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HNI Corp. (HNI)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Cheryl, and I will be your conference operator today. I would like to welcome everyone to the HN1 – HNI Corporation First Quarter Fiscal 2020 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. McCall, you may begin your conference.

Matthew McCall

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

Thank you, Cheryl. 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 first quarter fiscal 2020 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 the website includes additional factors that could affect actual results. The Corporation assumes no obligation to update any forward-looking statements made during the call.

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

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Thanks, Matt. Good morning, everyone. Our members delivered strong first quarter operating results and we will come back to that in a moment. I want to start with an update on the ongoing COVID-19 pandemic. What we are experiencing, what we are assuming, and how we are currently responding? Upfront, the two most important points I would like to emphasize are, first, we will prioritize the health and well-being of all HNI members during this pandemic; and second, we will successfully navigate this pandemic.

With respect to my first point, the HNI culture again is rising to the occasion. Our members are coming together to support our communities and doing what is necessary to move the business forward. To help protect our teams, we have aggressively implemented measures consistent with CDC guidelines across our organization. We have reorganized our production facilities to provide appropriate social distancing. We have increased the frequency and depth of facility cleaning. All members able to work remotely are currently doing so. With these measures in place, we are currently operating in our major facilities.

Additionally, we are utilizing our facilities in Iowa, New York and North Carolina to produce personal protective equipment. These efforts include the manufacture of washable cloth facemasks, facemask coverings, and protective gowns for use by healthcare professionals and the public in general. We are donating these critical supplies to our first responders, healthcare systems, and hospitals in our communities.

Let's talk about my second point. How will we successfully navigate this pandemic? We have a strong balance sheet and have liquidity and cash flow to maintain our business and meet our obligations for a prolonged period. With a sudden global economic shock, while the sudden global economic shock has been felt across the majority of our businesses and geographies, we are responding accordingly and our teams are focused on three objectives. Number one, we are adjusting to the current operating environment and staying vigilant in our short-term scenario planning. Number two, we are maintaining our long-term strategic focus. And number three, we are focused on emerging from this period with our business poised to hit the ground running.

Let me detail some of the actions we have taken to date to reduce costs and support our free cash flow. First, we temporarily reduced salaries across the board. Base salaries were reduced by 10% for all exempt salaried employees and by 15% for all executives. My salary was reduced by 25%. We plan to re-evaluate these measures in six months. Second, our Board of Directors elected to reduce by 25% both their cash retainers for the next six months and their annual equity award. Third, to better match staffing levels with demand activity, various groups and our members have been furloughed. We are supporting our furloughed members by covering all health and dental insurance premiums during the furloughed period, both the company and member portions. These furloughs are being continuously re-evaluated as conditions evolve.

Fourth, we suspended our share repurchase activity. As a point of reference, in recent years, buybacks have averaged approximately \$55 million annually. Finally, we reduced our capital expenditure budget for 2020 from approximately \$65 million to \$35 million. Our planned growth investment spending for 2020 is being maintained at a reduced level of approximately 50%. In total, we currently anticipate \$60 million to \$65 million of cost improvement during 2020 as compared to 2019, with the full run rate expected by mid-Q2.

In addition, from a cash flow perspective, savings associated with our buyback suspension and our CapEx reductions will add to our liquidity buffer. Again, these measures are part of our balanced approach to address the impact of the pandemic and are aimed at supporting our members and our free cash flow in 2020 as we navigate through these uncharted waters.

I will now share some thoughts on the business and demand picture, what we are experiencing and currently assuming. While the extent of the pressure from the crisis is still uncertain, we believe several data points indicate

we will see near-term slowdown in our businesses. The first data point is our recent order activity. Not surprisingly, our orders over the last four weeks are trending down. Domestic office furniture orders are down 35% versus prior year period. That rate does not include e-commerce which continues to show strong growth. In fact, our e-commerce orders are up 120% versus the prior year levels, in large part due to an acute spike in demand for home office products. Orders from our Hearth business during the same period are down 20%.

The second data point to consider is our experience in China. Our furniture business in China faced pressure from the pandemic in Q1. Although China is a very different market compared to the US, our experience there may provide insight into the trend we could see domestically. Demand dropped quickly as measures to counteract the pandemic were implemented. Approximately eight weeks later, we started to see volume trends recover as businesses began to reopen. While we are still well below normal levels, the trend has improved.

The third data point to look at is what happened to our markets in previous recessions. We are not saying the current downturn will play out that the same way, but this one is certainly unique. But looking at history gives more data points to consider. In each of the last two downturns, the commercial furniture industry volume declined a little over 30%. Building products in housing were hit hard in the last recession. We are not expecting that level of severity this time. Compared to the Great Recession, construction levels are lower, inventories are tighter, and there is not an overhang of homes held by speculative buyers and sub-prime borrowers.

Based on these data points, we anticipate and we are seeing a significant near-term slowdown in our businesses. Right now, we do not have good visibility on the depth and duration of the decline. We have run and are prepared for a variety of scenarios. Despite these near-term pressures, we see the potential for the post-crisis environment to possibly impact our business segments in a couple of different ways.

In our furniture segment, in addition to incremental demand tied to work-from-home trends, office floor plates will most likely see change to accommodate less dense configurations that better support social distancing. In fact, in the last few weeks we have already seen companies reconsider their plan layouts. In addition, our architectural products platform is also well positioned for this trend. The diverse product lineup can quickly create physical separation with minimal construction time, while maintaining natural light.

In our Hearth Products segment, we may see increasing benefit from a shift away from dense multi-family construction toward more single-family homes. This would be a positive demand driver for our Hearth Products segment. In addition, we believe the extended period of shelter-in-place could drive elevated remodel spending as consumers look to spend more money where they are spending more time.

I will now turn the call over to Marshall to discuss our first quarter results, our current financial position, and more color on the stress test we have performed in recent weeks. I will then come back and highlight the key elements of our long-term strategic framework. Marshall?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

Thanks, Jeff. Our members delivered a strong first quarter. Consolidated non-GAAP net income per diluted share was \$0.21, which represented a substantial increase versus the \$0.02 reported in the first quarter of 2019. First quarter consolidated organic sales decreased 2.5% versus the prior year to \$469 million. Including the benefit of acquisitions, sales were down 2.2%. In the Office Furniture segment, first quarter sales decreased 4.3% year-over-year. We again generated strong profit growth in Office Furniture, with first quarter non-GAAP operating income improving \$4 million.

Sales in our Hearth Products segment increased 2.6% year-over-year organically, or 3.5% when including acquisitions. Within the Hearth segment, new residential construction revenue grew 3.2% organically, and sales remodel and retrofit products increased 1.9% year-over-year. We also showed strong profit improvement in the Hearth segment. Hearth non-GAAP operating profit increased 17% versus the prior year quarter.

For HNI, overall, first quarter gross profit margin expanded 220 basis points year-over-year to 37.6%. Non-GAAP operating profit grew 279% versus the prior year, and non-GAAP operating margin in the first quarter expanded 220 basis points to 3.0% of net sales. Our non-GAAP results exclude \$37.7 million in charges related to intangible impairments and onetime items related to the COVID-19 crisis.

So, overall, our first quarter results demonstrate the strength of our operating platform. Our annual productivity and cost saving efforts again drove improved profitability. Let's now talk about our liquidity and debt levels. At the end of the first quarter, we had \$230 million in total debt, representing a gross leverage ratio of 1.0. This is well below the 3.5 times gross leverage covenant in our existing loan agreements. Our first debt maturity is not until 2023. Liquidity, as measured by the combination of cash and available capacity on our lending facilities, totaled more than \$350 million at quarter-end. This is equal to approximately two years of recent free cash flow levels.

Okay. Let's shift to covering some of the scenario analysis we've done. Let's start with emphasizing that we are not providing sales and earnings guidance. That said, we have evaluated our earnings, cash flow and balance sheet under various scenarios. The scenarios indicate the following: First, we would be able to manage to a 25% deleverage or decremental margin with our cost actions. Second, we would generate free cash flow at or above our current dividend level. Third, year-end debt levels would be similar or slightly above last years' ending balance. And finally, we would remain well within our debt covenants.

They also indicate we should expect a sizable earnings loss in the second quarter. In our scenarios, we do remain solidly profitable on a non-GAAP basis for the year and will manage costs accordingly. In addition to these scenarios, we thought we'd share the results of our stress test, where we modeled the limits of our current capital structure. What it showed is we can support nearly \$270 million in debt with zero cash earnings. This is due in part to the \$77 million in annual depreciation and amortization we incur. Please note the stress test is not an outlook or a scenario, we're not providing color around what circumstances might drive us to this condition. It has been solely to illustrate the financial flexibility of our business model.

With that, I'll now turn the call back over to Jeff. Jeff?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Thanks, Marshall. In my letter to shareholders recently published in the HNI Annual Report, I introduced our three strategic priorities. While HNI's unique member-owner culture remains our foundation, our corporate-wide focus and members efforts going forward are centered on the following three pillars. First, we will be laser-focused on the customer. Customer journeys in our markets are changing and the impacts of the pandemic will create more change. To capitalize on these changes and identify and take advantage of the new market dynamics, we are investing in new tools and capabilities in the areas of data analytics, digital assets, branding, e-commerce, and expanded market coverage.

Second, we are simplifying the buying process. Buying office furniture and hearth products can be complicated and time consuming. There are large numbers of options and configurations to sort through complicated installations to coordinate and tight timelines to manage, and navigating the process can take multiple in-person

interactions. Customers today are less willing to go through that kind of process and they are upping their expectations. We are focused on transforming the experience to reduce their effort.

Third, we will leverage our lean heritage. HNI's longstanding and well-established culture of rapid continuous improvement in our recent results demonstrate our capability to leverage that lean heritage. We are doubling our efforts here in order to unlock our toolset in support of our first two pillars that I just referenced. Again, while our near-term focus is on our members' health, safety, and our overall cash flow, our strategic framework will help drive significant improvements over the long-term. Later this year, as the pandemic-driven economy, economic uncertainty moderates, we plan to roll out a more detailed version of our framework.

We'll now open up the call for your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] The first question is Steven Ramsey of Thompson Research Group. Please go ahead. Your line is open.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

Good morning. I guess, I will start with the Hearth. Maybe share a little bit more on the M&A activity. Was that started prior to COVID or was that in response to COVID, players that were weak and could shore up bringing with you guys coming in?

And then, I guess the financial side of it, \$9 million for the acquisitions net of cash. Is that all the cash that will be deployed or were there more that were done that the cash would be laid out in Q2?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, thanks. The M&A activity on the Hearth side that you referenced was started before the COVID pandemic. Yes. And on the cash side of things, Marshall, why don't you comment?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah. Steven, that is what we anticipate in that, this acquisitions of some small distributors, and it does add about \$1 million of revenue to the quarter, we expect it to add somewhere in the neighborhood of \$9 million to \$12 million of revenue for the full year.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

Excellent. And then, I missed the specific numbers on Hearth growth, but maybe review those and then share more on why it strengthened as the quarter went along?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah. Hearth new construction was up 3.2% organically in the quarter and that really just strengthened as we moved through the quarter. If you look at sort of mid-February to mid-March before the crisis hit, it was running in the high-single-digits, around 7%, the orders were running there, and I think that indicates the strength of the new construction market prior to the crisis.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

Great. And then, I guess shifting to Office, I guess first on dealers, how is dealer health currently on our collections of [ph] receivables fine (00:18:11) from dealers for any recent – recently completed sales?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah. Dealer health so far has been good. We haven't seen really any fallout. Obviously, we're in constant contact and we have high levels of engagement with our dealer partners, both on the Office side and on the Hearth side, and they've been able to navigate these things in the past. And so far, we're monitoring their health, but we haven't seen any real stress yet.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

Great. And as we think about the future of office formats, less density as you guys discussed, is – how quickly do – as we're pondering this change early, would you expect that to roll out, I guess quarters as they pick up, maybe later Q2, early Q3, whatever the speculative timeline is, those orders, would they go ahead and fit that in that less densified office format or is that going to happen one year, two years down the road?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah. It's a good question. I think it probably – there'll be some short-term impacts from people who want to do some quick hits on screening and retroing a little bit of what they have, and then, obviously, people who are in development of projects. And then, they'll be – I think, it'll continue to catch steam as you go further out and people have more options available to them than just short-term quick reconfigurations, and then that will become more of a planning paradigm that has more permanency to it probably in 12 months or so.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

Great. And last question for me on CapEx, I don't know if I followed it well, but with the growth investment percentage of the previous plan, can you maybe explain that again, and if the growth areas of CapEx, what areas specifically are you focusing on or de-emphasizing in the near-term?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah. In terms of CapEx and growth, roughly speaking maybe a quarter of that \$65 million we previously planned to spend was for maintenance and the rest is for growth and capabilities. So, now it's roughly half, right? We've reduced it from \$65 million to approximately \$35 million this year. And what was cut is broad-based, there's not a single large item there.

Steven Ramsey

Analyst, Thompson Research Group LLC

Okay. Great. Thank you, guys.

Q

Operator: Your next question is from Greg Burns of Sidoti & Company. Please go ahead. Your line is open.

Greg J. Burns

Analyst, Sidoti & Co. LLC

So ...

Q

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Good morning.

A

Greg J. Burns

Analyst, Sidoti & Co. LLC

...I guess, you mentioned that your major manufacturing facilities are online, but what capacity are they currently running? What was the percent of your capacity [ph] currently (00:21:37)?

Q

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Yeah. I mean, it's kind of all over the board. We have – we've taken down capacity in response to order incoming, but we can ramp back up pretty quickly. We're running anywhere in the 50% to 60% capacity right now, Greg.

A

Greg J. Burns

Analyst, Sidoti & Co. LLC

And you mentioned, [Technical Difficulty] (00:22:07-00:22:26)?

Q

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Yeah. We've mentioned, Greg, you may have missed it, the four-week average on Office, for instance, is running down about 35%. And on the Hearth side, four-week average run down about 20%. The funnel has – it's really been pushed. I haven't really seen much cancellation. We've seen push out of the second quarter into the third or into the fourth, but we haven't really seen cancellations.

A

Greg J. Burns

Analyst, Sidoti & Co. LLC

All right. And then, I guess, while I guess this answers my next question, but I was going to ask, the Hearth business the last recession was obviously a housing-led recession. So, I don't know if that's kind of indicative of what's happening this time around. But generally, it's the Hearth business more or less cyclical than the Office business, or maybe vice versa?

Q

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

It just depends greatly on what drives that recession, Greg. If you go back to the 2001 recession, our Hearth business actually increased profit – profitability during that recession, we had very minor impact on housing in that timeframe. And as you mentioned, housing starts declined like 80% from peak to trough in the last recession. So, it's just a really wide range of outcomes there. I don't know that it's inherently more or less cyclical in Office, but Office has been a little more consistent the last two recessions, as Jeff noted in his comments.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

And then, I don't know if you outlined some cost savings initiatives. Did you put a number behind what you expect, what kind of savings you expect from?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

We did. There's probably two points. The first one is just to reiterate the numbers that we expect generate about \$60 million to \$65 million of cost improvement in response to the pandemic. The second point is that because of those actions and whatever else we can find to offset the pressures, we expect to deleverage at about 25%. So, if we lose the dollar sales, we drop operating profit about \$0.25.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. And did you mention maybe a timeframe on when you might achieve that \$60 million to \$65 million?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah, it's ramping up pretty quickly. We expect to be at a full run rate mid second quarter.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Thank you.

Operator: Your next question comes from Reuben Garner of The Benchmark Company. Please go ahead. Your line is open.

Reuben Garner

Analyst, The Benchmark Co. LLC

Q

Thank you. Good morning, everybody. Apologies if I repeat anything, I got kicked off for a few minutes. So, maybe I'll start with a follow-up to one of those last ones, so the decremental margin at 25%. What does that assume from a mix of business standpoint from your different end markets, I know you said that Office was down a little bit more than Hearth, is that the assumption that's kind of baked into that scenario?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

It is, Reuben, it's sort of commensurate with the order rate that we're seeing currently. It's basically an average blend of that.

Reuben Garner

Analyst, The Benchmark Co. LLC

Q

Okay. And then, you referenced e-commerce getting a spike in home office products, I know you guys have been ramping capabilities in recent years. Can you update us on what the near-term and longer-term opportunities are with e-commerce, is it just home office that you saw a spike in here recently or is it boosting business in the [ph] Office space or in the – sorry (00:26:18), commercial world as well?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yes. It's a good question. We – the business targets small office and home office, that's the platform we're building out. So, we've seen nice growth in this long before the home office spiked, that's kind of additive to the – on top of what we've been experiencing. It's a business that is continuing to ramp up. We're investing in it, we're building out the platform, and we really think it can be used to hit home office and small office commercial.

Reuben Garner

Analyst, The Benchmark Co. LLC

Q

Okay. You referenced a couple of times and there was a question about it already about the future layout of the Office, kind of post-COVID. Can you – I guess, in your minds, does the post-COVID world for office furniture, is this a net positive potentially for the industry that there's going to have to be a reconfiguration in the way offices are set up and at least the more business is working from home, more of a headwind than not, what – just kind of how do you look at the world broadly coming out of this?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah. That's good question. Now, it's early days. But I would say, it's going to be a net positive, because there – it's a furniture event. Anytime you touch your space, it's a furniture event. And I think as people figure out how they want to bring people back and the distancing that maybe be required, it's early days. We're in conversations with clients real-time to discuss that. But it means there's activity, it means there's content on the floor play, and the home office piece of this, candidly, I think, is a positive as well. For us in particular, given some of our assets and our brands that can service that business really well, I think that people won't go full on in the home office. I mean this has been a pretty forced March for people, it's been pretty dramatic, pretty emotional, and I think it's got to point to the fact that people like to work together and get things done. And – but it's also a point of the fact that you can be someone efficient, effective at home. So, I think you're going to get some upside on both fronts from our perspective and we see that as a real opportunity going forward.

Reuben Garner

Analyst, The Benchmark Co. LLC

Q

Are there any substantial investments that you think you'd have to make to service these kind of changes, or is it your existing kind of offering, but just maybe is used in a different way going forward?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

A

Good question, I think it's going to be some of both. I think we'll probably be looking at some different product types, different finished materials, things of that nature, so they'll, but our architectural products group is seeing a lot of pull right now, and I think that'll be an asset that's going to be heavily utilized going forward as well. And that

will be continued, as we said, we're going to continue to invest in making the processes here, which I think is going to help us on the home office front as well.

Reuben Garner

Analyst, The Benchmark Co. LLC

Q

Okay, great. And then last one for me, the four-week trends, I think, is the way you described the Office being down 35%, Hearth down 20%, have those been trending lower? Were they worse at one point and they're starting to stabilize, what's just – or has there been relatively kind of in that range, kind of since this all started a month ago?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

There's been some volatility to it, Reuben, but in general they've been trending lower as you might expect. What we saw in China and Jeff referenced this is that for the first eight weeks really after the crisis started there, we did see orders trend lower and then they bottomed and started to trend more favorably, still down versus the prior year, but trend better. And so far that's consistent with what we're seeing here.

Reuben Garner

Analyst, The Benchmark Co. LLC

Q

Okay, great. Thanks, guys. Stay safe and good luck navigating through this.

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

A

Great. Thanks. Appreciate it.

Operator: There are no further questions....

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

So, again – okay, again, our near-term priorities are the health and safety of our members and the support of the company's cash flow. We entered this unexpected period from a position of strength. We will successfully navigate this pandemic and stay vigilant and disciplined in our approach to balancing the near-term with our focus on the long-term opportunities in front of us. I'm confident in our HNI members and their abilities to achieve our goals. We look forward to speaking to you again next quarter. Have a good day and stay safe. Thanks.

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

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