



HNI Corporation NYSE:HNI

Earnings Call

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CALL PARTICIPANTS	2
PRESENTATION	3
QUESTION AND ANSWER	6

Call Participants

EXECUTIVES

Jeffrey D. Lorenger

*Chairman of the Board, President
& CEO*

Marshall H. Bridges

Senior VP & CFO

Matthew Scott McCall

*Vice President of Investor
Relations & Corporate
Development*

ANALYSTS

Beryl Bugatch

Water Tower Research LLC

Gregory John Burns

Sidoti & Company, LLC

Reuben Garner

*The Benchmark Company, LLC,
Research Division*

Rexford Henderson

Water Tower Research LLC

Steven Ramsey

Thompson Research Group, LLC

Presentation

Operator

Good morning. My name is Audra, and I will be your conference operator today. At this time, I would like to welcome everyone to the HNI Corporation Fourth Quarter Fiscal 2022 Results Conference Call. [Operator Instructions] Mr. McCall, you may begin your conference.

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 fourth quarter fiscal 2022 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. 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, and thank you for joining us. On the call today, I will highlight 4 key topics. First, we delivered strong earnings growth in the quarter despite a soft macro environment. Second, our Workplace Furnishings margin expansion initiatives are delivering results. Third, we are prepared for 2023. And fourth, we are positioned for strong growth beyond 2023. Following those comments, Marshall will review our outlook. I will then conclude with some general closing commentary. We will then open the call to your questions. Moving to the first topic. We delivered strong earnings growth in the quarter even though we experienced a softer demand environment. We generated solid year-over-year margin expansion and 47% year-over-year non-GAAP earnings growth in the fourth quarter. This was despite volume pressures associated with macroeconomic concerns. Consolidated gross and operating margins expanded on a year-over-year basis, led by favorable price costs, which continued to improve in the quarter. And for the full year, we fully recovered the price/cost shortfall driven by the rapidly rising inflationary pressures we experienced in 2021. Fourth quarter profit improved in both segments. Residential Building Products operating margin expanded 170 basis points year-over-year, reaching nearly 20%.

Our fourth quarter results demonstrate the strength of our differentiated business model in residential building products. In Workplace Furnishings, fourth quarter non-GAAP operating profit more than doubled despite lower sales. The year-over-year top line decline was driven by divestitures and restructuring activities implemented earlier in 2022. Excluding these actions, fourth quarter year-over-year segment revenue growth was just over 4%. Although these streamlining efforts negatively impacted our top line, they contributed to our margin expansion, reflecting our commitment to improving profitability in workplace furnishings. That leads to the second topic. Our initiatives to expand workplace furnishing margins are delivering results. Non-GAAP operating margin expanded 150 basis points year-over-year in the fourth quarter and in the second half of 2022. Favorable price cost and benefits from our cost reduction and simplification efforts drove the improvement.

As we have discussed on prior calls, we are driving multiple initiatives to expand margins in workplace furnishings. These efforts are in 3 broad categories. First, we are simplifying our business to focus on our most attractive markets. Actions taken in 2022, including the sale of Lamex, the e-commerce business restructuring and the discontinuation of a small workplace brand reflect our efforts to drive profit improvement through simplification and focus. Second, we are lowering our cost structure. We announced the \$30 million cost reduction planned last quarter. That plan is well underway, and we are now on track to reduce cost \$30 million to \$35 million in 2023. Approximately \$25 million of that total will impact

Workplace Furnishings this year. Third, we are driving productivity, and we'll see future benefit from ongoing operational investments. Our fourth quarter productivity improved versus the prior year as we continued to benefit from our lean actions and improving supply chain health. We expect our productivity momentum to continue and positively impact 2023.

Regarding investments, our largest operational investment is our new facility in Mexico. In 2021, we started up a new seating plant in Saltillo, Mexico. We plan to expand that operation and shift to a larger building during 2023. Although these actions have negatively impacted our short-term results, they will drive margin expansion as they mature. The third topic is we are prepared for some headwinds in 2023. In Workplace Furnishings, we expect to drive profit improvement, notwithstanding anticipated top line pressures. Our margin expansion initiatives focused on simplification, cost and productivity will continue to gain traction this year. We expect those efforts, when combined with favorable price cost will more than offset lower volume driven by macroeconomic concerns and inconsistent office reentry patterns. In residential building products, we are prepared for a slowing near-term demand environment. Cost actions and favorable price cost will partially offset volume pressures while we continue to position for growth beyond 2023. Overall, our cost structure has improved. Our balance sheet is strong, and we expect a strong free cash flow year despite an overall weaker demand environment in 2023.

That brings me to my fourth topic for today. We anticipate and are positioned for strong growth beyond 2023. In Workplace Furnishings, our research indicates the market will recover and demand patterns will change in a way that aligns with our market positions. Specifically, population migration patterns towards secondary and tertiary geographies, positive employment and demand trends with small to mid-sized offices and feedback from large corporate customers regarding return to office plans and adoption of hybrid work models, all aligned with our strong market coverage in product and price point breadth and depth and point to the return of sustained volume growth post 2023. In residential building products, we are continuing to invest in our growth initiatives in the areas of category awareness, new product innovation, online capabilities and the expansion of our wholly owned installing distributor footprint. Overall, the housing market has strong fundamentals. It is undersupplied and demographic trends support future demand growth. Additionally, an aging housing stock will drive remodeling activity. The average home is now 40 years old, supporting robust renovation growth. Given the market's strong fundamentals, our unique growth opportunities and our category-leading positions, we are bullish about our growth in this high-margin, high-return business beyond 2023. I will now turn the call over to Marshall to discuss our initial outlook for 2023. Marshall?

Marshall H. Bridges

Senior VP & CFO

Thanks, Jeff. Let's start with seasonality. This is important because we are expecting 2023 seasonality to be different than what occurred in 2022. And that difference will distort quarterly year-over-year comparisons of sales and profit. Specifically, we expect sales and earnings seasonality in 2023 to be more in line with pre-pandemic trends. That follows 3 years of abnormal seasonality. 2022 seasonality was particularly unusual in that quarterly revenue peaked in the second quarter and first half revenue exceeded second half revenues. That unusual pattern was primarily driven by backlog dynamics that positively impacted the first half and deteriorating workplace furnishing demand that negatively impacted the second half of 2022. As a result, our first half comparisons will be more challenging on a year-over-year basis and our second half comps less so. Due to the change in seasonality, we expect more than 85% of our annual profit will be generated in the second half of 2023, that compares to 60% in the second half of 2022. All right let's move on to our outlook for the first quarter.

In Workplace Furnishings, we expect first quarter revenue to decline at a year-over-year rate in the low 20s. This decline is the result of last year's unusual seasonality, the continued negative impact of broader macroeconomic concerns and the sale of Lamex. With respect to seasonality, first quarter 2022 benefited from the unwind of backlog built up during 2021. That unwind will not repeat in this year's first quarter and accounts for more than 10 percentage points of our expected year-over-year sales decline. In addition, the sale of Lamex will lower growth in Workplace Furnishings by 5 percentage points or \$17 million in the first quarter. First quarter Residential Building Products revenue is expected to decline at a year-over-year rate in the mid- to high teens. It is important to note that segment backlog is currently

approaching normal levels, which means our revenue after the first quarter should trend more closely with pre-pandemic seasonality and be fully impacted by weakening new construction and remodel retrofit activity. In total, consolidated revenue for HNI overall is expected to decline at a high teens rate in the first quarter.

We expect consolidated non-GAAP operating income to be approximately breakeven in the first quarter of 2023. Let's move to our outlook for 2023 overall. During 2023, we plan to drive \$80 million to \$85 million of year-over-year profit support through improved price cost, better productivity and reduce structural costs. These items will partially offset the earnings pressure associated with top line trends. Importantly, our efforts do not come at the expense of future growth, we will continue to invest throughout 2023. Looking at the segments, we expect the \$80 million to \$85 million of profit support to drive profit growth in Workplace Furnishings and offset much of the negative impact from lower volume in residential building products that's being driven by the weakening housing market. Shifting to the balance sheet. We have a strong financial position, which provides flexibility for investment and positions us well for a slowing economy. Gross debt to EBITDA as calculated for our debt covenants was 0.7 at the end of the fourth quarter. We have a history of generating strong free cash flow through a variety of economic conditions, and we expect free cash flow in 2023 to benefit from a return to more normal working capital levels. Our low leverage and continued free cash flow generation will provide flexibility for the dynamic environment and continued investment. I'll now turn the call back over to Jeff.

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Thanks, Marshall. Before we take your questions, I want to take a moment to mention that in December, HNI was again named one of America's most responsible companies, ranking #6 in Newsweek's fourth annual list of America's 500 most responsible companies. These rankings are based on public data that analyzes the top performance across environmental, social and corporate governance categories. Important components in our HNI members daily efforts include a commitment to reducing our environmental impact, making a positive social impact and practicing good corporate governance. Our goal of enhancing where people work, live and gather shines a light on our decades-long commitment to sustainability and good corporate citizenship and most importantly, on the commitment and efforts of all HNI members who make a positive difference every day. In closing, we remain focused on our 2 primary long-term objectives, improving the profitability of our workplace furnishings segment by driving margin expansion and delivering strong top line growth in residential building products by leveraging our differentiated business model. We will now open the call to your questions.

Question and Answer

Operator

[Operator Instructions] And our first question comes from Rex Henderson at Water Tower Research.

Rexford Henderson

Water Tower Research LLC

Congratulations on a really impressive quarter. Terrific margin performance. I did have some questions about, first of all, order trends in the 2 segments is coming out of December into January and February, directionally what are you seeing in those order trends in the 2 segments?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Okay, Rex. Look, let me start with Workplace. We kind of -- I look at it in 3 buckets in kind of our mid-market segment, they remain strong. Orders in the Q4 and year-to-date are both were up strong double digits. We -- it's consistent with what's going on in the market, actually, migration patterns, large cities losing office jobs, smaller cities gaining employment trends, small, midsized businesses, adding jobs. So that's what we're seeing in that portion of the market. And then we go to our contract segment is stabilizing to improving. Orders are flat year-to-date. I would say their presale activity is improving as people focus on hybrid environments. I think we're looking for more of a second half improvement there. And then third, we have -- our transactional business is still down. Those trends are down double digits. And those are real short cycle, small orders that are really sensitive to macro environment headwinds.

Marshall H. Bridges

Senior VP & CFO

kay. And Rex, as it relates to Residential Building Products, our orders were down 18% in the fourth quarter, and we saw some pressure in both the new construction as well as remodel retrofit, they were down similarly. Now we do expect new construction to be down more than remodel retrofit during 2023.

Rexford Henderson

Water Tower Research LLC

Â Okay. So you've already answered one of my other questions, which is some differentiation between what's happening in new build and retrofit and remodel in RBP segment. And so new construction is worse than the retrofit business. Is that right?

Marshall H. Bridges

Senior VP & CFO

Yes. We expect it to be worse traditionally, at least historically, the remote retrofit business is just not as volatile. And we basically track single-family construction activity in the new home side exactly. So we're seeing some pressure there. I expect it to really be fully impacted in the second quarter and the quarters thereafter.

Rexford Henderson

Water Tower Research LLC

Â And then one other question. Your gross margin performance here was really quite impressive. I'm wondering if you're beginning to see any competitive pressure or customer pushback on prices as commodity prices come down? Are you seeing anybody pushing back on prices at all?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Rex, that's a good question. We monitor that pretty closely. We haven't seen anything yet as I think there's some in these spaces, particularly in the workplace side, are still announcing price increases. And

we're kind of in line. We've been in line with what we've seen in the market. So -- but we keep an eye on for that. But so far, there hasn't really been -- I think it was such a shock to the system that, I think, in general, people were kind of getting hit with inflation across the board. So it's so far been accepted.

Marshall H. Bridges

Senior VP & CFO

And Rick, there's still inflationary pressures out there that we have to cover, and we are still recovering our margins. So we're still making progress there and it seems like the market is behaving pretty similarly.

Rexford Henderson

Water Tower Research LLC

Okay. Very good. I'll pass on the question to someone else.

Operator

We'll move next to Budd Bugatch at Water Tower Research.

Beryl Bugatch

Water Tower Research LLC

Yes. also thank you for taking my questions. I hope everybody is well there. I just want to follow up on Rex a little bit with the -- in terms of hearth -- are we seeing any change in the product mix? I know you've done a great job on the logistics, but I'm wondering are we seeing anything in terms of penetration, in terms of new housing? And is product mix like electrical making a change on what are making an impact there?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Yes Budd, good question. I mean I think we are -- we've been working on that for a bit. And when it comes to electric, for example, look, we're seeing a lot of opportunity there. We're launching a lot of new products in that category. It's expanding the category. We've got examples where we've got places in the country where the IR rate was 0, and it jumps to 50% just because of the electric availability on that unit. So it's really an expansion of the category, not a replacement of the category. And so that -- and then we also are seeing some traction, as we've talked in the past on our insert business as that because as customers become more aware of their ability to do an insert that's easier than having to blow up a whole remodel and replace maybe an old wood burner with an insert gas that's made for an easy install. We're starting to see a lot more traction there as well. And that's really category expansion because otherwise, they weren't going to be looking out a remodel just yet. So it's a way that we can get a unit in there without doing a full remodel.

Beryl Bugatch

Water Tower Research LLC

Jeff, that incident rate jump sounds really fantastic. Do you -- is it really moving the needle? Is it of a size yet to make a difference in the overall category? Or is it still too small?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

It's still in its early innings, but I'd say we're in the first -- bottom of the first. But I think we're seeing -- I believe it's going to be a material contributor to our business going forward. But the -- we're off a low base right now.

Beryl Bugatch

Water Tower Research LLC

Okay. And do you see much more in the way of M&A activity in that segment in that business unit in terms of additional dealers?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Yes, that's a good question. I think, look, we do have a unique model and our wholly owned installing distributor network is a really nice asset in this business. And we do see lots of -- there's a lot of opportunity out there for that aspect of our business. And we aren't -- we operate in tandem with our distribution, our independent, and it's always we -- but there's succession events, there's geographical expansions. So we absolutely have that in our quiver, and it's a focus of ours, and I do believe that would be something that you'll see more of down the road.

Beryl Bugatch

Water Tower Research LLC

Okay. Great. And last for me, I know commodity inflation, and particularly in steel was was unwelcome and had to be covered over the last post-covid period. Are we seeing some retreating there? And Marshall said, we're still seeing inflationary pressures, but I wonder if you can pinpoint where it is or maybe quantify what we're seeing in that.

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Yes, Budd. But so look, we're seeing inflation in 2 broad categories. The first one is wages. I would say that the wage inflation has moderated, but we're still seeing year-over-year increases like you do in any given year. And then there's a second bucket where there's kind of a broad set of commodities that are still under some pressure. A lot of that's carried over from the prior year. So we're seeing some inflation from those 2 buckets. That's been partially offset by lower steel costs. But the net of the 3 is that we're seeing inflation, roughly speaking, we're expecting input cost inflation to be up in the \$15 million to \$20 million range for the year.

Beryl Bugatch

Water Tower Research LLC

Got you. But like the return to seasonality, that's not significantly different than we see almost every year, which we cover with a small price increase once a year annually. Is that a fair way to look at it?

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Absolutely. That's very fair.

Beryl Bugatch

Water Tower Research LLC

Okay. Great. Thank you very much. And let me add my congratulations to Rex's. The margin performance is impressive. Thank you very much and good luck on 2023.

Operator

We'll go next to Ruben Garner at the Benchmark Company.

Reuben Garner

The Benchmark Company, LLC, Research Division

Â Maybe to start, you referenced profit improvement in workplace kind of in the face of the volume headwinds. Can you give any detail on exactly how much volume decline you can withstand with some of these changes or a way to think about decremental margins kind of ex the price cost and savings and productivity initiatives that you have?

Marshall H. Bridges

Senior VP & CFO

Yes, Ruben, we do expect to see volume improvement -- I'm sorry, profit improvement despite the lower volumes. I think maybe the way to answer your question is that we're roughly thinking that workplace volume for the year in terms of total top line would be down on an organic basis in the low to mid-single digits and that would be a big decline in the first half followed by some moderation in the second half. So under those conditions, we have enough profit support to drive our operating profit growth that we mentioned. In terms of decremental margins or incremental margins in the workplace, on average runs around 35%. And of course, we have offsets to help mitigate that. So really, the decremental margins for Workplace would not really be calculable, right? We're expecting lower volume, lower sales and higher profit.

Reuben Garner

The Benchmark Company, LLC, Research Division

Okay. And that low to mid-single-digit decline in Workplace. Last quarter, you talked about strength you were seeing in mid-market. That low to mid-single digit seems like a relatively modest decline relative to what the industry orders have been in recent months. Can you update us there? Is mid-market still outperforming? And is that kind of what gives you confidence that maybe you'll do something better than what we've seen of late.

Marshall H. Bridges

Senior VP & CFO

Yes, there's 2 things there, maybe to point out is, first of all, our orders in the fourth quarter when you exclude the restructuring of the e-commerce business and divestiture lanes were up 3%. So we did see fourth quarter activity that's in line with that expectation. Secondly, just to remind everyone that we saw a pretty significant step down in demand in the back half of 2022. So as we anniversary that step down, it's not that we expect a lot of demand growth where we are right now, but we'll certainly see lower comps that are going to be easier to compare against.

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Yes. And I think, Ruben, as I commented earlier, that the mid-market, for lack of a better term, is year-to-date is running up strong double digits. Presale activity points to continued strength there. And so we just believe the migration patterns and employment trends align with our strengths. And so that's really maybe offsetting some of the other areas of the business.

Reuben Garner

The Benchmark Company, LLC, Research Division

Okay. And then on the housing side, new construction, I think, is a little bit easier for us to get a handle on or at least kind of guess where the market is going. Can you give us any color on the R&R side of your business? How you expect that to hold in? Any kind of other puts and takes, whether it be share gain opportunities or any other drivers outside of the market specific to your fireplace business.

Marshall H. Bridges

Senior VP & CFO

Â I think Jeff mentioned a couple of the strategic growth initiatives that probably had a little more on the R&R side than they do on the new construction side. And as I mentioned earlier, Ruben, the R&R side is historically less volatile. So we're expecting new construction decline, like I said, in line with single-family housing activity and the existing home or remodel retrofit side of the business to be down less, expecting a little pressure in both sides. That's for sure, though.

Operator

We'll move next to Steven Ramsey of Thompson Research Group.

Steven Ramsey

Thompson Research Group, LLC

Sorry, if I'm repeating myself getting on a little bit late here, but I'm curious how much of your inventory currently is still carrying higher costs from inflation and how that works its way through the P&L early in 2023 to benefit margins? And maybe as a follow-on to that, how do you think about past generation this year and is working -- net working capital a tailwind there?

Marshall H. Bridges

Senior VP & CFO

Â Steven, the quick answer to your inventory question is that our inventory was essentially flat on a year-over-year basis. So we've normalized a lot of inventory that we brought in during 2022. So I don't -- it's not going to have a material impact on our margins. The second part of your question about working capital, that's a continued focus for us. We have used working capital for the last 2 years as we dealt with all the supply chain disruptions. We brought in some inventory to buffer against that. We are working inventory efficiency as well as overall working capital efficiency. As I touched on in our prepared comments, we expect to have more normalized working capital levels during 2023, and that should be a source of cash for us this year.

Steven Ramsey

Thompson Research Group, LLC

Â Great. And then thinking about cash generation for this year as well as a low leverage level, can you talk about cash deployment, the willingness to do acquisitions on the resi side of things in an uncertain period if people are willing to deal and how you think about share buybacks in the slower time period.

Jeffrey D. Lorenger

Chairman of the Board, President & CEO

Yes, Steven, we -- as I said just a bit ago, I think on the resi side, we are always kind of looking at the marketplace and trying to decide if there is what opportunities are out there. And we've shown an ability and an appetite to do that in the past, and that will continue as we see attractive opportunities on the resi side for sure.

Marshall H. Bridges

Senior VP & CFO

Â And in terms of our priorities, Steven, look, we expect to deploy capital. Historically, our primary objective is to invest in the business. We also look to maintain and modestly grow our dividend, and then we pursue M&A insurer purchase a case-by-case basis depending on conditions and opportunities, and we should continue to do that.

Operator

And we'll go next to Greg Burns at Sidoti.

Gregory John Burns

Sidoti & Company, LLC

Marshall, you mentioned the backlog normalizing on the building products side of the business, and that will kind of get the business more back to a normal cadence. Can you just talk about what historically the typical seasonality that business is? And I guess, maybe what you're expecting in terms of like the current demand trends there?

Marshall H. Bridges

Senior VP & CFO

Â Yes. So historically, residential building products sort of hit a trough in the second quarter and then builds in the back half and then it starts to decline again and then again, bottoms out in the same quarter. So that did not happen last year. Last year, if you look at our quarterly revenue, we were pretty consistent from quarter-to-quarter, and that's because the backlog buffered the seasonality. We had more demand than we really had capacity. And so we pretty much had the same revenue plus or minus a few percent

each quarter. So this year, in the first quarter, we're basically normalizing the backlog. So as we enter the second quarter, we're going to start to experience that typical seasonal debt as well as start to begin to feel the impact of the housing market declines.

Gregory John Burns
Sidoti & Company, LLC

Â Okay. And then you did talk about the improved profitability you expect on the Workplace Furnishing side of the business, but in total, I guess, with the \$80 million to \$85 million of savings you're projecting, do you expect to grow earnings next year?

Marshall H. Bridges
Senior VP & CFO

In Workplace Furnishings, we do expect to expand margin and grow profit dollars in the segment.

Gregory John Burns
Sidoti & Company, LLC

I mean on a consolidated basis, like are you going to be able to offset the declines in volume on the building products side of the business and generate consolidated earnings growth next year?

Marshall H. Bridges
Senior VP & CFO

Our expectation right now is that there's a pretty significant decline in residential building products, which is going to -- even though we're going to offset a good chunk of it with our actions, that the net impact of that is going to be more than the profit growth in workplace furnishing. So consolidated earnings, we expect to be down, just maybe not nearly as down as you might think given the amount of volume that was being declining.

Operator

And that does conclude our question-and-answer session at this time. I would like to turn the conference back over to Mr. Lorenger for closing remarks.

Jeffrey D. Lorenger
Chairman of the Board, President & CEO

All right. Well, thanks, everybody for joining us today. Have a great day, and we'll talk to you next time.

Operator

And this concludes today's conference call. Thank you for your participation. You may now disconnect.

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