

22-Jul-2016

# HNI Corp. (HNI)

Q2 2016 Earnings Call

## CORPORATE PARTICIPANTS

Jack D. Herring  
*Investor Relations Manager*

Kurt Tjaden  
*Senior Vice President and Chief Financial Officer*

Stanley A. Askren  
*Chairman, President & Chief Executive Officer*

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## OTHER PARTICIPANTS

Matthew Scott McCall  
*BB&T Capital Markets*

Bobby Griffin  
*Raymond James & Associates, Inc.*

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good morning. My name is Christian, and I'll be your conference operator today. At this time, I'd like to welcome everyone to the HNI Corporation Second Quarter 2016 Fiscal Results Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] As a reminder, today's conference call is being recorded. Thank you.

Mr. Herring, you may begin your conference.

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Jack D. Herring  
*Investor Relations Manager*

Thank you. Good morning. I am Jack Herring, Manager of Investor Relations. Thank you for joining us to discuss our second quarter fiscal 2016 results. Here with me are Stan Askren, Chairman, President and CEO; and Kurt Tjaden, Senior Vice President and CFO. Copies of our financial news release, earnings presentation 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 risk. Actual results could differ materially. The earnings presentation posted on our website include additional factors that could affect actual results. The corporation assumes no obligation to update any forward looking statements made during the call.

I am pleased to turn the call over to Mr. Stan Askren.

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Stanley A. Askren  
*Chairman, President & Chief Executive Officer*

Good morning, everyone. We'll share our assessment of the second quarter 2016, provide some thoughts on our outlook for third quarter and full-year 2016 and then open it up for questions.

I'm very pleased with our year-to-date profit performance. We delivered a 34% increase in non-GAAP earnings per share on 5% lower sales. Gross profit has improved significantly driven by strong operational and material productivity. We are clearly realizing the significant financial returns for our investments, including our business system transformation initiative.

Our businesses are strong and we expect to deliver record non-GAAP earnings per share in 2016 while still continuing to aggressively invest and position our businesses for continued long-term profitable growth. We're on track with our goal to double our earnings every three years to five years and are feeling great about that. So for the second quarter, non-GAAP earnings per share increased 28% on 6% lower sales. Sales results for the quarter were as we expected.

Office furniture sales were down 5%, down 7% on an organic basis. Sales in the supplies-driven channel were up 1%, or down 2% on an organic basis. Sales in our other office furniture businesses which include North American contract and international, were down 11%. Our North American contract business was down 9%.

Our hearth sale decreased 8%. Strong continued growth in the new channel – the new construction channel [ph] continued (3:00) with sales increasing 8%. Sales in our hearth retail channel were down 23%. During the quarter, dealers with our Majestic, Monessen and Vermont Castings brands adjusted their buying patterns and inventory levels. As a result sales of our retail non-pellet products were down 18%. So let me explain a little bit.

Our industry-leading operational capabilities provides a more efficient delivery model with better cash flow for our dealers. These dealers are reducing their inventory levels and realigning the timing of their seasonal orders to the back half of the year. Our retail pellet products, which represent 4% of our hearth sales in the second quarter, were down 52% due to the impact of warm weather and lower energy costs. So, overall, I'm very pleased with our strong performance in the second quarter and first half of the year.

I'll turn it over to Kurt Tjaden.

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## Kurt Tjaden

*Senior Vice President and Chief Financial Officer*

Thank you, Stan. Additional financial highlights for the second quarter include non-GAAP consolidated gross margin of 39.9%, was an improvement of 340 basis points versus the prior year. These results were driven by strong operational and material productivity and price realization which was partially offset by lower volume.

Non-GAAP selling and administrative expenses were down versus the prior year due to cost reductions at both the operating segments and corporate, partially offset by the impact of incentive based compensation and acquisitions.

As we look to the third quarter of 2016, we anticipate consolidated sales to be up 3% to flat. On an organic basis consolidated sales are forecasted to up 1% to down 2%. Office furniture sales are expected to be up 4% to flat and organic office furniture sales will be up 2% to down 2%. Supplies-driven office furniture sales are projected to be up 6% to 9% or up 3% to 6% organically. Sales in our remaining office furniture businesses are forecasted to be down 3% to 6% and sales in our North American contract business are expected to be flat to down 3%.

Hearth sales are expected to be up 3% to down 1%. New construction channel sales are forecasted to be up 6% to 9% and sales in our remaining hearth businesses are expected to be down 3% to 6%. Within those remaining

hearth businesses we are projecting retail non-pellet sales to be up 3% to flat and retail pellet sales to be down 16% to 19%.

Non-GAAP gross profit margin is expected to be approximately the same as the second quarter of this year when it was 39.9%. Non-GAAP SG&A is expected to be approximately 20.5%. So our estimate of non-GAAP earnings per diluted share for the third quarter is now in the range of \$0.90 to \$0.95 a share.

So for the full year 2016, our current best estimate of non-GAAP earnings per diluted share is now in the range of \$2.80 to \$2.95 a share. We expect consolidated sales to be down 1% to 3%, in line with our prior guidance. We are forecasting office furniture sales to be down 1% to 4% and sales in our hearth business for the year, expected to be flat to down 3%.

Stan?

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**Stanley A. Askren**

*Chairman, President & Chief Executive Officer*

All right. Well, thank you, Kurt. I'll wrap up here. Our businesses are strong and well-positioned for the future. Our brands are competing well in their respective markets. We continue to identify investment opportunities that will deliver strong financial returns in the future. I'm confident in our ability to drive long-term shareholder value.

So with those comments complete from Kurt and myself, we'll now open it up to questions.

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## QUESTION AND ANSWER SECTION

**Operator:** [Operator Instructions] And our first question is from Matt McCall with BB&T Capital Markets. Your line is open.

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**Matthew Scott McCall**

*BB&T Capital Markets*

Q

Thanks. Good morning everybody. So let's – maybe start with the guidance for next – or for this year and really, talk about it relative to what you talked about in mid-June, just before NEOCON. What did you see the change there? I know there're some changes to interest expense. What debt load did you assume in the previous guidance? And I'm really getting at, did anything really change on the top line or from a margin perspective, or was it mostly just the benefits of the lower interest expense that caused you to take the guidance higher from June?

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**Stanley A. Askren**

*Chairman, President & Chief Executive Officer*

A

Well, first off, Matt, as Kurt indicated to you, our guidance for the remainder of the year on top line is consistent with prior guidance. So we're seeing the overall market kind of behaving as it did the last time we addressed this or spoke about it. There's no real change there. The upgrade in the guidance is just continued strong execution, operational performance. And we're believing that's going to continue as we go forward. I'll let Kurt address the interest.

Kurt Tjaden

*Senior Vice President and Chief Financial Officer*

A

Yeah, I don't think the interest changed, Matt, in our outlook. We refinanced our credit agreement in April and took out some private placement debt with a revolver that does lower financing, but I would say that was all incorporated in our full year – our quarter and full year guidance. So to Stan's point, it's really driven by that strong operational performance which we've seen through the first half of the year and continuing through the back half.

Matthew Scott McCall

*BB&T Capital Markets*

Q

Okay. All right. So when I think about the contribution margin, just the core contribution margin of the two segments, how should I think about [ph] them (9:09)? I'm really think about as I move out into next year, I don't want to ask about the top line, but if I think about the operating contribution margin for each of the segments and then layer in the savings from the initiatives that you've quantified, can you just talk about how we should – and maybe a refresher on the timing of some of the savings might help as well. But operating contribution margin by segment, how to look at it and then how to layer in that savings and the timing of that savings?

Kurt Tjaden

*Senior Vice President and Chief Financial Officer*

A

Yeah, I wouldn't think about it too differently than we've talked in the past, Matt. I would think of office furniture 25 percentage points or so that can be plus or minus a few. In hearth, we've set...

Stanley A. Askren

*Chairman, President & Chief Executive Officer*

A

Of leverage.

Kurt Tjaden

*Senior Vice President and Chief Financial Officer*

A

...of leverage and hearth operational leverage in the 30% to 35% [indiscernible] (9:52) on kind of a normalized basis. So, Matt, you're exactly right, the add is those structural cost takeouts on top of it. And I think what we've said last quarter – a couple of quarters before, remains similar to today. Our outlook, we said we'd start to see a modest amount of benefit here in the back half, really the fourth quarter, of 2016 and kind of 50% to 60% in 2017 of that \$35 million to \$40 million that we had laid out in run rate by 2018. So I think it's pretty consistent with what we've talked in the past but if you're thinking about how you layer that up, you're on the right track.

Matthew Scott McCall

*BB&T Capital Markets*

Q

And that 50% to 60%, will it be front half loaded, back half loaded, pretty evenly weighted?

Kurt Tjaden

*Senior Vice President and Chief Financial Officer*

A

I probably skew it more as it builds through the year, as you think about it. So that would be my direction.

Matthew Scott McCall

*BB&T Capital Markets*

Q

Okay. So a question on the hearth business. That was good color on what's going on at retail. The retail pellet business still down, I'm trying to make sure – I think it was the retail non-pellet business you said was facing some inventory adjustments. Is there, I guess the continued weakness overall in hearth, I know there are a lot of things working against you, the inventory now layered in. But when do you anticipate there could be some growth just looking not even changes in the market but more about changes in the comp situation and getting some of these one-time items out of the way.

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**Stanley A. Askren**

*Chairman, President & Chief Executive Officer*

A

Next year. So experiencing strong growth in new construction channel, [ph] like in (11:42) in that a whole lot. Interesting sort of dynamics around this supply chain, destocking, whatever term you might want to use of the acquired Vermont Castings dealers, which includes Monessen, Majestic and Vermont Castings brands. So we have, one of our strengths in the hearth business is really an outstanding ability to deliver products through a manufacturing capability and a distribution capability closer to time of order. So that allows the dealers to not – they don't have to take early buy inventory and hope and pray it sells through as they're able to take it as they order it and that creates tremendous opportunities for improved cash flow for the dealers and we become sticker with them as well. So that's all good. And then – so that's going to work us through. That should work us through between now and the middle of next year, I would say.

And then the other is this pellet decline. So it's a dramatic decline. It ran up dramatically, the previous 24 months and now it's running down dramatically. And I would say we're getting down towards the bottom of where I think that's going to settle out. That's probably another through this burn season, so the middle of next year it should start to annualize there. And it's becoming a smaller and smaller portion of our business, so it has less and less of an impact.

So to your question, again, is I would say the middle of next year, Matt, is when we should start to see all this stuff kind of reach an equilibrium and we'll feel the full benefit of the new construction growth and less of the downdraft from sort of supply chain, inventory positions and the negative draft from pellet decline.

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**Matthew Scott McCall**

*BB&T Capital Markets*

Q

Okay, perfect. And then my final question. Similarly on the contract side, you talked about flat to down 3%. We heard some decent commentary at NEOCON about the project environment and maybe some strength in the back half of this year into the early parts of next year. Are you seeing anything that's consistent with that that would leads you to believe that that growth could return for that part of your business?

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**Stanley A. Askren**

*Chairman, President & Chief Executive Officer*

A

Well, Kurt provided some guidance on this. So really we're seeing – and it's – our view hasn't changed on this. It's going to continue at the current run rates, the comps become easier and we like a lot of what's going on with our business there but I don't think, Matt, we're calling anything additional up or recall anything additional down since we spoke with you last.

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**Kurt Tjaden**

*Senior Vice President and Chief Financial Officer*

A

Yeah, Matt, just as you think about that guidance for the year, that would imply back half on our North American office furniture businesses would be flat to up very modestly. And that's in line, as Stan said, with what we've talked about before.

Matthew Scott McCall

*BB&T Capital Markets*

Q

Okay. Got it. Thank you guys.

**Operator:** The next question is from Kathryn Thompson with Thompson Research. Your line is open.

Q

Hey, good morning. It's [ph] Chris (15:09) calling in for Kathryn today. Just a couple of questions. One, I was hoping you could shed some light on any differentiation in demand trends for supplies versus your contract office business?

Stanley A. Askren

*Chairman, President & Chief Executive Officer*

A

Say more please. I'm not sure I understand the question.

Q

Well, are you [ph] saying (15:26) different products being sold to the supplies segment of your business versus your contract segment of your business, or is it the same type products or are you seeing a differentiation between the two?

Stanley A. Askren

*Chairman, President & Chief Executive Officer*

A

Nothing that we would call out.

Q

Okay. And then I know you spoke about expenses earlier. I think first half corporate expenses were lowered by about 18%. Is this something that we should expect to continue in the second half and how much of the cost reductions are the result of fixed versus variable expenses?

Kurt Tjaden

*Senior Vice President and Chief Financial Officer*

A

So I will take your corporate question first. I would expect, from a full year basis, corporate expenses to be up slightly, we've got some issues on timing. We had some big cost reductions in the back half of last year that will anniversary, some strategic investments; some of the things with our self insurance programs around medical and other insurance programs that move between the quarters. And then finally, you think about incentive-based comp that rose through their, predominantly around profit sharing for our members as our business profitability improves. So we'd expect to see full year core non-allocated corporate to be up very modestly versus prior year. And your second question was a broader variable, fixed...?

Q

Well, just if you separate – when you look at the reductions you've had, is it more fixed cost related or is it more variable cost related?

Stanley A. Askren

*Chairman, President & Chief Executive Officer*

A

Everything in our business is variable. We [indiscernible] (17:02). So we don't really separate that out in our thinking. We take cost out and we expect cost to come out and it stays out when it comes out.

Kurt Tjaden

*Senior Vice President and Chief Financial Officer*

A

And I'd add, I'll take a slightly different twist on it. If you think about structural cost, a bit to Matt's earlier question, what we've yet to see the real benefit of, [ph] as (17:26) important is the structural – the big structural cost takeouts, we talked about at the beginning of this year, just starting to come in to play in the back half of the year. So there remains significant opportunity as we look out from now through the next three years to further reduce our structural cost. And we called out, back in February, again \$35 million to \$40 million on a run rate basis.

Stanley A. Askren

*Chairman, President & Chief Executive Officer*

A

And we feel good about that opportunity in front of us. That – we haven't backed off that at all. So as Kurt said, that's still yet to be executed and still yet to be accounted for as we go forward.

Q

Okay. Very helpful. Thanks for taking my questions.

**Operator:** The next question is from Budd Bugatch with Raymond James. Your line is open.

Bobby Griffin

*Raymond James & Associates, Inc.*

Q

Hi Guys. This is Bobby filling in for Budd. Congrats on another strong operational quarter. Most of my questions have already been answered, but I was just curious, Kurt, can you maybe talk to us a little bit about what you're seeing from raw materials and maybe what the outlook is for the remainder of the year?

Kurt Tjaden

*Senior Vice President and Chief Financial Officer*

A

Yeah. So...

Stanley A. Askren

*Chairman, President & Chief Executive Officer*

A

You want me to take a round on that?

Kurt Tjaden

*Senior Vice President and Chief Financial Officer*

A

So clearly first half of the year there was some modest deflation. And as we look at, in the second half of the year, we'll start to see that flat kind of be flat. So we won't see the same benefit. But remember, Bobby, we buy particularly steel and many of our materials on an index basis, so we tend to lag. So it's more of a 2017 and really as you start to get past the second quarter before we start to see any significant impact from a material cost increase.

Bobby Griffin

*Raymond James & Associates, Inc.*

Q

Okay. And then is there any announced – there's no announced plans now of a price increase, but a price increase could be on the table in the typical fashion. It usually is as you guys approach it in 2017, if steel does reflate or continues to reflate, I guess, is the better way to say it?

Stanley A. Askren

*Chairman, President & Chief Executive Officer*

A

Yeah, that's – I think you summarized it well, Bobby.

Bobby Griffin

*Raymond James & Associates, Inc.*

Q

Okay. And then – that's pretty much it. So I appreciate you guys answering my questions and best of luck moving forward.

Stanley A. Askren

*Chairman, President & Chief Executive Officer*

A

Thanks, Bobby.

**Operator:** I'm showing no further questions at this time. We'll turn the call back to the presenters.

Stanley A. Askren

*Chairman, President & Chief Executive Officer*

Well, thank you so much for tuning in. We appreciate your interest in HNI and we look forward to speaking with you more in the future. Have a great day.

**Operator:** Ladies and gentlemen, this concludes today's conference call. You may now disconnect.

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