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Earnings Call

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Call Participants

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Steven Ramsey

Thompson Research Group, LLC

Presentation

Operator

Good day, everyone, and welcome to the HNI Corporation Third Quarter Fiscal 2023 Results Conference Call. Today's call is being recorded. [Operator Instructions]. I will now turn the conference over to Matt McCall. Please go ahead.

Matthew Scott McCall

Vice President of Investor Relations & Corporate Development

Good morning. My name is Matt McCall. I'm Vice President, Investor Relations and Corporate Development for HNI Corporation. Thank you for joining us to discuss our third quarter fiscal 2023 results.

With me today are Jeff Lorenger, Chairman, President and CEO; and Marshall Bridges, Senior Vice President and CFO.

Copies of our financial news release and non-GAAP reconciliations are posted on our website. Statements made during this call that are not strictly historical facts are forward-looking statements, which are subject to known and unknown risks. Actual results could differ materially. The financial news release posted on our website includes additional factors that could affect actual results. The corporation assumes no obligation to update any forward-looking statements made during the call.

I'm now pleased to turn the call over to Jeff Lorenger. Jeff?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Thanks, Matt. Good morning. Thank you for joining us. During the third quarter, our profit transformation actions continued to accelerate reflecting the focus and dedication of our members. We delivered 31% year-over-year growth in non-GAAP earnings per share despite facing top line headwinds from ongoing macroeconomic pressures.

On the call today, I will highlight 3 key topics. First, we continue to deliver strong margin expansion in workplace furnishings. However, we are not finished and see more opportunity ahead. Second, the divestiture of Poppin will drive immediate financial benefits and the integration of Kimball International is progressing nicely. KII accretion exceeded our expectations in the quarter, and we expect the rate of accretion to increase over time. Third, we demonstrated the resiliency of our Residential Building Products business model in the face of housing market weakness.

Cost reduction actions enacted last quarter helped operating margin in the segment remain unchanged, compared to the same period of 2022. This was despite a year-over-year revenue decline of 22%. Following those highlights, Marshall will review our outlook. I will then conclude with some general closing comments before we open the call to your questions.

Moving to the first topic. We continue to deliver strong margin expansion in Workplace Furnishings. When excluding KII and Poppin, non-GAAP operating margin in the segment expanded 820 basis points year-over-year to 10.7% as our profit transformation plan continues to deliver results. This was the sixth straight quarter of year-over-year operating margin improvement. Both operating profit margin and operating profit dollars reached the highest level since the third quarter of 2019 despite lower industry volume. We made strong progress with our profit transformation initiatives. However, there is still work to be done, and we have line of sight to additional improvement opportunities.

As we have discussed on previous calls, our profit transformation plan in our legacy Workplace Furnishings business consists of 4 primary actions: First, we are driving increased productivity. Our focus on lean, cost reduction and better efficiencies continues to deliver improvement, and we expect our recent investments in Mexico to provide outsized benefits as they mature over the next couple of years. Second, we have streamlined our cost structure. Our last year's third quarter call, we announced a \$30 million corporate-

wide cost savings program. 12 months later, not only have we achieved that goal, we have added to it. Our cost savings run rate now totals approximately \$50 million across the corporation.

More specifically, in Workplace Furnishings, \$25 million of that total is contributing to our margin expansion in 2023. Third, we continue to simplify our business as we focus our efforts on the most attractive markets. Examples of portfolio simplification actions taken over the past year include exiting Poppin, divesting our China business and rationalizing our e-commerce offering, all of which are contributing to our improved margins.

And fourth, price-cost improvement continues to benefit our profitability. These actions and our recent results demonstrate our profit transformation plan does not require volume growth. However, despite a mixed near-term picture, we continue to see encouraging trends related to future workplace furnishings demand, particularly given our market position. We continue to see growth in the small to medium-sized customer segment, where we have an unmatched competitive position.

SMB orders grew 6% year-over-year in the third quarter and are up 9% year-to-date. In general, this segment has benefited from healthy dynamics. Small- and mid-sized firms have accounted for nearly 100% of net post-pandemic hiring. This segment has also benefited from population shifts to smaller secondary metros where office visits are nearly back to pre-pandemic levels. We believe this segment will continue to outperform.

Switching to contract. Recent demand has been down modestly. However, we are seeing encouraging signs for the future. Orders from contract customers were down 4% year-over-year in the third quarter and have declined 3% on a year-to-date basis. Those rates are consistent with lower return to office rates in the larger markets and lagging hiring activity by large companies.

Looking forward, we see dynamics which support an increase in furniture buying events. I'll remind you that furniture events are the primary driver of demand in our industry. Replacing office furniture is an episodic event, generally driven by an office move or need to refresh an environment for employee recruitment and retention.

Going forward, the predictive acceleration of lease expirations and the need for companies to adapt their spaces for hybrid work, support an increase in these events. Hybrid work has become the new normal. According to a recent Gallup survey, more than half of all remote-capable employees are now working in hybrid environments, with that number expected to move to 60% in coming quarters. And office lease rollover activity is expected to more than double next year and remain elevated through 2028. These factors taken together support an increase in furniture buying events.

Moving to my second topic. We completed the divestiture of Poppin and the integration of Kimball International is progressing nicely. Excluding Poppin, KII added approximately \$0.06 of non-GAAP EPS in the quarter. These results exceeded our expectations. Moreover, KII generated a strong operating margin of 10.6%, this was despite incurring \$5 million of incremental purchase accounting costs during the quarter. Our confidence in the strategic and financial benefits of the combination with Kimball International continues to build. KII better positions us to lead in the evolving workplace environment and provides new opportunities for profit growth.

And importantly, we continue to see the previous announced annual run rate synergy amount associated with the KII acquisition of \$25 million as a floor with a strong potential for upside. The sale of Poppin, which we completed in early September, provides immediate financial benefits, recall Poppin had an annual operating loss of nearly \$20 million prior to the sale. While KII's operating margin is already in double digits, cost synergies, elimination of Poppin losses and ongoing productivity efforts point to additional margin expansion opportunity in the months and years ahead.

My third topic is we demonstrated the resiliency of our Residential Building Products business model in the face of housing market weakness. Third quarter operating margin in the segment remained unchanged versus the prior year and was up sequentially. This was despite a year-over-year revenue decline of more than 20% as this segment continues to face volume pressure in line with the overall weakness in the broader housing market. We continue to see \$15 million to \$20 million of our targeted cost savings

benefiting Residential Building Products this year with another \$5 million to \$10 million of benefit next year. These cost reduction efforts along with normal seasonal patterns will result in further improvements to segment profitability in the fourth quarter of this year.

Importantly, demand trends in this segment continue to stabilize. Third quarter orders were 18% below year ago levels, which represents an improvement compared to rates seen in the first half when segment orders declined 29% year-over-year. Both new construction and remodel retrofit activity have shown similar sequential improvement. Additionally, the improvement has continued in the early part of the fourth quarter. Although mortgage rates and affordability continue to weigh on housing, single-family new construction has been a bright spot. Year-over-year growth in new single-family permits averaged 5% in the third quarter, which supports further new construction improvement in 2024. Despite the near-term headwinds, we are bullish on the intermediate to long-term dynamics for the segment.

The demand fundamentals remain strong. U.S. housing is undersupplied, demographic trends point to robust future construction growth, renovation activity will benefit from an aging housing stock, and there are indications that renovation activity will accelerate as existing homeowners are less likely to relocate given the current mortgage environment with many having attractive lower interest rates.

In addition to the strong long-term market fundamentals, we have unique growth opportunities. We continue to invest in our initiatives aimed at expanding the market, including in the areas of category awareness, new product innovation, online capabilities and the expansion of our wholly owned installing distributor footprint. The market's fundamentals, our unique growth opportunities and our category-leading positions point to the return of growth.

I will now turn the call over to Marshall to discuss our outlook. Marshall?

Marshall H. Bridges

Senior VP & CFO

Thanks, Jeff. Let's start with our expectations for demand in the fourth quarter. In Workplace Furnishings, we expect organic revenue to be approximately flat with fourth quarter 2022 levels. That outlook is consistent with recent order patterns, it excludes Kimball International, and it assumes continued SMB outperformance.

In Residential Building Products, we expect revenue declines to further moderate in the fourth quarter with revenue declining at year-over-year rates in the high single digits to low teens. That outlook assumes new construction will outperform our model retrofit.

Let's shift to the expected impact of Kimball International. For the fourth quarter, we expect KII to add \$140 million to \$150 million of revenue. We also project KII accretion will be consistent with third quarter results. An additional note on KII, earlier, Jeff mentioned \$5 million of incremental purchase accounting costs in the third quarter of that \$5 million, approximately \$3 million is associated with inventory step-up and should be considered onetime in nature. That points to an adjusted operating margin for KII of approximately 12.5% in the third quarter.

Fourth quarter non-GAAP EPS is expected to solidly increase year-over-year to be modestly below our just reported third quarter results, this is consistent with normal seasonal patterns. Recall we typically see lower sequential volumes and margins in workplace furnishings as we move from the third quarter to the fourth.

Shifting to the balance sheet. We ended the third quarter with total debt of \$509 million, which was down significantly from the \$598 million outstanding a quarter ago, our working capital dynamics continue to improve and return to historical levels that drove free cash flow per share of more than \$2 in the third quarter. In terms of leverage, our gross debt to EBITDA at the end of the quarter was 2.2x. Our reasonable leverage and strong cash generation will continue to provide flexibility for the dynamic environment and ongoing investment.

I'll now turn the call back over to Jeff.

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Thanks, Marshall. Our strategies are delivering results. Operating margin in Workplace Furnishings continues to expand, reaching 10% in the third quarter. Our profit transformation initiatives have momentum, and we expect continued year-over-year profit improvement in the segment. The integration of Kimball International is doing well. KII is already strengthening our business and delivering earnings accretion, which will only increase as our synergies mature. KII better positions us to lead in the evolving workplace environment and provides new opportunities for profit growth. And we are increasingly confident in the combination of strategic and financial benefits.

In Residential Building Products, we have adjusted the cost structure and demonstrated the resiliency of our margins. While continuing to invest in our growth strategies, leading brands and operating platforms. Although the near term remains dynamic, we are uniquely positioned to drive high-margin growth as housing recovers.

In summary, we remain committed to our core strategies of continuing to expand margins of Workplace Furnishings and drive long-term high-margin revenue growth in Residential Building Products. I want to thank all HNI members including our new members from KII. Our results reflect their collective effort and dedication.

We will now open the call to your questions.

Question and Answer

Operator

[Operator Instructions] We'll take our first question from Steven Ramsey with Thompson Research Group.

Steven Ramsey

Thompson Research Group, LLC

Maybe to look at SMB up again an outperforming contract, do you expect this to persist for a few more quarters even though contract is stabilizing? Is there anything in the pipeline that may show directionally how the 2 customers drive results in the next few quarters?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Yes, Steven, I mean, look, I think we continue to think SMB will outperform. As I laid out in the prepared remarks, I mean, we have a strong position there. That's part of it. The market is healthy. They've been hiring, returned to office. They're still -- even though they've returned, they're still looking at furniture events in those spaces. So our belief at this point is SMB will continue to outperform and contract will stabilize. That's -- I think that's a good way to think about it.

Steven Ramsey

Thompson Research Group, LLC

Okay. Helpful. And then on the population shift, it's clearly helping the Workplace segment as you've discussed for a few quarters now. Can you talk to how this is or could help the Resi-segment over time? Do you have the distribution in place where the population shift is occurring?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

That's a good question, Steven. We do -- we've added -- first of all, we have a strong independent network that is services those markets. And we've also added some wholly owned distributor footprint in some of those markets recently. And we continue to be active keeping an eye on all of that. So I do believe that the population shift will also benefit over time the resi-business.

Steven Ramsey

Thompson Research Group, LLC

Okay. Helpful. And then last one for me, again, on the resi-business. Curious the dynamic you're hearing on the ground for the R&R side of resi -- hearing from others that it's sluggish but steady out there and not continuing any kind of demand degradation on a sequential basis, but I'm curious if that's how you would describe spending on fire places?

Marshall H. Bridges

Senior VP & CFO

I think overall, Steven, we're seeing demand kind of declines moderate -- new construction is the relative bright spot there, specifically related to model retrofit, we're also seeing declines moderate, but not nearly as much as they are in new construction. We still have a pretty low existing home turnover, which drives your modeling events. And of course, consumer sentiment is not helping there. But certainly, the trend is improving, although still down year-over-year.

Operator

We'll take our next question from Reuben Garner with Benchmark Company.

Reuben Garner

The Benchmark Company, LLC, Research Division

Congrats on the strong quarter, guys. So maybe on the workplace margins to start. Jeff, I think you said, I think the words were, there's room to run or more to go there. Can you talk about -- I see the savings or heard the savings come in better than anticipated that \$50 million, was that a recognized to date number or run rate? And when you say there's more to go, I mean, is this 10-plus percent kind of legacy number sustainable without volume acceleration because of your initiatives? Or was there anything kind of mix driven or onetime in this quarter that kind of boosted it?

Marshall H. Bridges

Senior VP & CFO

Yes, Reuben. So several questions in there. The first one is that the \$50 million that Jeff mentioned is our cost savings program. That was really enacted starting early this year, and we had another tranche kind of mid-year. \$40 million to \$45 million of that will hit 2023 with another \$5 million to \$10 million rolling over into '24. The part that rolls over in the '24 is mostly associated with the Residential Building Products segment. As it relates to Workplace Furnishings, it's got about \$25 million of that total \$50 million that hits that segment, all of which hits this year.

In terms of where the margins can go, we see continued opportunity. The reason we were up so much year-over-year in the third quarter is really 3 things; at favorable price cost, we have better productivity and we have better SG&A efficiency. And we see opportunity in all 3 of those to continue, maybe not all the same rates. And on top of that, we have this investment in Mexico to be making that will begin to mature and help out subsequent years.

Reuben Garner

The Benchmark Company, LLC, Research Division

And then on the residential side, you mentioned existing home sales. Just curious how much fireplace activity, retrofit activity is tied to inspection? Is that a big part of what can drive demand. And if we do see a rebound in-home sales when rates drop, that can kind of get the R&R segment turned around?

Marshall H. Bridges

Senior VP & CFO

I'm not sure we have precise data on inspections, but we do know that remodeling events are pretty highly correlated with the purchase of a new home, usually remodeling events occur in a year or 2 after the purchase. And given that new homes are not selling as much, existing homes are not selling as much, we're definitely seeing some softness in that segment. But if it did -- if we do see existing homes tick up, we would see remodeling tick up eventually.

Reuben Garner

The Benchmark Company, LLC, Research Division

And last one for me, a nice snapback in margins in the residential business. I think if I'm looking at it correctly comparable to a year ago on a much lower base, is there any positive price cost in there as well? Or is all of that from the initiatives you put in place earlier in the year?

Marshall H. Bridges

Senior VP & CFO

Yes, we were flat at 17.7% operating margin in Residential Building Products in the third quarter. And yes, there's multiple factors there, kind of the same 3 factors I mentioned. We did have favorable price cost there. We also had better productivity as well as some better SG&A efficiency.

Operator

We'll take our next question from Greg Burns with Sidoti & Company.

Gregory John Burns

Sidoti & Company, LLC

The outlook for flattish workplace growth. I think last quarter, you were talking about low single-digit growth in the second half. So a little bit of a reduction there. Can you just talk about what changes you're seeing in the demand environment there to lower your outlook?

Marshall H. Bridges

Senior VP & CFO

Greg, I'm not sure I'd characterize it as a major change. We did talk about low single digits. I think the organic revenue and workplace, excluding KII and Poppin was 1.7% in the third quarter, so right in that range. And then flattish maybe puts us at the low end of low single digits for the back half, but I wouldn't call it a major change.

Gregory John Burns

Sidoti & Company, LLC

And I know Kimball had a good-sized health care business. Can you just talk about maybe some of those adjacent markets like health care, education, where maybe you could drive incremental growth at the core office segment isn't recovering to the pre-COVID levels? Like what initiatives do you have in place? And I guess, specifically, how was Kimball's healthcare business this quarter?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Yes, Greg, good question. I think we -- the activity is pretty -- been pretty solid throughout the year and it's starting to build in the healthcare segment and KII had quite a bit of product pipe in that piece of the business that will be coming online in '24 as well. So we like that position, and we do believe that's an opportunity for growth, overall. Education, they've been strong in education, similar to our Legacy business. Both have had pretty solid years to date. We see the education vertical as an opportunity for growth going forward as well.

And then I would mention they have a hospitality business that's competing well at this point, and we see some good second half growth in their hospitality business, kind of pent-up demand to catch up from kind of the post-COVID remodel activity, refresh rates for hotels. So all 3 of those, healthcare, education, hospitality, we can rotate into and lean into notwithstanding core commercial.

Operator

We'll take our next question from Budd Bugatch with Water Tower Research.

Beryl Bugatch

Water Tower Research LLC

Congratulations, on a very good quarter, to your team and to your members, really impressive. Marshall, I would love to get -- maybe if you could walk on the workplace, the Legacy Workplace even just on a GAAP basis from a \$5.6 million operating profit in last year to \$39.6 million this year. And I can't remember if the \$5.6 million included much of Lamex a drawdown of that. I thought that might have been included all balled into the gain number. So maybe you could give us some more color on that -- on a walk from that -- those margins because that's pretty impressive.

Marshall H. Bridges

Senior VP & CFO

But there is a bit of Lamex in the GAAP numbers in the prior year, both sales and profit as well as the gain. If you look at the non-GAAP, it's probably a little cleaner the segment, excluding KII and Poppins, up \$31 million in operating profit year-over-year. And there's really 2 big items there. You got price-cost favorable about \$21 million and net productivity was up about \$11 million. And so there's some rounding there. But that -- those 2 things really drove that \$31 million profit improvement in the segment.

Beryl Bugatch

Water Tower Research LLC

So the 11 continues? Or is that -- that continues and then anniversaries and the ['21]? How do we think about that going forward? How do we think about that kind of 2:1 kind of ratio?

Marshall H. Bridges

Senior VP & CFO

Well, the productivity is going to continue. We certainly see benefits from our ongoing lean initiatives as well as the Mexico investment as we look out. Price-cost, this is -- we're anniversarying some lower price periods and we got pretty stable commodities. So I don't think that's going to continue at the same rate. But it's not going away immediately.

Beryl Bugatch

Water Tower Research LLC

And commodities are they stable? Or are they starting to -- or have they fallen -- and are we having to do any -- are we worrying anything about pricing having to be retraced?

Marshall H. Bridges

Senior VP & CFO

For the year, commodities are pretty stable. We had some inflation when you include everything early in the year, and we had a little bit of deflation here recently. As we look to the fourth quarter, we're starting to see a little bit of pressure from diesel and some other commodities. But in general, input costs are pretty stable.

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

And we think pricing, but we'll kind of hold in there where it's at today, where that's kind of what we're seeing in the marketplace.

Beryl Bugatch

Water Tower Research LLC

And we typically do a once-a-year price increase. Do we not usually have that adjustment? Is that usually a beginning of the year kind of thing? And I know in this environment, nothing is usual, but trying to -- I'm showing the -- I'm showing my age.

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

But yes, it's typically kind of in the first quarter. It moves around a bit depending on the cycle, but it's typically in the first quarter.

Beryl Bugatch

Water Tower Research LLC

Okay. And this has been part of your strategy, Jeff, of getting the Workplace Furnishings margins back to this kind of level. So the other side is RBP and having that grow, keeping the kind of great profitability you have there, are there any new programs that you are anticipating to try to maybe sparked a little bit more of the RBP stuff? Or is it the environment just too tough.

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

No, look, we're continuing to invest in that. You hit it right on the head, Budd. We're -- this has been our goal is to reset margins and have a line of sight for more, and that's what we start -- we've been talking about that for a couple of years, and that will continue. RBP -- look, we like our operating model. We're going to continue to invest in that business because it's only a matter of time. And the fact that we've been able to kind of hold our margin profile in that business, notwithstanding the volume decline, we like

where that can go. I'd say, right, the third piece of this, though, is the integration of KII. That's where we're working hard there.

I commented on their business in healthcare and hospitality and also integration in synergies. So that's -- that would -- I would say the 2 items we've been talking about continue. We're continuing to lean in the workplace margins and RBP growth investments and then bring KII on and kind of mine that those -- that profit and that model, it's got strength, but there's more to do.

Beryl Bugatch

Water Tower Research LLC

That's -- you got right to my third area of questioning, was on Kimball. What kind of [RCII] or RCI programs do you see going for that. They have a number of -- had a number of divisions that might not have been performing up to snuff. Anything that you feel comfortable talking about at this point in time?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Yes, Budd, really, all I would say is we had -- we got -- we dispossessed the Poppin thing. That was kind of job one as we got in there. And now we're getting our arms around the synergies and the team, and they're doing great. And there'll be more -- we'll probably have more details on that going forward. But right now, I'd say 50,000 feet, it's going great. I love the team and what they bring to the table, and we're continuing to invest in that business as well.

Marshall H. Bridges

Senior VP & CFO

Budd, I would just add to that. And look, healthy margins in that business right now is very strong. We do see synergies moving forward. In the run rates we see right now in their profitability is about \$10 million of annual improvement related to duplicative corporate costs. So that's \$10 million of the \$25 million of synergies that we expect as a floor. And so the other \$15 million, we see coming over the next couple of years and feel real clear line of sight to that. And as Jeff mentioned it, is strong potential for more that we'll communicate as we get further into it.

Beryl Bugatch

Water Tower Research LLC

And how does that feather in? I mean how much have we seen so far? And how much -- how much feathers in over the next couple of quarters -- quarterly rate?

Marshall H. Bridges

Senior VP & CFO

Yes, we're averaging about \$2.5 million a quarter right now. So we've got about a \$10 million run rate as we sit right now. Probably add \$5 million to \$8 million next year, and then we get the full incremental \$15 million in 2025 for a \$25 million run rate. When you take that \$25 million plus the \$20 million benefit from exiting Poppin plus the strong profitability that KII had before the acquisition. Again, we're looking at EV to EBITDA multiple on the acquisition of near [\$5 million]. It really speaks to the value creation opportunity that we have.

Beryl Bugatch

Water Tower Research LLC

And last for me is corporate overhead looks -- is this the current run rate of \$20-some million? Or how do we think about that on a quarterly basis? And how much of that was variable comp.

Marshall H. Bridges

Senior VP & CFO

Corp -- if you look at the fourth quarter, we do think it's going to be up \$6 million or \$7 million being that \$21 million to \$22 million range, not just up a little bit from the third quarter. And yes, the big drivers of

the year-over-year increase are variable comp. It was pretty low last year and it's rebounded this year. And we got some variation in insurance programs that also contribute to that variation.

Beryl Bugatch

Water Tower Research LLC

Congratulations again on a really impressive performance in the third quarter.

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Thanks, Budd.

Operator

There are no further questions at this time. I'd like to turn the call back over to Jeff Lorenger for any additional or closing remarks.

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Great. Thanks, everybody, for joining us today. Again, once again, thanks to all HNI members. Have a great day.

Operator

And that concludes today's presentation. Thank you for your participation, and you may now disconnect.

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