago, but the reality is underlying that business, there is strength. The current administration is very focused on infrastructure improvements. I mean I think every other day, we're reading about issues at the FAA, for example, and the need to dramatically update those services. There's obviously a huge, huge effort to -- for the U.S. to remain first in AI and investment around that. And so lots of big infrastructure-type projects being discussed as well. So all in all, I think the federal space is a very good space to be in right now, and we'll see how that plays out over the coming quarters.

Sebastiano Carmine Petti
JPMorgan Chase & Co, Research Division

So real quick on that. Lots of focus on DOGE's impact to the government and public sector trends across the enterprise space. Do see that as -- so I guess, do you see that as more of an opportunity at this point versus the threat?

Christopher David Stansbury
Executive VP & CFO

Yes, we really do. So again, the contracts that were signed kind of pre-DOGE, those installs continue, right? The bigger opportunity here though is that the things that we're working on, right, to drive the use of AI to make it easier to consume, to reduce latency, to reduce cost for large enterprise and in this case, public sector, that's how we get to a better place. We can actually modernize the underlying infrastructure in the country, which is in deep need of investment, and at the same time, position ourselves to save an enormous amount of money.

So we feel we sit in a spot where the investment is needed because it's ultimately going to drive the efficiencies that come from AI. And by the way, that's true in large enterprise as well, not just public sector. This is where companies are starting to turn to very aggressively in how they start to light up AI.

Sebastiano Carmine Petti
JPMorgan Chase & Co, Research Division

And you talked about -- I guess, on the 4Q call, you talked about some onetime headwinds related to the public sector this year driven to TDM transition. I guess that's now expected to come through in the second quarter, I think you talked about. Remind us what's driving that? And could this perhaps be a longer-term opportunity?

Christopher David Stansbury
Executive VP & CFO

I think it is a longer-term opportunity. I think it's linked to some of the things I just said on public sector, frankly. Look, if you look at the historical landscape in enterprise, right back to that core principle of never talked to a customer once you have them on a legacy service, we all buy and sell our networks to and from each other, right, everybody that's in the space because none of us have footprint that can get from everywhere to everywhere.

And so what historically has happened as those agreements and contracts near their end is there's a lot of rerate activity. And a couple of providers have been very, very aggressive around their rerates, to the point that on a compound basis over a few year period, we're talking 10,000%, 20,000% kind of increases.

And so it's not good for the customer. It's definitely not customer focused. It's not good for the country because it's coming out of taxpayers' pockets. And I think we're getting to the point where with our customers, we've come to an agreement on how we start to disconnect some of those services because it's not tenable anymore. Now in that, there's an opportunity around the modernization, and I think we're well positioned for that.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

Great. Okay. So on the call -- sort of pivoting to waves here, on the call, you touched on lit demand coming from enterprises. I guess what's the latest perhaps on the pricing dynamics in that market? Has competition evolved in the last 12 months? Obviously, some of your competitors has a very big focus of this?

Christopher David Stansbury
Executive VP & CFO

Yes. Yes. It's -- I actually love this question, and I kind of want to run into it rather than away from it because this is the fundamental problem across the industry, but it's also our opportunity and why we're going to win. Every invention and new technology that has come into the enterprise space ultimately has faced commoditization and price pressure. And I think for years, you and your peers would have appropriately said, "Hey, all this moves down into the right eventually, right? Everything converges to the mean." And that's been true. And it's been true because people have been playing this game that has failed, which is we're going to out-scale those commodity pressures, wrong. We are the poster child for that, given what we went through a couple of years ago around the debt because you can't outrun that problem.

And if you look at some of our competitors who have invested in that space, they've got a leverage problem that is dramatically larger than ours was, and they continue to double down on that strategy. That's great. Here's the problem. We can compete with that pricing. We have a very modern network. We've got -- we're pulling a lot of fiber, and we will continue to sell waves. But again, that's not how we're going to win.

Here's how we win. If you think about those competitors, look at the metrics that they talk about today. They're talking about how many data centers they've connected. And that's important, and the data centers are important, but the data centers, because there's been no innovation in the enterprise space have become the de facto network. The only way as a customer, a large enterprise customer, you can get from your enterprise to Google, Microsoft, AWS to consume cloud is through a data center paying really high cross-connect fees.

So what's a better way? What's a better value orientation for the customer? I can give you direct cloud connect from your enterprise through our network with much lower latency, which by the way, is an AI killer, right? We've addressed that much higher security because there's fewer hops and you don't have to pay those cross-connect fees anymore.

So yes, you have 2 choices. You can buy really cheap commoditized waves and then pay cross-connect fees or you can ride on Lumen's network and go direct to cloud. And so it's about changing that value proposition and bringing new and better ways to customers that we think wins the day, and that's where we're focused.

Sebastiano Carmine Petti
JPMorgan Chase & Co, Research Division

And I guess this speaks to Kate's comments about perhaps dumb pipes on the call, I think.

Christopher David Stansbury
Executive VP & CFO

That's it. That's it. And I think there's been an assumption that dumb pipes is really all networking is, and therefore, it becomes a commodity. The reality is the underlying network itself can create a moat that we can build those digital services on top of. And we think our network is well positioned for that, not just because of its breadth, but there's been a lot of divestiture activity around things, for example, like wire centers, right? Those wire centers are where the equipment sits to give you direct cloud on-ramps. That real estate is really important real estate as you start to bring more services to customers. So a lot of our competition has sold off those assets. So the ability, even with investment, if they were to digitize to compete is limited because the structure of their networks has limited their ability to do that. So we think there's a pivot here that's significant, and that's what we're focused on.

Sebastiano Carmine Petti
JPMorgan Chase & Co, Research Division

And then help us think about just, I guess, your competitiveness or the network. You did mention you are pulling a lot of fiber, right, continue to sell waves, but maybe any update on where you are in terms of network speeds on the lit side time line to 400...

Christopher David Stansbury
Executive VP & CFO

Yes, it's -- yes, there's -- it is very clear that enterprise has shifted to 100 and really 400 gig waves. The fiber that we're pulling today is very expandable. We just ran a test. There was a press release around it, where we did 1.2 terabyte over 1,800 miles. I mean it's staggering. And so we're going to quickly see that continue to move as the equipment that powers that fiber continues to evolve. So speed is critical, again, latency, right? There's a theme here. And so we're definitely seeing the trend and positioning ourselves for that explosion and growth as we go forward.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

And are you seeing within the existing base migrations continue to move up towards those higher speeds?

Christopher David Stansbury

Executive VP & CFO

Yes. I mean if anything, I think we're seeing the lower speed waves start to stabilize and, frankly, decline, right? There's still some demand and some customers who will want those lower-speed services, but we're definitely seeing the pivot to higher speeds and the demands for that.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

And so you kind of touched on this a moment ago, but Kate was notably excited about Lumen's opportunity within the network ecosystem, direct fiber access, highlighted your recent partnership with Google there. I believe she said this is a \$15 billion TAM and cited a huge amount of demand from that -- for that offering. So maybe you did and you have touched on a lot of it, but just help us think about why you are best equipped to win in that market, I guess, this notion of total cost of ownership? I sure it kind of came up on the call.

Christopher David Stansbury

Executive VP & CFO

Yes. We're really excited about it. This is disruption in a big way. It is estimated at a \$15 billion kind of incremental TAM. And it's important because this is a benefit not just to customers but also to the cloud providers because the ability for a customer to ramp up more quickly and be consuming more of those products faster is enabled by these on-ramps.

The -- what positions us differently is, I mean, first, again, start with the network as a moat, a lot of super high-speed fiber, obviously, strong relationships with all the hyperscalers. We have not just the intra and intercity routes, but again, we have the physical real estate locations where the equipment can sit that allows us to connect directly to those clouds. And there's also IP in there. I mean we've talked previously about things like ExaSwitch, which is a routing technology.

But let's take it one step further. And this really, I think, came out with the announcement with IBM last week, where we also have another asset, right, that was sitting there largely dormant edge compute. The company invested heavily in Edge. They saw the opportunity for Edge, before Kate and I arrived. But in a very kind of enterprise telecom way, it was an inside out rather than an outside-in approach. So an engineered solution that didn't have a home with a customer. Well, now it does.

Yes, the discussion that Kate had with Arvind at IBM think was really that as customers are pulling data down, not just from one cloud, from many clouds and maybe their private cloud, they want to run AI applications across those data sets and then push the data back to where it needs to go.

Having the ability to pull that to the Edge very quickly, use Lumen's edge compute network, do whatever work they need to do and then push that data back, those are huge unlocks Nobody else has that. They don't have the ExaSwitch capability. They don't have the direct cloud on-ramps. They don't have the infrastructure to support that and they don't have edge compute. So this isn't just a concept that's real. Again, we still have to build it out, but we have a significant advantage because of the assets that exist today.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

And now, I guess, pivoting to the fiber, the separation of your mass market business from the enterprise business, you didn't comment on recent sales rumors during the IQ call. Anything to share today perhaps with us? And then just maybe remind us why a separation makes sense? Why is that in the best interest? And while not necessarily touching on the deal specifically or any -- the process, can you maybe touch on your notion of the core network versus last mile considerations as you kind of think about a potential separation?

Christopher David Stansbury
Executive VP & CFO

Yes. Look, we've been very public now for a number of years that we've got 2 great businesses, and they both need investment. We could not be more proud of what the mass markets team has done with that fiber product, and they're killing it. They're doing really great work. That said, we have also said for years that at some point, the market would undergo consolidation that needs to consolidate. The payback on investments like consumer fiber is a very long window. And so the only thing that makes sense to try to truncate that is consolidation.

And I think the other thing that really has played out is convergence, right? And the bundle of fiber to the home with wireless is a real thing. We're never going to be a wireless company. So if you think about our right to win, if you will, we don't really have a right to win in that space. But we've got a great asset that somebody else could acquire and quite frankly, take much further because of convergence. And at the same time, strategically, that would allow us to focus on all the things we've discussed so far in terms of expanding the disruption of enterprise telecom.

The other big unlock here when you think about it is a fiber-only sale would be effectively today selling very little EBITDA because it's an investment mode, and it would also be removing the obligation to spend almost \$1 billion a year in CapEx. So the free cash flow implications of a sale, not just on the initial closure, but on the ongoing investment required, free cash flow benefits are significant.

So we have a strategic situation where convergence is real. The value of our asset is real. We have a right to win in enterprise. And we can potentially find ourselves in a scenario where we dramatically improve free cash flow and fundamentally delever the company. I mean if a transaction were to take place, we will be the most boring company at the credit conferences, and I can't wait for that moment. So that's the opportunity.

The -- but you touched on something super important. If you look at other transactions in the space, it's been across the board, right? We're going to take everything. We're going to take the copper footprint and the fiber footprint. I think the only way that it works for us is if somebody is willing to buy only the fiber because that footprint that is all the long-haul fiber, the real estate that goes with that, the EBITDA that sits in consumer fiber and quite frankly, sits on the business, the enterprise and wholesale side that rides on that is significant.

And so the other deals that have taken place in the space, there's been a lot of EBITDA on that, but that's not been the focus. That EBITDA has been attributed to the consumer fiber, it's not. A lot of these deals, about half of that is EBITDA for the enterprise. That's valuable EBITDA to us. That's valuable real estate to us. That's valuable fiber long haul for us to go expand our enterprise vision. So I think the only way it works is if it is fiber only, and we'll only do it if it's dramatically delevering and it significantly improves free cash flow.

Sebastiano Carmine Petti
JPMorgan Chase & Co, Research Division

And so as we think about that, does that entail then a -- if you're just separating just the fiber but maintaining the network, I mean is there wholesale kind of considerations or things like that, that would probably come out of a deal?

Christopher David Stansbury
Executive VP & CFO

I think there's -- it's complex. And so again, I think we have to see where this goes. But certainly, given the complexity, I think there'd be kind of ongoing relationships to some extent. But again, we'll have to see how that plays out.

Sebastiano Carmine Petti
JPMorgan Chase & Co, Research Division

Great. And I think in the first quarter, so strong net adds once again in that business, the momentum is going -- continues. But I think it didn't necessarily come up on the call, but ARPU growth was quite strong there as well. And so I guess what's driven the reinvigoration or rejuvenation in that business over the last couple of the quarters and months?

Christopher David Stansbury
Executive VP & CFO

So the team has been tremendously focused on driving not just the enablements, but also the penetration. And I think they've done really great work. The other thing we said for a long time is that when we started these builds, we didn't have the scale to really do

marketing efficiently. Obviously, the bigger we get, that gets a little easier. So our ability to do more marketing has helped as well. But executionally, the team is just -- it's crushing it. We get -- Kate and I get weekly updates from all the businesses. And that team -- the leader of that team has now come up with creative ways to tell us that they're on plan. He said, it's another boring update. So they'll do something boring is good, boring is good.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

So you talked about being the most boring company at the credit conference. As you think about perhaps on the other side of a transaction, help us think about your near-term priorities from a balance sheet perspective and...

Christopher David Stansbury

Executive VP & CFO

Yes. We've been really clear -- look, when we did the debt deal, one of the things that we had to do to navigate through that was a super priority layer that for those that hold it, they love it. For those who don't hold it, they don't. We understand that. But it's expensive, it's restrictive. And that's the first place we'd go. So I'd say that's our focus. But beyond that, there's tremendous opportunities. And by the way, a lot of that sits in 29 and 30.

I think as we go forward, we're starting to see more positive momentum. We would like to think that there's more positive upgrades coming. As those upgrades come, it allows us to refinance the structure that exists today. So the goal really is to not just delever but to also normalize the maturity curve and continue to simplify the structure. And while we do all those things, I think we'll see a dramatic reduction in our cost of capital and our interest expense. So I think there's a lot of goodness there.

Sebastiano Carmine Petti

JPMorgan Chase & Co, Research Division

Well, I think a great place to end it. Chris, thanks for joining us today, and thanks, everybody.

Christopher David Stansbury

Executive VP & CFO

Thanks a lot.

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