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# HNI Corp. (HNI)

Q3 2021 Earnings Call

## CORPORATE PARTICIPANTS

**Matthew McCall**

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**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

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*Senior Vice President & Chief Financial Officer, HNI Corp.*

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## OTHER PARTICIPANTS

**Gregory J. Burns**

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**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

**Steven Ramsey**

*Analyst, Thompson Research Group LLC*

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good day and thank you for standing by. Welcome to the HNI Corporation Third Quarter Fiscal 2021 Results Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Matt McCall, Vice President, Investor Relations and Corporate Development. Please go ahead.

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**Matthew McCall**

*Vice President-Investor Relations & Corporate Development, HNI Corp.*

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 2021 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, 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 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?

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**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

Thanks, Matt. Good morning and thank you for joining us. In the third quarter, our members stayed focused on servicing our customers while we continue to experience ripple effects from the pandemic, which are creating constraints in the near-term. While we drove strong order growth, ongoing difficulties tied to labor availability, supply chain disruptions, and inflation across all input cost categories negatively impacted our results. Despite these pressures, we are increasingly encouraged about 2022 given the actions we are taking, the ongoing recovery in Workplace Furnishings, and strength in Residential Building Products.

Our two differentiated business segments are well-positioned to benefit from multiple secular trends and numerous HNI-specific growth initiatives. We have a track record of effectively deploying capital, driving annual productivity and cost savings, and managing through macro and operational challenges.

On today's call, I will cover three key points. First, we are addressing the constraints negatively impacting our second half results. Second, our Residential Building Products segment continues to deliver strong revenue and profit growth. And third, demand in Workplace Furnishings continues to improve. I will cover these three key points, Marshall will then go through our fourth quarter outlook, I will conclude with some general comments and, finally, we will open up the call to your questions.

I will now cover our first key point, what we are doing to address the near-term macro dynamics impacting our business. As we discussed in our business update on September 23, we continue to generate strong order growth across our businesses. Workplace Furnishings orders in the third quarter increased 31% versus the prior-year period, and were 5% above third quarter 2019 pre-pandemic levels. Residential Building Products orders in the third quarter were 35% higher year-over-year. We have market momentum and are capturing demand.

However, our third quarter profit was below prior-year levels and was well below our potential due to three constraints, all of which we are addressing. The first constraint is labor availability. There are simply fewer people in the labor pool than there were before the pandemic. This has prevented us from increasing production as fast as we would like. Our current production staffing is 11% or approximately 340 members lower than what we would like to have given the strong demand we are generating. Along with the reduced labor pool, we have experienced increased impacts from COVID as the Delta variant ramped up in the third quarter. This has temporarily amplified the staffing shortage at our facilities and with our suppliers.

To combat this issue, we are taking several steps. First, we're making our operations more efficient. Much of this is being driven by our lean manufacturing expertise. For instance, at one of our larger facilities, we're altering the layout and flow, which will allow us to improve output at that location by 17% with the same head count. We are also pursuing productivity gains related to automation.

Second, our new facility in Mexico will provide an additional source of labor to help meet growing demand. We expect that location to employ 250 members once it is fully ramped up next year.

Third, we continue to aggressively hire, move production to facilities where labor is more readily available, and assess new labor pools with part-time and seasonal programs. These efforts are getting traction, and we have seen staffing levels improve over the last 45 days.

That brings us to our second constraint, supply chain capacity. Like many, we are experiencing disruptions, largely tied to staffing shortages at suppliers, port congestion and material availability. These items limited our ability to keep up with demand and also made our members less productive. To strengthen our supply chains, we have started to diversify the supply base, create inventory buffers and increase our monitoring and coordination

efforts with key suppliers. We will continue to focus on these efforts as we expect supply chains to remain stressed for the foreseeable future.

The third dynamic is rampant inflation across all input cost categories. Input costs increased \$44 million in the third quarter compared to the prior year, which is by far the most inflation we have ever seen in a quarter.

All of our input cost categories experienced increases led by steel and ocean freight. We have responded with aggressive pricing actions, the cumulative benefit of which will allow us to fully offset these cost pressures. Accordingly, our price-cost headwind is temporary. We expected to narrow in the fourth quarter and turn positive early next year. We are taking a more agile and aggressive approach with pricing moving forward. We are prepared to manage in an ongoing inflationary environment and have the market power to get ahead and stay ahead of these headwinds.

My second key point is, Residential Building Products delivered strong results despite increasingly difficult comps and multiple sources of pressure. Revenue in our Residential Building Products segment increased 25% year-over-year in the third quarter on an organic basis. As I mentioned earlier, segment orders increased 35% year-over-year. Growth in the remodel/retrofit channel slightly outpaced the new construction channel, despite increasingly difficult comps in R&R.

Our Building Products segment was impacted by the three factors I discussed earlier, and as a result, lead times have extended and price-cost continued to be negative. However, our members worked hard to maintain production output and service levels, and the business generated more than 10% year-over-year operating profit and an EBIT margin of more than 17%.

As we look forward, we remain optimistic about the prospects for both remodel/retrofit and new construction. As we have stated previously, our Residential Building Products business is supported by favorable trends and unique opportunities. Long-term demographic trends and a housing supply-demand imbalance will continue to support a prolonged housing cycle and elevated remodeling activity. Nesting and de-urbanization trends also provide secular support. And, we have an outstanding opportunity to organically grow the category in both new construction and remodel/retrofit.

In addition, we have opportunities to enhance our strategic position through acquisitions. As an example, earlier this month, we acquired Trinity Hearth and Home, a large installing distributor headquartered in the Dallas metro area. Trinity generates approximately \$40 million of annual revenue and employs approximately 100 members. Trinity will act as a hub to better serve the rapidly growing Southwest region, and it further strengthens our unique, vertically integrated business model and regional distribution infrastructure. Following this acquisition, we now own 26 Fireside Hearth & Home locations. We're excited to have Trinity join the HNI family.

Our third key point, demand in Workplace Furnishings continues to recover with year-over-year order growth up at least 25% in each month of the quarter. In total, Workplace Furnishings orders increased 31% during the third quarter on a year-over-year basis, and we are seeing growth across all major channels. Although demand was strong, the three constraints discussed earlier drove a year-over-year profit decline. As I previously noted, we are addressing these constraints. And as we look into 2022, we expect a return to driving profitable growth.

We are increasing our capacity, strengthening our supply chains and taking aggressive pricing actions to offset the ongoing and increasing inflationary pressures. We also expect strong revenue growth in 2022, supported by our elevated backlog and the ongoing recovery.

Our Workplace Furnishings businesses have unmatched price point breadth, channel access and market reach, and we're investing in multiple strategic initiatives aimed at driving continued outperformance. We have unique exposure to fast-growing segments of the market including education, home office, and with small- to mid-sized customers. Our investments, along with our existing competitive differentiators, position us well to benefit from office re-entry, work-from-home, and de-urbanization trends.

I will now turn the call over to Marshall to provide some detail around our fourth quarter outlook. Marshall?

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## Marshall H. Bridges

*Senior Vice President & Chief Financial Officer, HNI Corp.*

Okay. Let's start with our outlook for our fourth quarter revenue growth. We expect consolidated fourth quarter revenue to grow in the mid- to high-single digit percent range compared to the prior-year quarter, including the impact of acquisitions. Labor and supply chain issues are expected to limit our output in both segments again in the fourth quarter.

In Workplace Furnishings, we expect growth in the mid-single-digit percent range on a year-over-year basis, including acquisition impacts. In Residential Building Products, we expect year-over-year growth rates in the high-single-digit percent range, including acquisitions.

Next, let's cover fourth quarter profitability. We expect the margin pressures we faced in the third quarter to continue in the fourth quarter. As a result, we expect operating profit and earnings per share to be at or below what we just reported in the third quarter. As Jeff mentioned earlier, as we look to 2022, we are increasingly optimistic the combination of our order trends, backlog levels, increased capacity, and strengthened supply chains point to revenue strength, particularly for Workplace Furnishings in the seasonally lower first half.

From a profitability perspective, we are addressing price-cost. In 2021, we estimate price-cost will be approximately a \$60 million headwind. Next year, we expect to have positive price-cost and recover much of 2021's deficit. As a result, we expect profitability, margins, and earnings to recover in 2022.

Finally, some comments on our cash flow and balance sheet expectations. Quarter ending debt levels were approximately \$178 million. That was modestly lower than last quarter and up slightly from the third quarter of last year. The gross leverage ratio at the end of the third quarter was approximately 0.9, unchanged from last quarter. And our projected cash flow will provide ample capacity for continued growth investment, dividend payments, and opportunistic M&A and buyback activity.

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

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## Jeffrey D. Lorenger

*Chairman, President & Chief Executive Officer, HNI Corp.*

Thanks, Marshall. Let me wrap up by stating that as we look forward, we remain optimistic about our businesses and our ability to drive profit growth. Our members continue to effectively manage through the post-pandemic environment, allowing us to maintain our revenue momentum. Our focus in our Workplace Furnishings is on expanding margins. Our focus in Residential Building Products is on driving above-market revenue growth, while maintaining our strong margins. As we move past the recent headwinds, we'll do so well-positioned to grow revenue, expand margins and increase cash flow.

I would like to conclude by stating I'm extremely proud of and thankful for the efforts of all HNI members, particularly given how hard everyone is working to overcome the constraints we have described.

We will now open up the call to your questions.

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## QUESTION AND ANSWER SECTION

**Operator:** Thank you. [Operator Instructions] Our first question comes from the line of Greg Burns with Sidoti & Company.

**Gregory J. Burns**

*Analyst, Sidoti & Company, LLC*

Q

Good morning. Just want to start with the order patterns, order trends you're seeing throughout the quarter on both sides of the business. How they trended throughout the quarter and what you're seeing in the early part of the fourth quarter?

And then, secondly to that, on the Workplace side of the business, are you seeing any change in forward indicators like mockups, pipeline opportunities, like, in terms of dollar value or a number of project opportunities you're seeing? Any change there that might indicate a shift in demand going forward, given what we're seeing with COVID? Thank you.

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah. Sure, Greg. Let's start with orders in Workplace Furnishings. For the segment, their orders were up 31% versus the prior year for the third quarter. And if you look at the individual components, [ph] you've cooked down (00:15:01) each business. We were pretty consistent. So, we saw similar growth rates in the contract business, as well as the business focused on small- to mid-sized offices. And the growth rates through the quarter were pretty similar. There were some noise related to timing of price increases, but we exited the quarter pretty similar to the rate that we had for the whole quarter there. So, there's no change in trajectory, it feels pretty decent.

In Residential Building Products, orders were up 35% versus the prior year. Remodel-retrofit was up a little more and new construction was about a low 30% growth range there. New construction was really consistent through the quarter. Remodel-retrofit has started to taper off. Now, it's not an issue of the dollar intake tapering off, that remains good. It's just we're starting to come up against some tougher comps in the prior-year period. So, the growth rate is slowing as we might expect given the growth rates we saw late last year to early this.

As it relates to forward-looking indicators, what I'd tell you is that we probably have a little bit less visibility than we normally would have on that front right now, Greg. The customers and the dealers maybe shifted a little bit more of their focus to dealing with the here and now, given the construction delays that are out there and just overall supply chain disruptions that we're seeing.

So, I'm not sure we have a great view of that. What we do see is that contract is strengthening and the SMB business continues to be strong.

**Gregory J. Burns**

*Analyst, Sidoti & Company, LLC*

Q

Okay. Okay. And then you mentioned a focus on improving margins on the Workplace side of the business. How should we think about, I guess, what your goal is or where you think that business can get to because I know you were starting to see a little bit of improvement in 2019 before the pandemic hit. So, I just wanted to get a feel for what your aspirations are for that segment and where you think you can get the margins over time, if inflation and some of these supply chain issues improve.

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah, long-term, Greg, we believe we can get back to the margins we were at in the 2015-2016 timeframe in Workplace Furnishings. In the short term, we've got two big levers that will help us out in next year. And the first one is improving price-cost.

Price-cost is a major headwind this year. We're looking at about a \$44 million negative price-cost for Workplace Furnishings. And we think we can recover the majority of that next year which can add approximately 300 basis points of margin. The second big lever in the short-term is just catching the volume that's out there. Our backlogs are extended, demand continues to run. As we increase our capacity and get more productive with the capacity we do have, we can capture some volume, maybe get another 150 basis points of margin expansion there.

As you look into subsequent years, we're committed to expanding margin. We've got some efforts underway to improve our underperforming businesses. And, of course, we've got our ongoing annual cost savings initiatives.

**Gregory J. Burns**

*Analyst, Sidoti & Company, LLC*

Q

Okay. So, when you reference, like, 2015-2016, so that would be like a high-single-digit kind of number to go back and look – it looks like you were in the – in that range, 8% to 10% kind of range?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yes.

**Gregory J. Burns**

*Analyst, Sidoti & Company, LLC*

Q

Okay. All right. Thank you.

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Thanks, Greg.

**Operator:** Our next question comes from the line of Reuben Garner with The Benchmark Company.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

Thank you. Good morning, everybody. So, it sounds like some optimism surrounding 2022. And Marshall, you mentioned \$60 million of price-cost drag that is a way which I think is a little over \$1 a share if my math is right. Does that include the all-encompass – is that an all-encompassing figure with the supply chain parts of it, or is that purely sort of material costs? And, I guess, is there any other things to think about as we – as we're putting together a bridge for 2022 other than that \$60 million headwind going away?

**Marshall H. Bridges**

*Senior Vice President &  
Chief Financial Officer,  
HNI Corp.*

Yeah, Reuben. Our input costs include materials, wages, freight, your classic input costs.

it doesn't include any kind of disruption to productivity related to supply chain disruptions and things like that. Yeah, I think as you look to next year, the two big levers is, what I explained to Greg, is the recovery of price-cost and then the leverage off volume growth as we expand capacity and also use the capacity that typically isn't used in the first half. There's – we're not going to see a lot of seasonality next year in Workplace Furnishings, it's just due to the pent-up demand and the backlogs we have.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

Great. And that feeds nicely into my next question about the capacity additions. Can you put into perspective the Mexico operation? How much does that add to capacity? I think it's a seating facility. Is that where you need capacity the most or is that just going to allow you to better utilize your facilities in the US for some other product categories?

And then, secondarily, and sorry for the long-winded question, but the production rate, Jeff, that you mentioned, I think you said you're 11% short of where you want to be. Where does that number normally sit just kind of in a more normal environment, if there is such a thing?

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Yeah, Reuben. Well, what I can tell you is the Mexico operation, yeah, it will relieve pressure overall in the network, so that's a positive thing. And we're – it's multiple levers. It's additional hiring, it's enhanced productivity, it's shifting production around, it's Mexico, it's Marshall's point about level loading the first half as opposed to kind of the cyclical nature of the business. We're looking to increase output somewhere in the 15% to 20% range for 2022 over 2021 levels from a capacity output standpoint. So that's – and it's not just isolated to Mexico, but it's kind of all those items.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

Okay. And then – that's great. What kind of investment are you make – having to make to increase the productivity by that much? Is there going to be an incremental pressure on CapEx next year or is this within your sort of normal spending parameters?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

Reuben, most of it's in our normal spending. The Mexico facility, obviously, is going to have a little bit more, but it's not a dramatic change. And mostly what we're trying to do is utilize the capacity we have and excess labor which is just not as capital-intensive as some capacity expansions would be.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

Okay. And then on the Workplace Furnishing side, I think there's some skepticism from investors or, I guess, unknown about the recent surge in demand, how much of it is catch-up from the last year and how much of it is a return to normalization? How much of it is spending to reconfigure the office to be better for or more COVID-friendly going forward? I know this is a tough question, but any sense from you guys on those three buckets, what we're seeing right now, can you tell by the types of products that are being ordered? Is this just kind of things returning to the way they were prior to COVID or are there other factors?

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Reuben, that's a great question. I think it's both, [ph] and (00:23:20), to be candid. I think we're seeing people ramp up, particularly in some segments, education, SMB businesses are moving forward with their life and their businesses doing well.

So, that's just demand coming online as those businesses do well. I don't think the reconfiguration for post-COVID has really hit yet. Office reentry in major metros has been delayed. So, that's still, I think, out there. I think we hear a lot of discussion about the war for talent and operating in a hybrid environment. And those – I think that demand is still TBD as companies figure that out.

So, I would characterize this as – we've seen nice return in certain segments of the business, and that's driving our strong order patterns and there's still another couple of chapters to be played out as companies kind of augur through a return to office scenario and hybrid. And then you layer on top of that, the war for talent. And there's a lot of discussions underway about how that's going to play out.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

Okay. I'm going to sneak one more in. We haven't seen a surge in fuel or energy costs like this in a while. Back in 2014 and 2015, I think it was your hearth business had a pretty big boost from folks looking for different ways to heat their homes in the winter. I guess, any chance that we see something like that given the current environment? And then secondarily, do you have the capacity in that kind of area to service an uptick in demand if there was one?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah, it's a great question, Reuben. We always enjoy talking about the pellet business. Yeah. We would expect that to run, given how high energy is. I would say we haven't necessarily seen it yet. So, I guess, it remains to be

seen and we are pretty tight in capacity across the hearth business, so we're going to have to figure out how to capture all of it, but that's a potential upside for us as we go into next year.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Great. Thanks, guys.

Q

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

Thanks, Reuben.

A

**Operator:** Our next question comes from the line of Steven Ramsey with Thompson Research.

**Steven Ramsey**

*Analyst, Thompson Research Group LLC*

Hey, good morning. Thinking about the Q4 guidance, to start with sales, it looks like Q4 sales being better than Q3. Can you maybe go through how much of that is pricing flowing through and how much of that is better production and shipments?

And then secondly, if Q4 sales are higher sequentially, but profits at or below, what is driving that dynamics, is it price-cost or are there other items?

Q

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

Yeah, it's good question, Steve. Let me let me try to answer the second part of your question first. So, as you look at the fourth quarter as it relates to the third quarter, we said conditions would be generally the same. But there's a lot of moving parts that basically knit together, offset each other. So, maybe walk through them and I think that answers both of your sub questions.

So, on the positive side, we are going to see better price-cost. Our pricing is ramping up. And even though inflation continues to increase, we're going to narrow that gap. So, that's an improvement sequentially. Also, the volume in Residential Building Products will improve sequentially. That's really related more to shipping inventory we produced in – earlier in the year. We're pretty tight on production, as I said earlier.

So, those two positives get offset by basically three negatives. The first one is, there's some seasonal uptick in the corporate unallocated overhead. We were about \$11 million in the third quarter there. That should increase \$7 million. But the year-over-year increase in each of those quarters is still pretty small, just how those costs flow.

We're also going to see fewer production days. So, this is a – the fourth quarter has got more holidays. And so, the Workplace Furnishings business will have lower unit volume, price excluded. And then, lastly, we're going to see a little bit lower productivity, particularly in Workplace Furnishings related to two factors: One, starting up the New Mexico facility; and then secondly, the supply chains are still not back to being healthy. So, in that, altogether, we're looking at pretty similar profitability and the volume picture excluding price depends on which segment.

A

**Steven Ramsey**

*Analyst, Thompson Research Group LLC*

Q

Okay. Very helpful, very helpful. And then, thinking about the constraint improvement, is one improving sooner than another, thinking about supply or labor getting better, how much of that is factored into your bridge to 2022? And kind of on the other side, as these things get better, which one is a greater tailwind to profit, supply or labor, and maybe some of this is chicken and egg, so maybe it's not right to break it out that way?

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Yeah. I – it's a good question. We watch this every day, Steven. And I think it is a bit of a chicken and egg. The labor pressure is kind of ripple through the supply chains as well, just like us. So, we make – we're making some progress on both is what I would tell you. And we continue to have to try to balance those two things kind of in tandem.

So candidly, if one runs way ahead of the other, it's not going to really net out as well as it could or should anyway. So, we're really working hard at both of those levers. And we do expect improvement, stability first and improvement as we get into 2022 on both fronts. But like I said, it's kind of six to one. They both need to improve kind of at the same rate and as people – and we've seen some stabilization in the supply chain. But we watch it daily.

**Steven Ramsey**

*Analyst, Thompson Research Group LLC*

Q

Okay, great. And then last one for me, so HNI is known for being extremely efficient. And we talked to many people in the supply chain and in procurement that think just in time inventory will change permanently from this situation the world is in and, therefore, more companies will hold more inventory. So, I guess, have you contemplated how you will change managing inventory and working capital as on the other side of the current issues?

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Yeah. That's a great question. And we have absolutely contemplated that. And I do think we're no different. We will be hearing more buffers. Candidly, if you even think about our business model, some of the small, medium-sized business that we have, we got some high runners that we can build ahead. And so, we will definitely use the balance sheet appropriately to change that dynamic over time.

Now, it won't happen overnight. But I do think we're entering a period here, maybe a permanent period in which the business is going to have to kind of reset its expectations on just in time versus inventory. I think that's a – and we're going to be playing that, pulling some of those levers as we get into next year.

**Steven Ramsey**

*Analyst, Thompson Research Group LLC*

Q

Helpful. Thank you.

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Thank you.

**Operator:** This concludes the question-and...

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

All right.

A

**Operator:** This concludes the question-and-answer portion of today's call. I will now turn the call back over to Mr. Lorenger for closing remarks.

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

Awesome. Thank you. Again, thanks, everybody, for joining us today. Have a great day and we'll talk to you soon. Thanks.

**Operator:** This concludes today's conference call. Thank you for participating. You may now disconnect.

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