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HNI Corp. (HNI)

Q4 2019 Earnings Call

CORPORATE PARTICIPANTS

Matthew McCall

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

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

OTHER PARTICIPANTS

Gregory J. Burns

Analyst, Sidoti & Co. LLC

Steven M. Ramsey

Analyst, Thompson Research Group LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Tiffany, and I will be your conference operator today. At this time, I would like to welcome everyone to the HNI Corporation's Fourth Quarter and Year-End Fiscal 2019 Results. All lines have been placed on mute to prevent any background noise. 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.

My name is Tiffany. 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 2019 results. Here with me are Jeff Lorenger, Chairman, President and CEO; and Marshall Bridges, Senior Vice President and CFO.

Copies of our financial news release, earnings presentation and non-GAAP reconciliations are posted on our website. Statements made during this call that are not strictly historical facts are forward-looking statements, which are subject to known and unknown risk. Actual results could differ materially. The earnings presentation posted on our website includes additional factors that could affect actual results. The corporation assumes no obligation to update any forward-looking statements made during the call.

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

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

Thanks, Matt. Good morning, everyone. We will share our assessment of the fourth quarter, giving you detail around what met or exceeded our expectations, and what did not play out as we had anticipated. We'll then

provide some thoughts on our outlook for 2020. Finally, we will open up the call for your questions. Our teams delivered a strong fourth quarter. We generated our best top line growth rate of the year and expanded operating margins despite choppy demand and tariff challenges.

Our annual productivity and cost savings initiatives continued to gain momentum and drive improved profitability. Overall, our results show the performance our organization can drive, and I'm optimistic about what we can accomplish in the future.

We grew fourth quarter non-GAAP earnings per share by 16% year-over-year, and we came in at the high end of our guidance range. I would like to highlight the following three items that came in, as, or better than expected. First, we delivered strong cost and expense control. Gross margin and SG&A as a percent of sales were both better than we had expected. Our fourth quarter EBITDA margin was the best in over 15 years. Our teams delivered strong margin improvement and we expect solid gross margin expansion in 2020.

Second, Contract furniture revenue grow – grew in line with our outlook. The broader furnishings environment remained solid. We are investing heavily in areas that will drive future growth and improve margins, and we are forecasting continued furniture segment growth in 2020, but also expect conditions will remain choppy.

Third, free cash flow was strong and better than expected. In 2019, we generated \$153 million of free cash flow compared to our initial plan of \$130 million to \$140 million. We returned \$136 million to investors through share buyback and dividends and we reduced our debt levels by \$75 million, representing a 30% improvement. Our balance sheet is in excellent shape and along with our free cash flow expectations; it provides capacity to support our strategic growth initiatives in 2020 and beyond.

There were two items in the quarter that did not play out as we had anticipated, neither of which derail our longer-term view. First, revenue in the hearth segment fell short of projections. Our new residential construction business ramped up more slowly than expected. However, we are encouraged by the improvement in single-family home construction and have multiple initiatives underway to drive growth in 2020.

Second, growth in our supplies-driven office furniture business was below expectations. That said, supplies did grow 9% year-over-year in the quarter, which was a significant improvement compared to the first three quarters of 2019. We had forecasted more growth. Our shortfall was driven by lower than expected e-commerce holiday sales. It is important to note that e-commerce was up 50% compared to the prior year quarter and we continue to see – we continue to see strong growth in 2020.

As we look to 2020, we expect solid profit growth. We will achieve this while significantly increasing our investments in strategic growth initiatives, which will drive sustained revenue growth, margin expansion and free cash flow generation over the next three to five years.

I'll now turn the call over to Marshall to provide more details about our 2019 yearend results and our guidance for 2020. Marshall?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

Thanks Jeff. Fourth quarter consolidated organic sales increased 3.9% versus the prior year to \$616 million. Including the impacts of closures and divestitures, sales were up 3%. In the office furniture segment, organic fourth quarter sales increased 5.9% year-over-year. Within the office furniture segment, supplies-driven revenue

increased 9%, contract sales were up 3% organically. And we generated strong profit growth in office furniture with fourth quarter non-GAAP operating income up 39% versus the prior year.

Hearth product segment sales decreased 1% year-over-year, within the hearth segment new residential construction revenue was down 1%. In sales of remodel and retrofit products also declined 1% year-over-year. We also showed strong profit improvement in the hearth segment, Hearth non-GAAP operating profit increased 9% versus the prior year quarter. Overall, the fourth quarter gross profit margin expanded 50 basis points year-over-year to 38%. Non-GAAP operating profit grew 12% versus the prior year quarter and non-GAAP operating margin in the fourth quarter expanded to 80 basis points to 10.5% of net sales. Non-GAAP net income per diluted share was \$1.12, representing a 16% increase versus the \$0.97 reported in the fourth quarter of 2018.

Below the line, we benefited from reduced debt levels and continued share buyback activity, as expected. This drove approximately \$0.03 of our total \$0.15 of non-GAAP EPS growth versus the prior year.

Okay, let's shift to our 2020 outlook. For 2020, we are forecasting the following, revenue of \$2.30 billion to \$2.35 billion. That represents total year-over-year growth of 2.5% to 4.5%. We're also forecasting diluted earnings per share to be in the range of \$2.60 to \$2.90. From a segment perspective in 2020, we expect revenue in office furniture to be at 2% to 4% and hearth products to be up in the 4% to 6% range. We expect gross margin to expand 70 basis points to 90 basis points versus the 37.1% we generated in 2019. Operating margin expansion is expected to be at least as we ramp up our growth investments.

One comment on seasonality as you're modeling the year, we expect our quarterly earnings progression in 2020 to follow the pattern we've seen over the last two years. That means we'll generate most of our profit in the second half and have minimal first quarter earnings.

Finally, a quick note on the coronavirus. We are expecting the coronavirus to negatively impact us. The situation is obviously dynamic, but based on what we currently know; we estimate that coronavirus will reduce sales in the PRC and Hong Kong, and lower consolidated 2020 sales growth by approximately 1 percentage point. That impact is included in our guidance and we'll update you as the situation develops and evolves. We also have exposure to China on the cost of goods lines through our global supply chain. At this point, we're not expecting a significant impact there.

Jeff?

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

Thanks, Marshall. To summarize, we had a strong finish to 2019, demonstrating the results our organization can drive. We expect solid profit growth in 2020, while significantly increasing our investments to drive sustained revenue growth, margin expansion and free cash flow generation over the next three years to five years. Our teams continue to manage well. I would like to thank all of our HNI member owners for their continued commitment and dedication.

With those comments complete, I'll open it up for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from the line of Greg Burns with Sidoti. Your line is open.

Gregory J. Burns

Analyst, Sidoti & Co. LLC

Q

[ph] There seem to be (00:09:33) a bit of mixed results among the peer group, obviously you had a pretty solid quarter both sides of the office furniture business. But maybe can you just give us your view on the macro, any changes in the demand environment particularly on the contract side of the business? And maybe if you could give us maybe a little bit of color on order growth rates or order patterns and you know how they're shaping up in the early part of this year?

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

A

Yeah, sure Greg. You know on the macro kind of demand environment, you know in the office side, the cyclical drivers are mixed there. I'd say they're better than they were six months ago, had that slow patch – it started out pretty good January through May we had kind of a negative slow patch in late summer and then we saw kind of firm up as we exited the year. I mean you look at the major drivers we tend to look at CEO confidence. It was down, but it's recovering.

Office worker and employment is growing. It supports kind of our outlook for 2020. Interestingly enough, small business where we have disproportionate exposure was kind of flattish in 2019. And then the office continues to grow, office construction you know there's still activity there. Small business confidence is still at historically high levels. So overall kind of at a macro level, you know it's kind of firmed up for us a bit. I would expect the demand patterns to be solid. And you know I still think there's going to be some choppiness out there just given all the different currents kind of falling back and forth.

Gregory J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. Thanks. And then looking into 2020, obviously you're still projecting some operating leverage but maybe a little bit less so than we saw in 2019. You mentioned putting some money to work on some various growth initiatives. Can you give us a little bit more color on what exactly those are, where you're spending putting your money to work and are there any larger ones in particular that we should be focusing on?

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

A

Yeah. You know we are if you go back a couple of years, Greg, we went through this ERP implementation. And you know despite the fact that it went well and we came through that, it was still disruptive. And so we've – we're now through that and we're starting to see the benefits, number one, and now we're going to start to add to those. So we're looking at three areas primarily if I keep at high level. One is office furniture in general. You know we're ramping up across the board – across the board in the furniture business. The new product pipe is strong. We're accelerating that with dealer engagement activities, brandings, sales coverage, e-com we continue to invest in. So that – there's a lot going on kind of soup to nuts on the office furniture side.

And then on the hearth business you know we've got growth initiatives we're investing in pretty heavily as well. Homebuyer education you know connecting to homebuyers during their home buying process, [indiscernible] (00:13:03) awareness, where – existing homebuyers, we're doing direct outreach programs to existing homeowners for replacements and regional builders. We were targeting – there's a lot of regional builders out there as well. We've got some growth initiatives that are targeted right at them as well.

And then finally the third bucket is basically our digital assets and capabilities, and that's really focusing on customer experiences, improving the process you know and the sales process and those will be leveraged across both businesses.

Gregory J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. And then I guess maybe from a continuous improvements, cost improvement perspective, I guess you were targeting – I think it was \$10 million to \$15 million maybe in the back half of – it looks like you got most of that. But as we look into 2020, do you have any explicit kind of cost saving goals that you might be able to share with us or is it just kind of just general blocking and tackling, taking cost out of the business?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah, Greg. It is general activity sort of what drove our benefit in 2019 will continue onto 2020. But it is significant when you add it all up. We're expecting \$20 million to \$25 million of benefit from our annual productivity and cost savings efforts in the year.

Gregory J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay, thanks. And then the – your outlook for the office segment next year. I guess [indiscernible] (00:14:37) industry is looking for about 2% growth, so it looks like you're looking for a little bit of growth on top of that. So I – it felt like you had some easier comps from the earlier part of this year. So maybe you could just kind of give us your view on your office furniture segment this year, maybe China is a little bit of a detractor, why that's a strong you know outlook of – you know why are we looking for about 3% at the midpoint versus the industry versus what I thought was maybe some easier comps for you from the earlier part of this year?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah, Greg. We're expecting better growth in 2020 in office furniture than we saw in 2019. So I think that's the first point. Secondly, you know the market has firmed up but it's not as strongly that it was sort of in the middle of the year when we saw some really high growth rates particularly in contract. So, we do expect to start slowly. Our funnel and our preorder activity supports growth, but it's not going to start off super strong. We're feeling pretty good about that 2% to 4% growth rate guidance we gave for the year for office furniture, you know that includes some good e-commerce growth and I'm not sure the market I think that's at or above market. So I'm not sure the market is stronger in that right now from our perspective.

Gregory J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. Thanks. And then just lastly in terms of the seasonality in the fourth quarter, could you maybe help us quantify what minimal profitability means? Are you looking for about the same level that you were at last year, maybe a little bit better? I don't know, is there any way you could help us kind of quantify what minimal means?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah, I think minimal – if you look the last two years in the first quarter you know we were at minimal profit. You know we were \$0.02 last year. We're certainly going to try to exceed that, but it's not going to be a sea change from what we saw the last couple of years.

Gregory J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. Thank you.

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

Steven M. Ramsey

Analyst, Thompson Research Group LLC

Q

Good morning guys. I thought I would start with hearth, just strong outlook there starts with permits being strong. You know I guess given where new construction is and the outlook in the mid-single digit range, how much of that is just catching the wave of a strong environment? How much of it is the investments you're making to further penetrate, repair, remodel, replacement demand and new builders – that regional builders?

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

A

Yeah. You know I'd say it's some of both. I think the new construction is definitely a driver. We tend to lag permits 90 days. I think we're seeing some of that stretch out a little bit more. That's kind of I think what we saw in the fourth quarter, labor shortages things like that. So we're lagging maybe a little bit more than normal, but that's a big piece of it. But our growth initiatives do come online, you know some of them are early days, some of them are just getting rolling but they'll provide us some tailwind here in the back half.

Steven M. Ramsey

Analyst, Thompson Research Group LLC

Q

Got you. And on the replacement side of things, is this an offset or a negative contributor in the numbers you're putting out is basically new constructions growing better than your guide but repair and replacement [ph] is offset (00:18:20)?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah for hearth we're expecting to grow 4% to 6% for the year. I would say that the new construction side would be at the higher end of that and the remodel retrofit side to be at the lower end of that.

Steven M. Ramsey

Analyst, Thompson Research Group LLC

Q

Great. On office for 2020, can you maybe even broadly talk to supplies or contract driving better growth in – on e-commerce? Is that a bigger driver for supplies more than contract or vice versa?

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

A

Yeah, I'd say that the e-com business platform is probably a bigger driver on the supply side for sure. And that's that just where that business is at.

Steven M. Ramsey

Analyst, Thompson Research Group LLC

Q

And just thinking for 2020 broadly is supplies or contract a better growth driver?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah. Steven, I think that you know our view that splitting the office furniture business into these two categories supplies and contract is a little bit too simple of a way of describing our business, so we're going to try to move away from describing it that way.

What I would tell you is that we do expect to see more growth in what we formally called supplies due to the e-commerce as Jeff noted. And the contract business is where our international business is, it's going to be impacted by the coronavirus a bit. So we're expecting to be a little bit lower there. But again I think those general categories are a bit too simplistic to really describe the breadth of what we're doing these days.

Steven M. Ramsey

Analyst, Thompson Research Group LLC

Q

Got you. On F&D expenses, good job holding those well below sales growth. How much of that was just slower e-commerce trends in the quarter or is that a result of past investments that you're making bearing fruit, and just how that may play out in 2020?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah. The big driver there, Steven, is our productivity efforts. We had a good quarter, a good year on driving productivity and freight and distribution in our core business.

Steven M. Ramsey

Analyst, Thompson Research Group LLC

Q

Excellent. And on the gross margin expansion for 2020, could gross margins still expand even if you came in below your sales guidance range?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Certainly not having volume will make it harder, but we would fully expect to expand gross margins. And I think the big driver of that will be this productivity we mentioned earlier that we expect to drive in 2020 of \$20 million to \$25 million.

Steven M. Ramsey

Analyst, Thompson Research Group LLC

Q

Excellent. And then I guess lastly for me, we're hearing from various parts of the field, the channel that inflation overall is pretty nominal right now. Is that what you're seeing in either hearth or office contract side of things?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah. I think if you look at material inflation, we are seeing a pretty nominal maybe even slightly favorable, but we still see pressure on wages and healthcare and benefits and so forth. So we are expecting a little bit input cost pressure in 2020, but it's much less than we saw in 2019.

Steven M. Ramsey

Analyst, Thompson Research Group LLC

Q

Great color. Thank you.

Operator: [Operator Instructions] Your next question comes from the line of [ph] Rubin Gartner with Benchmark (00:22:17). Your line is open.

Q

Thank you. Good morning guys.

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

A

Good morning.

Q

So maybe let's start with the SG&A investments, just a couple of follow ups. One, can you quantify what you're spending or what the incremental investment is this year? And then secondly, are these new investments the way to think about it that that's kind of the new run rate for SG&A or are these one-time and you might have a bit of leverage that kicks in in 2021?

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

A

Yeah. The amount if you look across the SG&A is roughly \$18 million on an incremental basis [ph] Rubin (00:23:03) and I would say they would lever. We don't have exact timing on that, but they would probably start to lever in 2021 depending on the investment.

Q

Okay.

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

A

So it's not necessarily new – it's not necessarily a new run rate. And some of it – some of it will go into the run rate, but others will lever.

Q

Got it. And then, so you've got \$20 million to \$25 million in productivity offset by the \$18 million in incremental, what's your price cost outlook for this year? Is that expected to be a tailwind? And then I guess are there any other puts and takes on the margin front aside from those few factors and volume leverage?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Yeah, [ph] Rubin (00:23:55) on the price cost front we're expecting it to be favorable in a range of \$5 million to \$10 million on the year. That's mainly carryover from what we saw in 2019. You know the price realizations can be a lot less than we saw in the – as you said earlier the input costs are also less, though we still expect to be slightly favorable there. You know the rest of the drivers I think are smaller but we do have some headwinds on the SG&A front that involve variable comp and things like that which is probably the only missing piece of the puzzle that we haven't already talked about.

Q

Okay perfect. And then last one for me. A couple strong years of free cash flow generation, can you talk to me about I guess the puts and takes on the free cash flow front in 2020, you know specifically working capital you had a – it looked like a little tailwind in 2019 as neutral kind of the way to think about 2020? And then now that your balance sheet is – you're approaching no net debt, what are the plans for uses of cash? Are there acquisition targets on the building products side or in office that you could take a look at? Just talk to me about what the uses of cash are? Thanks, guys.

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

So let's take the first part that question first. You know as it relates to working capital, we did a nice job of freeing up some working capital out of the core business in 2019 which helped us generate that \$153 million of free cash flow we did in 2019. We're expecting free cash flow to be a little bit less in 2020 in the \$130 million to \$140 million range and the difference between the two is really working capital timing, and I'm not sure we expect to have the same working capital benefit that we saw in 2019 versus 2020, the – but still healthy cash flow.

Jeffrey Lorenger

President, Chief Executive Officer & Director, HNI Corp.

A

Yeah. And on the M&A question. I mean, you're right, we have dry powder. We have a strong position in the balance sheet and you know candidly we're always looking for value creation opportunities, you know both on the hearth side and the office furniture side. We look at capability, enhancements, products. And so that's – that's an active process that's ongoing and obviously when we see something, we'll pursue it.

Operator: There are no further questions in queue at this time. I turn the conference back over to our presenters.

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

Thank you everybody. And thank you for joining us today on the call, and thank you for your continued interest in HNI Corporation. Have a great day.

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

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