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HNI Corp. (HNI)

Q4 2016 Earnings Call

CORPORATE PARTICIPANTS

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Chief Financial Officer & Vice President, HNI Corp.

Stanley A. Askren
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Kurt A. Tjaden
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OTHER PARTICIPANTS

Matt McCall
Analyst, Seaport Global Securities LLC

Kathryn Ingram Thompson
Analyst, Thompson Research Group LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Kelly, and I will be your conference operator today. I would like to welcome everyone to the Fourth Quarter and Year-End Fiscal 2016 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.

Jack D. Herring
Treasurer, Director of Finance and Investor Relations, HNI Corp.

Good morning. I am Jack Herring, Treasurer and Director of Investor Relations for HNI Corporation. Thank you for joining us to discuss our fourth quarter and full year fiscal 2016 results. Here with me are Stan Askren, Chairman, President and CEO; Marshall Bridges, Vice President and Chief Financial Officer; and Kurt Tjaden, Senior Vice President and President of HNI International.

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

Stanley A. Askren
Chairman, President & Chief Executive Officer, HNI Corp.

Good morning, everybody. We'll share a brief assessment of our 2016 result and provide some thoughts on our outlook for 2017. We'll then open the call up for questions.

Before I start, I'd like to take a moment to welcome Marshall Bridges. As we recently announced, Marshall has been appointed Vice President, Chief Financial Officer for HNI. Marshall has been with HNI for 16 years in variety of financial executive positions. And he possesses significant finance, business strategy and transactional experience and expertise. Marshall's succeeding Kurt Tjaden, who is promoted to President of HNI International, following the retirement of Marco Molinari. Kurt possesses a strong background and knowledge of the Asia-Pacific region, and we're excited about what he brings to that role.

I want to thank Marco for his 13 years of service and contributions. He did an outstanding job, and we're excited for him as he pursues the next stage of his life in retirement. I also want to thank Kurt for his role and great leadership as CFO. We are excited that we have such capable and experienced members ready and able to fill any of these critical roles, as we pursue development and succession for the corporation.

Now, let me shift back to look at our full year results. 2016 was another strong year. Our businesses performed well. We increased earnings and generated significant cash flow and increased our strong dividend. Non-GAAP gross profit margins have increased by more than 100 basis points for the third year in a row and have now improved year-over-year for 14 consecutive quarters.

We continue to make deliberate strategic choices to further strengthen our core foundation. This process is an extension of our Rapid Continuous Improvement philosophy and culture, which includes product simplification, design commonization, operational consolidation and significant productivity improvements. These actions that we've taken will continue to improve future profitability, while providing a stronger platform for growth.

During the fourth quarter, we completed the sale of Artcobell, a kindergarten-through-12th-grade education furniture company. Our divestiture of this business allows us to improve our focus on the core and will increase profits by nearly \$5 million per year. We learned a great deal from this experience, and we'll leverage those insights moving forward.

Let me pause a little bit here and expand on this Artcobell divestiture. We bought the company five years ago as an extension to our core. We periodically make these types of acquisitions to expand our frontiers. During my tenure with HNI, we've used the same strategy to build our Hearth business into a leader in their industry and a powerful economic engine for shareholders. We've done the same to build a strong and profitable contract furniture presence.

Some of these probes work, some do not. We had a thesis around Artcobell that we failed to realize. I called the question latter part of last year, and we are now moving on. It was not an inexpensive probe, but we learned a lot which we have incorporated into our core businesses.

In the future, when we see opportunities to invest money to extend our frontiers, we will do so. We will go. Not all will be successful. The connection of risk and reward continues to live. There is no reward without risk. We have a strong, but not flawless track record of taking calculated risk to drive rewards for our shareholders and customers and will continue to do so in the future.

Back to the comments, we made strong progress on our long-term core growth strategies with investments, and new products, and selling capabilities. Yesterday, we announced the consolidation of our hearth manufacturing

facility into existing operations. This difficult decision was another action on our never-ending journey to reduce structural cost.

Consistent with our long history, we continue to drive core productivity and pursue structural cost reductions in good times and in bad times. We feel good about our results and our improvements in earnings and profit margins. We entered 2017 a stronger company positioned to drive increased value for our customers and long-term profitable growth for our shareholders.

I'll now turn the call over to Marshall Bridges for some specifics on the fourth quarter.

Marshall?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

Thanks, Stan. For the fourth quarter, non-GAAP net income per diluted share was \$0.82 compared to \$0.91 in the fourth quarter of 2015. Consolidated net sales increased 2.6% to \$581 million and were down 4.3% organically. Sales for the Office Furniture segment decreased 2.3% or minus 4.6% organically.

Looking within our Office Furniture segment, sales in our supplies-driven business increased approximately 1% or decreased by 3% organically. Sales in our North American contract business decreased 2%, while sales in our international businesses decreased 24%.

In our Hearth segment, sales decreased 3.4%. Looking within the Hearth segment, new construction sales decreased 3%, sales of retail wood/gas products decreased 2%, and sales of pellet appliances fell 19%.

Non-GAAP consolidated gross margins increased 70 basis points to 38.6%. Labor and material productivity gains were partially offset by lower volume. Non-GAAP selling and administrative expenses increased 110 basis points, as result of lower volume and the impact of stock price appreciation on deferred compensation. The increase in our stock price resulted in a \$0.05 per share reduction to quarterly earnings.

Stan?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

So, as we look at 2017, we expect strong performance driven by top line growth and the continued benefit of structural cost reductions in business productivity improvements. We expect demand to start slowly and build throughout the year driven by an improving economy, investments in our new products, selling and fulfillment capabilities.

In Office Furniture, we expect mid-single-digit organic growth that will improve throughout the year. In Hearth, we expect continued growth in our new construction business, driven by single-family housing starts. We project modest improvement in a retail wood/gas business, while retail pellet appliance sales are projected to stabilize.

Marshall?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

Thanks, Stan. As we look into the first quarter of 2017, we expect consolidated organic sales to be down 3% to 6%, or minus 5% to minus 8%, including the effects of acquisitions and divestitures. Office Furniture sales are expected to be down 7% to 10% or minus 5% to minus 8% organically.

Within Office Furniture, sales in our supplies-driven business are projected to be down 7% to 10%, or down 5% to 8% organically. Sales in our remaining Office Furniture businesses are forecasted down 7% to 10% or minus 6% to minus 9% organically.

Hearth sales are expected to grow 1% to 4% versus the prior year. Within the Hearth segment, new construction sales are forecasted to be up 2% to 5%. We're projecting retail wood/gas sales to be flat to up 3%, and retail pellet sales to be flat versus prior year.

Non-GAAP gross profit margin, as a percentage of net sales is expected to be approximately 39%, which represents an improvement over prior year. Non-GAAP SG&A, which includes freight and distribution expense is expected to be approximately 35% of net sales. Our estimated non-GAAP earnings per diluted share for the first quarter is in the range of \$0.17 to \$0.24.

For the full year 2017, we expect consolidated organic sales to grow 3% to 6%. The net impact of small office furniture company acquisitions and divestitures will reduce sales by approximately \$80 million. As a result, total net sales are forecasted to be in the range of minus 1% to plus 2%. Office Furniture sales are expected to be up 3% to 6% on an organic basis. Sales in our Hearth business are expected to be up 2% to 5%.

We are projecting the full year 2017 tax rate to be approximately 34%. Full year free cash flow is expected to be in the range of \$100 million to \$110 million, including approximately \$110 million of capital expenditures. Our best current estimate of non-GAAP earnings per diluted share for the full year 2017 is now in the range of \$2.80 to \$3.15.

Stan?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

Okay. So, conclude, our businesses are strong, well-positioned for the future. We continue to see attractive investment opportunities that will deliver strong financial returns in the future. I remain confident in our ability to drive long-term shareholder value.

With those comments complete, we will now open it up to questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Budd Bugatch from Raymond James. Your line is open.

Q

Good morning. This is [ph] David (11:39) on for Budd. Thank you for taking my question. My first question is on how much of your revenue in Q1 of 2016 was from Artcobell. I'm trying to get an idea of what the base should be to apply the organic growth to?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

[ph] David (11:59), for the year, Artcobell is approximately \$50 million of sales. And in Q1, it's much smaller than the annual rate would be. It's about \$6 million.

Q

Great. Thank you. And in Q1 and for all of 2017, what are you seeing, and what are you assuming for headwinds from raw material? When are we going to start to feel that? And is there any plans of a price increase to help offset that?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah. We are starting to see moderate signs of inflation for 2017. Just like to remind you that about half of our input costs are on contracts in which we lag spot prices, so we'll see the impacts of that as we go through the year. We're basically seeing around 4% on input costs. And we do expect to input productivity increases and price increases to offset that.

Q

Got it. And typically, price increases are earlier on in the year versus later. Is that how it's drawn historically?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yes.

Q

Okay. Great and then, last question, in terms of price competitiveness in the contract Office Furniture channel, what are you seeing there? Is it more competitive on pricing, and what's the trend?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

I would say, the trend is stable, [ph] David (13:30). If you look at the contract furniture industry, there are periods, market-by-market, quarter-by-quarter, where it kind of ebbs and flows. Got a little bit more intense, I think, last fall, just I think demand, supply, local skirmishes. Seems to us that it's stabilized. I don't think there's any significant trends that we need to communicate, or you need to be worried about further deterioration. We are always well-positioned with our sort of focus on cost and our cost structure to respond to those moves. We are in good shape. [ph] If we need to respond (14:12) to those. It's not a challenge or not a big issue for us.

Q

Great. Thank you very much for taking my questions.

Operator: Your next question comes from the line of Matt McCall from Seaport Global Securities. Your line is open.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Thank you. Good morning, everybody. I guess, first, congrats to Kurt and to Marshall; and I think, Jack has a new title, so congrats there, too; and Stan for the bench strength. Congratulations for all the good news for everybody.

So, let's see, first, maybe talk about the assumed acceleration. I mean, it's early days, but there's obviously some nice acceleration in demand assumed in the outlook. Can you just give us some of those indicators that are giving you comfort to forecast that?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Sure. So, Matt, first, we're counting on a bit of an economic uptick. Why? What are we feeling there? A significant portion of our business is driven by small business confidence. And it feels like, to us, that even though there's lots of volatility, and lots of crazy press, and lots of crazy stuff going on that, overall, small business is going to feel more confident, therefore, going to invest more, therefore, it's going to drive further true events.

As far as what we're seeing now, hearing that from our dealers are more optimistic and talking about increased activity. We're seeing a modest increase in our activity quote levels, bid activity, and just sort of overall sales momentum. And so, we're simply saying, it feels to us like we should see the overall economy up.

And then finally, we've gone through a period of pruning and cleaning up the portfolio, at the same time investing. And we believe that we'll see the return on those front-end investments, which include product, selling resources, distribution, programs, those sorts of things as well.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. And so you said you're seeing some of the quoting activity picking up. Do you think, and I've heard this before, that maybe there's a bit of a pause or hesitation around some of the tax policy, and what's going to happen with CapEx expensing and things like that? Are you hearing that from your customers? And should there be some clarity, could we see a pretty quick acceleration in some of this activity turning into orders?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah. We're not hearing that specifically, Matt. I'm not reading that same speculation, but I think that's a pretty fine point for sort of our filters to pick up. And I think it's a really interesting sort of time around what's going on here. And who knows how it's going to work out. We're, as we said, forecasting it to go up, position, prepared if it doesn't to sort of react like we always do.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. So, I guess, keeping with that theme, can you talk about your import exposure from a cost of goods perspective? Well, there's clearly some folks that are looking to that and trying to ascertain the risk associated with any type of change in the tax policy. Where's your exposure? How great is it?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yes. It's an interesting question, so I'm going to use your question, Matt, if you're okay to expand a little bit on how we feel about this potential for border tax or whatever. We're okay with that. We do import components from China, from Asia, other parts of the world. It's not a huge exposure. It's relatively moderate. By the way, we have the ability to domestically source or domestically produce a lot of those components.

Quite frankly, we have a significant project underway to develop manufacturing capabilities specifically around, seating, et cetera. Before this whole sort of political phenomenon has happened, really to in-source or to resource or backsource, seating made in America for our largest customers. So, we can play this either way. I think we're in a good spot regardless of where it goes with our domestic manufacturing capability, along with our offshore sourcing. And so, I can paint a picture either way that it'll be fine, maybe good, either way as we think about it.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. So, looking at it, as a percent of cost of goods is kind of meaningless, because you'd be able to adjust if you need it?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

That's a good way of thinking about it, Matt.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. Two more for me. So, as you talked about the plan or the targeted doubling of earnings over the next three to five years, I think you said that last year, was the Artcobell sale in that plan?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

That plan is a commitment, an objective, a very attainable aspiration, and so we don't [ph] parse in that finally (19:39). I mean, if you look at the actions we've taken, the Artcobell is relatively small and sort of the structural cost reductions. And so, you can add it on. It wasn't specifically in there. There's a lot of other bigger things, I think, that sort of make it look rather small, to be honest with you.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. And then when you look across the remaining businesses, I'm sure you have a range of profitability across and maybe not as extreme as Artcobell, but are there other Artcobells out there, where the thesis has failed or they haven't met your expectations, or was that kind of an extreme example?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah. I mean, we always are thinking about -we have a pretty disciplined process to look at our portfolio, Matt. And so, Artcobell was a very deliberate probe. And when we did it, we said, this is a probe. The profitability of that K-12 classroom furniture has been challenged. Our hypothesis was we can bring cost efficiency to this and create a profit pool that currently doesn't exist. And we found that we were not able to do that for all sorts of factors. And so, it was really a standalone probe that stood out.

Now, we are always cleaning up our portfolio, and there, well, we look at it and say, look is this business have a long-term strategic bid? Is it strategic, important? Is this something that we can generate a fair return for our shareholders over time? Is this something that our largest customers want from us and value from us? And we constantly are running those streams and some businesses come, some go.

I wouldn't say there's anything that stands out right now like Artcobell. If there was, and if there is, then we'll take action. We're pretty patient, by the way, about trying to make stuff work and fix it, but we're also - I've learned in my career that if you can't make it work after about five years, then you ought to just take the bitter pill. And this is a bitter pill for us both as a company, for shareholders and for us, even financially, as executives. You take the bitter pill, you move on, you apply the lessons learned and don't look back too much. Just keep leaning in into how do we continue to extend the frontier, get more profit from the core, then pick up these adjacencies when they make sense.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. All right. Thanks. Sorry Kathryn. One more, I'm going to sneak in. Since Kurt's in the room, and you're in a new role. I'd like to hear your voice and maybe get an update on the plan internationally. It's a tough quarter, but obviously, it's one quarter. But just kind of give us an update on changes you're going to make or plans you have.

Kurt A. Tjaden

Senior Vice President, President, HNI International, HNI Corp.

A

Well, I think, Stan said well. Marco did a fantastic job of building a strong foundation in that business. It's a long-term growth platform for us. It's two key markets, I'll remind you, around China and India. So, this is a continuation of strategy and a continuation of that growth opportunity. And I'd say, stay tuned, and you'll hear more from Stan and Marshall over the years.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

Q

Matt, I'm looking for some brilliant input and ideas from Kurt Tjaden.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

All right. I'm sure you're going to get them. All right. Thanks, guys.

Operator: Your next question comes from the line of Kathryn Thompson from Thompson Research Group. Your line is open.

Kathryn Ingram Thompson
Analyst, Thompson Research Group LLC

Q

Hi. Thank you for taking my questions today. And also, Matt, back at you. Shout out for you, start-up at Seaport. Good luck there.

So, first question, just really more of a clean-up with Artcobell, following on from Matt's question. We know that you do this process occasionally, where you look at particular assets and whether it makes sense to keep within the company. But help us understand what's the process, what's the process, what's the logic for the trigger to start that analysis? Because that will be helpful for us to think about future assets you have that may not make sense in your portfolio.

Stanley A. Askren
Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah. Kathryn, we're always looking at these businesses. We run this split and focus sort of strategy, and we look at individual P&L. And then we spend lots of time with the operating companies talking about strategy and what does their customers need, and what are logical extensions, and what are the acquisition opportunities? Is it make-versus-buy probe? And then we run up, and then we do constant evaluation.

And I talked about Hearth. We've done this at Hearth for years. We've done this in the contract. And most all of those started off as sort of challenged, troubled acquisitions. And it's sort of plan-do-check-adjust, plan-do-check-adjust. And sometimes, we conclude this like, look, we're not making enough progress; the hypothesis around the strategic fit has changed; the industry dynamics have changed, blah, blah, blah, and then we take action.

So, it's not like we have a season that we look at all these and act on. It's an ongoing consistent dialog with the operating companies. It's an ongoing consistent dialog with my corporate group as to what makes sense and what doesn't. Probably similar, the way you manage your investments, I would guess, is you look at your portfolio, you decide what mix you want, you decide whether somebody's got a prospect to getting better, and every now and then, you stop and say, no, this isn't a good bit. I'm going to take my losses, and I'm going to move on. And I think it's a similar process for us.

Kathryn Ingram Thompson
Analyst, Thompson Research Group LLC

Q

Yes, understood, although there are some times when look at an investment, and there's a catalyst to make that quick decision.

On the guidance, just following up again on earlier questions on that build throughout the year. If you were to weight it for your businesses, assume that growth is not necessarily driven by Hearth and would be disproportionately influenced by supplies also relative to contract. That's our assumption, is that correct? And maybe any other color in terms of what – we understand the small business confidence, but on your Office side, maybe a little bit more color on the different segments within Office that will be driving that guidance upside?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Kathryn, the growth prospects, we're expecting growth across all the businesses. So, there is growth in Hearth. As it relates to Office Furniture, we're seeing relatively similar outlooks for both the supply side and the contract side, albeit maybe just a tad more growth on the contract side. So, I hope that helps. And we'll look at more questions on that.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

That's helpful for that. And also, could you give any color on what you're seeing in terms of orders or backlogs, or in terms of size as the quarter progressed? And really maybe more color even into earlier this year. What's driving this question is what we're seeing particularly with large contractors as projects that were left on the shelf are being put back out on the market, which is a change in trend that we've seen with our industry survey. So, wondering, are you seeing any type of change in project size and pace of orders?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

I would say, Kathryn, first off, that's encouraging to hear your comment. We're seeing a little bit of that. I would say, as we look forward, consistent with small business confidence and where we historically play is likely to see more of the small to medium-sized project activity, less of the large project activity. Just, again, based on sort of economic dynamics and based on our strategic position and our history in Office Furniture.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. Great. Thank you very much.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

All right. Thank you.

Operator: And there are no further questions. I pass the call back over to the presenters for closing remarks.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

Well, we thank everybody for taking the time to tune in. Wish you all the best in the future, and we'll talk to you soon.

Operator: And this concludes today's conference call. You may now disconnect.

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