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Earnings Call

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CALL PARTICIPANTS	2
PRESENTATION	3
QUESTION AND ANSWER	7

Call Participants

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Gary L. Sims
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Len D. Devaisher
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Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the MidWestOne Financial Group, Inc. Fourth Quarter and Full Year 2023 Earnings Call. [Operator Instructions]. As a reminder, this call is being recorded.

I would now like to turn the call over to Barry Ray, Chief Financial Officer of MidWestOne Financial Group.

Barry S. Ray
CFO & Senior Executive VP

Thank you, everyone, for joining us today. We appreciate your participation in our earnings conference call this morning. With me here on the call are Chip Reeves, our Chief Executive Officer; Len Devaisher, our President and Chief Operating Officer; and Gary Sims, our Chief Credit Officer.

Following the conclusion of today's conference, a replay of this call will be available on our website. Additionally, a slide deck to complement today's presentation is also available on the Investor Relations section of our website.

Before we begin, let me remind everyone on the call that this presentation contains forward-looking statements relating to the financial condition, results of operations and business of MidWestOne Financial Group, Inc. Forward-looking statements generally include words such as believes, expects, anticipates and other similar expressions. Actual results could differ materially from those indicated.

Among the important factors that could cause actual results to differ materially are interest rates, changes in the mix of the company's business, competitive pressures, general economic conditions and the risk factors detailed in the company's periodic reports and registration statements filed with the Securities and Exchange Commission. MidWestOne Financial Group, Inc. undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances after the date of this presentation.

I would now like to turn the call over to Chip.

Charles N. Reeves
CEO & Director

Thank you, Barry, and good morning. On today's call, I'll provide a high-level overview of our fourth quarter results and an update on the significant progress that we've achieved executing our strategic plan over the last year. Len will then provide an update on our lines of business, and Barry will conclude with a more detailed review of our fourth quarter financial results.

Starting on Slide 3 of our earnings presentation. we delivered net income of $2.7 million or earnings per diluted share of $0.17. During the quarter, we sold $115 million of securities, resulting in a net pretax loss of $5.7 million as we continue to address our liability-sensitive balance sheet. We also recorded $438,000 in costs related to our previously announced voluntary early retirement program, $245,000 of merger-related costs and $105,000 reduction to the fair value of our MSR. Adjusting for those 4 items, adjusted net income was $7.7 million or $0.49 per diluted common share.

Now looking deeper at our results, I'm pleased with our balance sheet trends. We delivered 6.1% annualized loan growth for the fourth quarter and 7.5% loan growth for the full year as we continue to benefit from the expansion of our major market banking teams. Additionally, we achieved a modest core deposit growth in the fourth quarter and remain cautiously optimistic we can continue to grow our core deposit franchise through the year ahead.

While our balance sheet trends are encouraging, we do remain liability sensitive, and the interest rate environment continued to pressure our NIM and NII through the fourth quarter. That said, we have continued to see a moderation in the rate of our NIM decline and expect our margin will trough through

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the first half of 2024. Importantly, we continue to control what we can control and execute quite well on our strategic initiatives to transform MidWestOne Bank and position this institution to deliver financial results at the median of our peer group by the end of 2025.

As I've said on previous calls, we're working hard to become a top-performing bank and believe we are firmly on track given the substantial progress we've achieved over this past year. A key accomplishment was the realignment of our geographic footprint announced in September with the sale of our Florida operations and the proceeds to be reinvested in a highly attractive Denver MSA through our merger with Denver Bankshares. The long-established $272 million asset bank. During the fourth quarter, in that market, we hired an SBA officer and a treasury management officer, as we continue to further expand our platform and accelerate growth in this large commercially robust MSA.

Looking forward, we've received all regulatory approvals and expect the merger to close on January 31. At closing, we'll have approximately $640 million in loans and $400 million in deposits in the Denver marketplace and firmly believe we're on the path to building this MSA into a $1 billion-plus franchise in the coming years.

We also continue to expand and up-tier our commercial banking and wealth management businesses and have enjoyed robust loan and assets under management growth in our major metro markets of the Twin Cities, Denver and Metro Iowa. Our plan is to continue to add bankers as we target middle-market companies with $20 million to $150 million in revenue and individuals with investable assets of $3 million to $20 million.

Importantly, we're excited about the hiring of our new Head of Wealth Management, a seasoned leader with extensive super regional experience in the Midwest. We look to achieve double-digit annual revenue growth in this business segment in the years to come. Additionally, we added two experienced commercial bankers in our metro Iowa markets, one in Des Moines and one in Dubuque. Overall, we've made significant progress growing our product and talent capabilities in both our core markets and our specialty verticals of agribusiness and SBA. Accordingly, we expect an acceleration in loan growth to the high single digits for the full year 2024.

We're also extremely pleased with our 2023 expense discipline. As part of this, we outlined a plan to reduce our operating expense base by 5% and then reallocate 2.5% into more productive, profitable markets and departments. Through 2023, we've exceeded that stated plan and remain focused on the appropriate balance of cost containment and growth reinvestment.

To conclude, we've made substantial progress transforming MidWestOne and positioning the bank for improved earnings power and returns for when the interest rate cycle abates. While our liability-sensitive balance sheet has challenged current earnings, the execution of our strategic initiatives is progressing better and faster than what we've expected, and I remain very optimistic on what the future holds for our employees and shareholders.

At this time, I'd also like to thank our employees for their continued hard work, combined with their commitment to our company, customers and communities. This journey would not be possible without their unwavering support.

Now I'd like to turn the call over to Len.

Len D. Devaisher
President & COO

Thanks, Chip, and good day, everyone. Deposits have remained a consistent focus in 2023, and the results are showing. We're especially pleased at the improving quality of the segment mix with consumer and commercial deposits, muting a decline in high-cost lumpy public funds.

Our positive net new deposit accounts in 2023 and strong growth in services per household, which are up from [3.40 to 3.48] reflect our focus on a proactive relationship approach. Looking forward, we remain cautiously optimistic, having generated another quarter of core deposit growth, as highlighted on Slide 6.

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Our commercial banking team continues to drive strong growth on the asset side of the balance sheet, too. Our $50 million of commercial loan growth in the fourth quarter was driven by our focused markets, particularly Iowa Metro. We continue to see growth in CRE and ag balances. And in terms of new commitments, we see strong momentum in C&I.

Our loan story is about growth but also profitability and risk. We are pleased that our weighted average coupon of new commercial originations in December was up to 7.76%, an increase from 7.27% in September. Our renewal rate averaged 8.37% in December, up from 8.26% in September.

As outlined on Slide 8, our nonperforming assets ratio is stable. During the fourth quarter, we did see three relationships migrate from special mention to classified: Two in the senior living space and one in the office CRE space. Importantly, we saw only a de minimis amount of credit exposure migrate from past to special mention.

The credit risk profile of our portfolio remains solid with low net charge-offs of only 9 basis points for the full year and the leading indicator of 30-plus day delinquency at a low 26 basis points. Our portfolio remains well reserved with an allowance for credit losses of 1.25%.

As Slide 9 shows, we are well positioned with a diversified loan portfolio without outsized concentration in CRE and only 3.8% in nonowner-occupied office.

Turning to Slide 10, the talent investments in wealth also continue to bear fruit. Year-to-date, the team has been entrusted with new assets of $195 million, which represents a nearly 60% increase compared to 2022. As Chip mentioned, we see an opportunity to further grow our wealth business and are excited to have named a new head of our wealth business this past week.

With that, I'm pleased to turn the call over to our CFO, Barry Ray, to discuss our financial results.

Barry S. Ray
CFO & Senior Executive VP

Thank you, Len. I'll walk through our financial statements beginning with the balance sheet on Slide 12.

Starting with assets, loans increased $61 million or 6.1% annualized from the linked quarter to $4.13 billion. Strength in the fourth quarter was led by commercial real estate loans, which increased $49.3 million or 9.3% annualized from the linked quarter. The overall portfolio yield was 5.34%, a 15-basis point improvement from the linked quarter.

During the quarter, the allowance for credit losses decreased $100,000 to $51.5 million or 1.25% of loans held for investment at December 31. The small decrease reflected loan growth in portfolio segments with expected credit loss rates that are lower than other segments.

Turning to deposits. Excluding brokered, deposits increased $31.4 million or 0.6% from the linked quarter. This is the second sequential quarter of deposit growth, which points positively to continued growth in the year ahead as our deposit franchise stabilizes. For the fourth quarter, Total deposits increased $32.3 million to $5.4 billion at December 31 as compared to September 30. This increase, combined with our security sales, positioned us to reduce higher cost FHLB borrowings. During the quarter, total borrowed funds decreased $74.9 million to $423.6 million.

As Chip touched on, the rising interest rate environment continued to pressure deposit costs and our total funding costs in the fourth quarter. Specifically, the cost of interest-bearing liabilities rose 32 basis points to 2.65% comprised of increases to our interest-bearing deposits, short-term borrowing and long-term debt costs.

Finishing the balance sheet, total shareholders' equity increased $19 million to $524.4 million driven primarily by a decrease in accumulated other comprehensive loss.

Turning to the income statement on Slide 15, net interest income declined $2 million in the fourth quarter to $32.6 million as compared to the linked quarter, due primarily to higher funding costs partially offset by lower volumes of interest-bearing liabilities, higher volumes of interest-earning assets and higher

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interest-earning asset yields. Our tax equivalent net interest margin declined 13 basis points to 2.22% in the fourth quarter as compared to 2.35% in the linked quarter. Our net interest margin in the fourth quarter continued to be impacted by the increase in our funding costs which significantly outpaced the increase of 12 basis points in our total interest-earning asset yields. Noninterest income in the fourth quarter decreased $6 million, primarily due to the $5.7 million net loss on our security sale in the fourth quarter and $554,000 unfavorable change in loan revenue.

As Chip touched on, we sold $115.2 million of securities in the quarter, resulting in $6.7 million in losses, partially offset by a $1 million gain on the sale of [Visa] Class B shares. The decrease in loan revenue was due primarily to a $388,000 quarter-over-quarter change in the fair value of our MSR and $108,000 quarter-over-quarter change in revenue from mortgage originations. Excluding the loss on security sales and the change in MSR, our noninterest income was stable as compared to the linked quarter.

Finishing with expenses, total noninterest expense in the fourth quarter was $32.1 million, an increase of $587,000 or 1.9% from the linked quarter. As we discussed on last quarter's call, we expect that our noninterest expense to gradually rise as we continue to invest in our business.

Importantly, and as Chip alluded to earlier, we exceeded our expense savings target in 2023 and as a result, our go-forward annual expense base will be at least $3.25 million lower than had we not undertaken those cost savings measures. Expense control remains a key focus of our management team, and we are very pleased with our execution.
And with that, I'll turn it back to the operator to open the line for questions.

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Question and Answer

Operator

[Operator Instructions] Our first question today comes from the line of Terry McEvoy with Stephens.

Terence James McEvoy
Stephens Inc., Research Division

Barry, maybe just stick with that expense outlook and commentary that you finished with. The success in the cost plan but investing in the future. So how do you think about 2024 when you balance both of those? And what type of an expense outlook do you have?

Barry S. Ray
CFO & Senior Executive VP

Yes. A couple of things, Terry. Just as a reminder, in the first quarter, we'll have two months of the Bank of Denver coming on as well as we -- Florida will not roll off until the -- really the end of the second quarter. So if I look at it from where we were in the fourth quarter of 2023, we'll be higher in the first and second quarters. I expect we're going to -- I expect we would come out of that towards the end of 2024 in the $33 million to $35 million range per quarter.

Terence James McEvoy
Stephens Inc., Research Division

Perfect. And then a question on the margin, how much of the fourth quarter balance sheet restructuring was in the net interest margin in the fourth quarter? And is there an incremental benefit in the first quarter?

And then maybe just sticking with the margin, when the Fed hopefully begins to cut rates, given your liability balance sheet, can you get ahead of that? And how quickly do you think you'll see lower deposit rates?

Barry S. Ray
CFO & Senior Executive VP

Yes. On the first part of that question, Terry, the fourth quarter, we executed the balance sheet repositioning at the very end of the fourth quarter. So there's nothing in the fourth quarter margin, no benefit from that transaction in the fourth quarter margin. So that will be a 2024 tailwind, if you will, to the tune of about a couple of million dollars, I would say, of net interest income.

The second piece with respect to should the FOMC start to lower rate and how effective can we be given our liability-sensitive balance sheet. Certainly, what we're talking about internally here is how do we get in front of and be prepared for if and when those rate cuts do come. It will really be a function of obviously what's happening in the markets we serve competitive-wise. I do think there's still a lot of competition for deposits. And so I think that will drive how successful we can be at lowering our deposit costs if and when those rates come.

Terence James McEvoy
Stephens Inc., Research Division

And maybe if I could sneak one more in for Chip, you just did a lot of hires in a lot of key markets. What areas of the bank are you still looking to add talent? And where is the team complete, so to speak?

Charles N. Reeves
CEO & Director

I'd say our focus areas continue to be hiring within commercial banking and wealth management, Terry. I don't think we'll be done there almost ever. They are concentrated primarily in our metro markets as we continue to build out those. Len Devaisher is here as well. Len any further comment?

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Len D. Devaisher
President & COO

No, I would agree with that. I would say fundamentally, Chip, in his remarks talked about Denver and our vision for Denver, and I would put that one close to the top of my list as I think about wealth hires there. And with our new wealth leader, I feel encouraged about our ability to bring on new talent and continue to grow that platform.

Terence James McEvoy
Stephens Inc., Research Division

Yes. The $1 billion objective or goal did make my notes here and catch my eye.

Operator

Our next question comes from the line of Damon DelMonte with KBW.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

Just wanted to start off with from -- on the loan outlook, I think you said the mid- to high single digits or high single digits throughout the course of the year. I guess -- I think the commentary was that you had good growth this quarter on ag and CRE and you're gaining increased optimism on C&I. Do you expect that growth to be kind of more balanced as you go through 2024? Or is there one area of the portfolio that you feel is going to outperform the others?

Len D. Devaisher
President & COO

Yes. Damon, this is Len. Thanks for the question. So I would say I feel like we have a good balanced outlook. Actually, what I'm pretty fired up about is I see the C&I momentum going. I also see some strong things happening in our new agribusiness vertical. So -- as a nice complement to where we've continued to -- we've enjoyed historically, as you know, a lot of CRE momentum. So that's -- we're seeing the other pieces come into play now so I feel good about that.

I would also say that even though as you look at a balanced number from a C&I perspective in the fourth quarter, we did have one customer, we had a significant payoff with the sale of a business but we replaced those balances with new nameplates, bringing over and including some nice full relationships. So those things give me a lot of positive outlook as I look forward in '24.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

And then with respect to the margin, Barry, can you give us a little guidance as to what the expected impact is going to be from Denver when they hit later this month?

Barry S. Ray
CFO & Senior Executive VP

Yes. I think we'll get some incremental benefit in the margin from the Bank of Denver. Their net interest margin is higher than our net interest margin even though they're relatively small part of our balance sheet, obviously. And then we'll also get the benefit of the accretion from the interest rate marks as well. So I expect there will be some incremental lift in the margin just from that transaction moderated by just the size of the organization.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

And then did you say that with respect to the core margin, you could see a couple of million dollars of tailwinds from the restructuring on NII here in the first quarter?

Barry S. Ray

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CFO & Senior Executive VP

No, not in the first quarter, in the first year, Damon. 2024.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

The first year, got it. Okay. And then so when you look at just the core margin, you feel like it bottoms here by like the end of the second quarter?

Barry S. Ray
CFO & Senior Executive VP

That's kind of how we think about it, Damon, that perhaps the core margin troughs in the middle of 2024 -- first half of 2024.

Operator

We have no further questions. [Operator Instructions]. Our next question comes from the line of Brian Martin with Janney.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Just wanted to -- a couple more on the margin, Barry. I guess the margin for the month of December, can you give us an idea of where that was trending? And then just on -- just the restructuring and the basis point impact of that restructuring. Did you give that maybe -- I guess, can you put that -- can you frame that up, where that's at if you think about where the December margin was since it wasn't really in there?

Barry S. Ray
CFO & Senior Executive VP

Yes. Our net interest margin in December was 2.15%, Brian. Now that had some negative adjustments in net interest income associated with it. And so probably closer to our -- really kind of between, closer to 2.20% perhaps. I did not put the basis points on the benefit from the bond sale transaction. But again, it's around $2 million of interest income for 2024.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

And that will be in there -- just throughout the whole year so, okay. Perfect. And then I guess, just secondly, as far as the outlook for credit. And I guess, can you just talk about -- you talked about the special mention being de minimis this quarter is pretty negative, very low. Can you just talk about where are the concerns?

I know you talked about a couple of the credits that were downgraded in the assisted living front, but just kind of areas you're watching a little bit more closely in terms of risk as you're kind of staying in a certain time period here?

Charles N. Reeves
CEO & Director

Sure, Brian. This is Chip. And Gary Sims, our Chief Credit Officer, is here in the room with us, and we'll have him go ahead and walk through that for you.

Gary L. Sims
Senior VP & Chief Credit Officer

Brian, Gary here. And as you noted, the migration from special mention to substandard, three relationships, two of them were in senior living, one was an office credit. And when we think about the question of where we -- focusing on potential risk in our portfolio, that really kind of crystallizes where we're focusing our efforts in identifying risk.

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We have seen softness in the senior living and the office CRE. On the senior living side, for the most part, it's not about occupancy. It's about the operating statement and operating expenses, more specifically nursing care. And then on office, it is, in fact, about occupancy for the most part. So I'll stop, Brian. Did that answer your question?

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Yes. No, that's helpful. Just to get a little color, in -- any specific areas that are of more concern? I guess, as you kind of look forward other than what you've kind of already identified or just sectors within the commercial real estate bucket?

Gary L. Sims
Senior VP & Chief Credit Officer

Sure. And good place to state there. As we said, one of the things we were encouraged with as we finished out the year, we didn't see continued migration into the non-pass categories as we finished out the fourth quarter. That kind of gives us a picture that the portfolio -- we've identified the risk in the portfolio and it's not continuing to migrate. So we're encouraged by that trend as well. Beyond office and senior living, we're not seeing significant or material weaknesses in other categories at this point, Brian.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Okay. All right, that makes sense with the slowdown. And then maybe, I don't know, just Chip, if you said this -- I joined the call a bit late, but the -- your outlook for all the hiring and the initiatives that you guys have put in place on the fee income side, can you frame up or just talk a little bit about your outlook on fee income this year? Or maybe just kind of the cadence of given what you've done, the groundwork you've laid, kind of how we think about the trajectory of fee income this year to kind of benefit from some of your actions?

Charles N. Reeves
CEO & Director

We feel that -- so I'd say on the noninterest income side, we feel really good in terms of a couple of areas there, primarily, I'd say, led by wealth management and we divide that business line into two different sectors: One, our investment services, which is really more of our brokerage area and then our assets under management within our wealth department.

Our wealth group is growing nicely, assets under management coming into that area increased by about 60% on a year-over-year basis and primarily centered in a couple of our metro markets. In that segment, it was up about 10% from a noninterest income standpoint for the year of '23.

We believe, and Len mentioned and notated that we just hired a new Head of Wealth Management as well that we believe will continue to maintain and hopefully accelerate some of that revenue drive. Also, very comfortable with the build that we've had in our government/SBA group, and we're expecting more volume there from a gain on sale in '24 as well as our customer hedging or swap program showed a nice trajectory increase in '23 and we believe that, that will continue in '24. So overall, we're feeling pretty good about that noninterest income line.

The other that we're investing a heck of a lot in, and Len and his team have done an outstanding job in building out our treasury management offering and department, both from a talent standpoint but also a product and then also a structural standpoint. And so we're looking for more there as well in '24.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

And if you kind of frame up kind of the -- if the run rate today is in the $9.5 million, $10 million level, if you kind of look a year out, can you kind of give some guidepost around where you think you could get that to? Given maybe it's going to happen as you say, kind of throughout the year and just kind of building

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it. But if you kind of look out a year, kind of where you exit '24 in terms of kind of run rate on fees as you move forward.

Charles N. Reeves
CEO & Director

Yes. No. Ultimately, I think we can move this, the high single digit to potentially double-digit levels as we exit 2024.

Operator

We have no further questions. I'll turn the call back to the management team for any closing remarks.

Charles N. Reeves
CEO & Director

Thank you for everyone joining the call here today. Thank you to our team members for all of their work in 2023, a year of transformation for this organization and we look forward to what 2024 and beyond brings to this institution. Thank you, everyone.

Operator
Thank you, everyone, for joining us today. This concludes our call, and you may now disconnect your lines.

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