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HNI Corp. (HNI)

Q4 2017 Earnings Call

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OTHER PARTICIPANTS

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Greg J. Burns
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Steven Ramsey
Analyst, Thompson Research Group LLC

Katherine West
Analyst, Raymond James & Associates, Inc.

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 HNI Corporation Fourth Quarter and Year End Fiscal 2017 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.

Thank you. 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 fiscal 2017 results. Here with me are Stan Askren, Chairman, President and CEO; and Marshall Bridges, Vice President and Chief Financial Officer.

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, everyone. I'll share a brief assessment of the fourth quarter and then turn the call over to Marshall Bridges who will review some of the specific financial details and then I'll come back on and share some thoughts on our outlook and then Marshall and I will open it up for questions.

So to start, our fourth quarter played out as expected. We stabilized our supplies-driven business and made strong progress working through our operational transformations. We delivered solid organic sales growth and are excited about our market momentum. I'd like to take a moment to reflect on the year.

2017 was a year of transition. We confronted multiple challenges, some planned, some not. We dealt with rapid and significant changes in our markets. We took on large scale transformations involving our operational network, fulfillment models, business portfolio and our enterprise system. In short, we responded to our challenges, made investments, and adjusted our business to better deliver long-term profitable growth.

I feel good about where we're heading. We're nearing the end of our transitions. The investments we made put us in a position to drive new levels of productivity and take advantage of improving market demand. Our most significant investment has been our Business System Transformation initiative, we call it BST. I'm pleased to report we've successfully switched over to our new ERP platform earlier this month. This new platform is a key enabler for long-term value creation. And I'd specifically like to take a moment to thank the numerous members who have been involved in this project for their significant effort, dedication and success in helping us achieve this key milestone.

Our supplies-driven business is still in transition but stabilizing. We have a clear vision for how this business move forward and we're building out strategic capabilities. This includes a focused effort around dramatically lowering the effort required to buy office furniture and making the whole process more convenient and easier for sellers and customers.

During the quarter, we made the difficult decision to close our Paoli business. This decision was part of our continued efforts to drive portfolio efficiency and simplification. We will continue to serve these market requirements through product offerings from the broader family of HNI brands.

I'm excited about our future. Our office furniture businesses have momentum in the market and delivered 8% organic sales growth in the second half of the year. Our hearth business continues to perform very well with solid growth and record probability.

I'll now turn the call over to Marshall Bridges, our Chief Financial Officer, to review some financial details for the fourth quarter and then I'll return to discuss our views on 2018. Marshall?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

Thanks Stan. For the fourth quarter, consolidated organic net sales grew 3.7% versus the prior year, when including the impact of acquisitions and divestitures, sales increased 0.5%. In the office furniture segment, sales increased 3.2% organically or minus 1% in total. Within the office furniture segment organic sales in our supplies-driven business were flat or minus 4%, including the impacts of divestitures. Sales in our contract and International businesses increased 7% organically or plus 2% in total.

In the hearth segment, sales increased 5.1%. New construction sales increased 6%, sales of retail products including wood, gas and pellet products increased 4%.

Non-GAAP net income per diluted share was \$0.47 compared to \$0.82 in the fourth quarter of 2016. As expected the earnings decline was primarily due to lower profitability in our supplies-driven business which mainly resulted from increased strategic investments, higher input costs and an unfavorable business and product mix.

Okay. I'd like to take a moment to provide some color around some several non-recurring items we recorded in the fourth quarter. You can follow this in our GAAP to non-GAAP reconciliation contained in our press release and also in the earnings presentation posted on our website.

The biggest of these items was the impact of the recent tax legislation which drove a positive \$44.8 million revaluation of our deferred tax liabilities. We had \$20.9 million of impairment charges and a \$4.8 million loss on disposal of assets, both of which were primarily driven by our decision to close the Paoli brand.

We incurred restructuring and transaction costs of \$9.8 million related to the final stages of our structural cost reduction initiatives and we recorded a \$10.3 million valuation allowance on the long-term note receivable. The net impact of these items was a \$0.30 benefit to earnings per share which we excluded from our fourth quarter and full year non-GAAP results. Stan?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

So 2018 will be a return to profitable growth. We will conclude our operational transitions and deliver better benefits from core productivity improvements and structural cost reduction. Our profitability will improve over the course of the year. The supplies-driven market will continue to be dynamic. We're seeing stabilization in the wholesale channel.

Overall, we're expecting growth from our supplies-driven business both in top-line and profit. We continue to hold a unique competitive advantage which no other manufacturer can match. Our brands, products fulfillment capabilities provide unparalleled value to our resellers and to our customers.

Our contract driven businesses have strong momentum which we expect to carry through 2018. We are winning across multiple fronts, shrinking distribution expanding our product offering and deepening our relationships with key influencers.

The hearth business continues to deliver record results. We remain optimistic about growth in the hearth business as single-family new home construction remains strong and the remodel retrofit market expands. We remain a strong company with leading market positions and the financial capacity to aggressively pursue profitable growth for our shareholders. I anticipate 2018 to be a good year for HNI.

With that, I'll let Marshall provide some details on our outlook.

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

Okay. Let's start with the first quarter. We feel good about 2018, but the first quarter profit will be a low point for the year. When you are projecting strong organic growth of 5% to 8%, this will be more than offset by several factors. First, we'll have \$9 million of incremental costs related to our BST project in the form of amortization, support and switchover costs. Second, we're seeing a continuation of the unfavorable business mix, we experienced over the second half of 2017. When combined with inflation, we expect a negative \$10 million to \$12

million price cost gap. Third, we expect to see higher SG&A expenses of \$6 million to \$8 million, primarily driven by investments including our direct fulfillment initiative.

Additionally, the benefits from our transformations will not yet be fully realized. We expect these trends to reverse as we move through the year. We expect consolidated first quarter organic sales to be up 5% to 8% or up 2% to 5% when including the effects of divestitures and the closure of the Paoli brand. Office furniture sales are expected to be up 6% to 9% organically or up 2% to 6% in total. Sales in our supplies-driven business are projected to be up 7% to 10%. We're forecasting sales in our contract office furniture businesses to be up 7% to 10% organically or down 2% to up 1% in total.

We expect hearth sales to be up 1% to 4%. Within the hearth segment, new construction sales are forecasted to be up 2% to 5%. We're projecting retail hearth sales to be flat to up 3%.

Non-GAAP gross profit margin is expected to be similar to our fourth quarter result of 36.1% of net sales. Non-GAAP SG&A, which includes freight and distribution expense, is expected to be just below our fourth quarter level and be approximately \$174 million.

The impacts of the recently enacted tax legislation are included in our estimate. We expect our tax rate will be approximately 19% to 20% in the first quarter and 23.5% for the full year. Our estimate of non-GAAP earnings per diluted share for the first quarter is in the range of \$0.01 to \$0.06.

So now let's shift gears and talk about the full year, we expect to see improved earnings. We estimate non-GAAP earnings per diluted share will be in the range of \$2.40 to \$2.80. This is based on a 5% to 8% consolidated organic sales growth or 1% to 4% in total. We're expecting our office furniture businesses to deliver organic growth of 4% to 8% with our hearth business up 3% to 6%.

The impacts from the recently enacted tax legislation are included in our estimate. For the full year, the impact of the tax legislation will reduce our estimated effective tax rate to 23.5%. We expect full year free cash flow to be in the range of \$100 million to \$120 million, which includes estimated capital expenditures of \$75 million to \$85 million. Stan?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

Okay. Thank you Marshall. With those comments complete, we'll now open it up to questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from Matt McCall from Seaport Global Securities. Please go ahead. Your line is open.

Matt McCall

Analyst, Seaport Global Securities LLC

Thanks. Good morning, everybody.

Q

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

Hello.

A

Matt McCall

Analyst, Seaport Global Securities LLC

So, the full year outlook, Q2 through Q4 look really strong. Can you – you gave a little detail there about the top-line. Can you talk about the margins you anticipate and I'd love some detail from a segment perspective, if you could just what kind of margin assumptions are in that full year guide?

Q

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

Matt, for the full year 2018, we're expecting to reach record level gross profit margins in the 39% kind of range and that's really driven by two major factors, the growth that we're expecting the leverage from that as well as structural costs and net productivity improvements.

A

Matt McCall

Analyst, Seaport Global Securities LLC

Okay. Okay. Any commentary about SG&A for the year, Marshall?

Q

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

We are expecting SG&A to be up a little bit over prior year, including pre-distribution expenses it should run in the kind of 32% of net sales range.

A

Matt McCall

Analyst, Seaport Global Securities LLC

Got it. Okay. All right. So, the outlook you gave for hearth and you gave detail on this sub-unit I guess, when you talked about retail being flat in Q1 as we look at the cold weather in the country and the rising heat and oil prices, I guess the anticipation was that there'd be some more positive commentary around the retail side of the hearth business, any reason that that some of those trends are being offset?

Q

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

We're performing well there, Matt. So, you may be right, but there's all sorts of – its location by a regional sort of differences, there's dealer inventory et cetera. So our best guess right now is flat, but we like cold weather a lot.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Right.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

We like to get cold-warm-cold, because it takes two events to really rock the consumer off their procrastination to get them moving on and buying a hearth appliance. So you could be right.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

But I mean, I recall the last time we saw this, the growth rates were 50%, if I remember correctly. So, I mean nothing that's indicating that type of growth. I know it's a small part of the business today, just because of some of the weakness the last couple of years, but no indication that you're seeing that type of inflection.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Our best guess at this point is flat.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. That's fair. You mentioned product line expansion in office furniture. You guys don't go into too much detail on the product side, but can you provide a little bit more detail about what you're doing and I know – because there're so many questions about what's going on from a product perspective and a customer demand perspective and how those shifts are occurring, and the impact it's having on the industry. Can you just talk about what you're doing and maybe how you are addressing some of those shifts?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, I think, Matt, we're really talking about new product introductions and you said it the office is changing, moving from traditional products to more open collaborative sort of spaces, casual, soft seating is a major initiative for us. We continue to expand our walls business moving from traditional panel to more desking type solutions, sit/stand solutions, more seating solutions and different value profiles, sort of from the entry level values side and supplies, all the way up to the high-end. And so it's – as you know, Matt, we're a pretty broad and pretty deep company, and so you're seeing this virtually in all of the companies, all of the categories, all of the price points, just adapting and shifting to this new office.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. All right. That's fair. And then I guess one more. Marshall, on your Q1 outlook, you talked about the SG&A increase on a year-on-year basis and a lot of that was around the direct fulfillment model. Did I really say that the spending is going to kind of moderate post Q1 and the two elements that we've talked about in the past are not

only spending, but the return of the revenue? I mean, do you have any visibility into how long the spending – the elevated spending investments going to occur and when the revenue should return?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah, Matt. I think the first quarter is a period of investment. There I think you're referring to the direct fulfillment and yes, there is still investment going on in the first quarter and we expect that to moderate as we move through the year, as well as see some ramp-up in volume. But the volume is not something we have a clear view of right now that we're willing to share.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. Thank you, guys.

Operator: [Operator Instructions] Our next question comes from Kathryn Thompson from Thompson Research Group. Please go ahead. Your line is open.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

Good morning. This is Steven on for Katherine. I guess to think about the office unit first. Is the supplies mix of office sales still near the 50% level?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yes, basically.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

Okay. And then even thinking beyond 2018 or from a philosophical view on the supplies business, do you view this as a growing unit for you or is this once the investments in the shift has made over the next few quarters more of a cash flow run asset for you?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

We see this as a growing part of the business. We are – just overall the market is looking for better value, performance through price, looking for more convenience, looking for an easier selling process. We're uniquely positioned. We've invested aggressively. We have a long legacy of serving that market and as we have dealt with, the wholesale channel shift, I think we've put in place more direct fulfillment models for our dealers and the large national supply dealers. And I think that will serve us well as that market continues to grow. I think we're in a unique competitive advantage, a unique position.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

All right. And then on the contract side of things, could you discuss the sales trends on your legacy office products and new products and anything you would call out there not only in Q4, but looking back over the last year or two?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

We don't really have anything to call out specifically there, Steven. I think our – the sales trends are solid for our legacy products. Obviously, we're introducing new categories of products and expanding where we need to, but I don't think there's anything specific or unique to call out.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

All right. Thank you, guys.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Thank you.

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

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Morning. Can you just please talk a little bit more about the rationale of closing the Paoli brand and maybe just a little bit more color on how you look at some of your other brands, are you reviewing any of your other brands for maybe sale or closure?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Well, the answer Greg is we – like all smart business people, we try to look at the portfolio and over the years you make choices around brands and channels and portfolios and product categories and Paoli has been a great company for us. We just felt like due to the changing Abbas due to sort of where they're positioned where some of our other brands and product categories position, it was just best to go ahead and take that business another direction to exit that business. We have that coverage through other brands and through other channels. And so we're always looking at our portfolio and thinking about where do we add, where do we delete, similar to you and your investment portfolio.

We're always thinking about what's the future? Is there a future here, is it generating return or not and then we move accordingly. And so we've gone through a period of cleaning up our corporate portfolio. I think we're in really, really good shape right now for the near-term for the foreseeable future around how we're positioned and what's in the portfolio and what's not, to answer you more specifically.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. Can you give us a sense of maybe the accretion from that divestiture?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah, sure. Greg, the closure of the Paoli brand will add approximately \$8 million of profit to 2018.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. Thanks. And last quarter you had called out some of your structural cost saving initiatives were maybe taking a little bit longer to achieve. Have you gotten your hands around the projects that were causing the problems and do you feel good about getting that \$15 million of those structural cost savings in 2018 that you talked about last quarter?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, I think Greg that's what we meant included in those comments about largely completing those transitions and the business stabilizing. So the answer is yes, we do feel good that we have a handle on those. Now it's going to take a while to get – I think that 2018 results reflect that. First quarter is going to be a low point and then we're indicating that it's going to improve as we go through the year and as Marshall indicated, we should be at or near record gross profit levels and that includes getting a handle in resolving these transition issues.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. Thank you.

Operator: [Operator Instructions] Our next question comes from Budd Bugatch from Raymond James. Please go ahead. Your line is open.

Katherine West

Analyst, Raymond James & Associates, Inc.

Q

Hi. This is Katherine West on the line for Budd Bugatch. I just got a question kind of on that record gross profit number that you're estimating. When you move the supplies channel business to more to direct-to-consumer model, can you walk me through kind of what the margin will or the incremental margin difference there? And kind of what kind of factors into that gross profit obviously some cost savings, but – and how do you deal with steel inflation there?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah, Katherine, our gross profit improvement is really driven by the volume leverage that we're expecting in the organic growth and then that significant productivity and structural cost reduction that we're expecting in 2018. So the business mix shift is not a major story there. As it relates to inflation, we do expect to see some inflation kind of maybe in the 3% range and we expect to offset that with price realization.

Katherine West

Analyst, Raymond James & Associates, Inc.

Q

Okay.

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

So, we do expect to have a minimal price-cost gap.

Katherine West

Analyst, Raymond James & Associates, Inc.

Q

Also a follow-up question, you have some strong revenue guidance for the office furniture business, just kind of what you are seeing in the pipeline and just general industry demand there, you don't mind?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Well, I think as we indicated, we've reported some solid numbers in both segments of our office furniture business, so we see supplies stabilizing. We are excited about what we're seeing specifically in the dealer channel and I would say our wholesale sort of business has stabilized. And so, we see positive trends there. I think that's underlying sort of an overall economic – more positive economic climate uptick.

And then second, we finished the year, the second half of 2017, very strong in the contract segment. We continue – we expect that momentum to continue both large projects and small projects and day-to-day business. And so it's just kind of across the board, I would say and I think the – we had positive momentum rolling into 2018, I think the more positive economic environment helps that. Let's just hope that keeps happening.

Katherine West

Analyst, Raymond James & Associates, Inc.

Q

All right. Thank you.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Thank you.

Operator: And there are no further questions at this time. Thank you for joining. This concludes today's conference call. You may now disconnect.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

All right. Thank you so much for joining the call. We'll talk to you soon.

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