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HNI Corp. (HNI)

Q2 2017 Earnings Call

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Analyst, Thompson Research Group LLC

Beryl Bugatch
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Greg J. Burns
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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Christa and I will be your conference operator today. I would like to welcome everyone to the HNI Corporation Second Quarter 2017 Fiscal 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] And 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 second 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.

Thank you, Jack. Good morning, everyone. We'll share our assessment of the second quarter 2017 and then provide some thoughts on our outlook for the third quarter and full year. And then as usual, open the call up for questions.

So I'll start out by saying we continue to see dynamic market conditions with both the wide range of opportunities and challenges. On the positive side, we're driving strong growth in our contract office furniture businesses. Our North American contract business grew 9% in the second quarter. We are expecting stronger growth in the second half.

Our hearth business continues to enhance its leading market position. We increased profit on flat sales in the second quarter and expect solid growth through the remainder of the year. We are pursuing new opportunities and confronting several challenges. As previously communicated, our supplies-driven office furniture business experienced a significant decline in the wholesale channel. The decline was a step-down in a long-term trend we've been managing actively over the last several years.

In response, we are investing capabilities and advancing initiatives around quick ship, direct fulfillment. Our response to these shifts will make us stronger in the long-term as we become closer to our customers, delivering unmatched value. Separate from the wholesale challenge, orders in our supplies-driven business came in later in the quarter than we expected, started slow and recovered late in the quarter.

As a result, more of our second quarter orders will ship in the third quarter than we previously expected. Order rates have continued to recover and we're projecting growth for the supplies-driven business in the second half.

Our focus on cost remains. We're experiencing delayed cost savings as we ship resources to handle the rapid escalation of order rates. As a result, we estimate \$5 million to \$6 million of net cost savings will be delayed from the second half into next year. Despite these short-term challenges, our long-term view remains unchanged. We see opportunities for both top line growth and ongoing profit improvement. We will continue to drive our transformations, position our businesses for the future and continue to create long-term shareholder value.

With those comments, I'll now turn the call over the Marshall Bridges for some specifics on the second quarter. Marshall?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

Thank you, Stan. For the second quarter, consolidated organic net sales were flat versus the prior year. Including the impact of acquisitions and divestitures, sales decreased 4.1%. In the office furniture segment, sales increased 0.2% organically and declined 5.1% in total. Within the office furniture segment, sales in our supplies-driven business decreased 7% organically or minus 11% when including the impact of divestitures. Sales in our North American contract business increased 9% organically or up 2% in total. Sales in the international business increased 2%.

In the hearth segment, sales decreased 0.4%. New construction sales increased 2%. Growth was softer than anticipated due to variability and timing within the single-family home construction cycle. Sales of retail wood and gas products decreased 4%. This decline was due to the impacts of dealer distributors, moving to our more efficient, just-in-time delivery model. Sales of pellet appliances increased \$1 million or approximately 24%.

Non-GAAP net income per diluted share was \$0.42, compared to \$0.68 in the second quarter of 2016. The change was driven by input cost inflation, deeper discounting, strategic growth investments, non-repeating corporate adjustments and unfavorable product mix.

Stan?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

So we expect stronger demand in the second half of the year. Our contract office furniture businesses continue to drive strong growth. Demand in our supplies-driven business is stabilizing. And we're now seeing solid growth in our hearth business.

We're in the midst of multiple transformation, positioning our supplies-driven business for long-term success, driving further business simplification and improving our operational cost structure. I'm confident our growth together with our demonstrated record of cost efficiency will continue to drive long-term profit improvement for our shareholders.

We will continue to invest for the long-term. One of our major investments is our business systems transformation initiative. I'll remind you this initiative, which we call BST, is a broad-based transformation of how we work, a systematic RCI [ph] of our information factories (06:25) and is a key enabler to our long-term success.

We are progressing well towards our next significant milestone, which is bringing the large portion of our North American office furniture businesses up live on this new ERP platform at the beginning of the fourth quarter. In addition, we're investing in new products, selling and fulfillment capabilities. This will further grow and solidify our position as the best cost producer in markets delivering unmatched breadth, quality and services for our customers.

So Marshall, back to you.

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

For the third quarter, we expect consolidated organic sales to be at 7% and 10% or down 1% to up 2% when including the impacts of acquisitions and divestitures. Office furniture sales are expected to be up 8% to 11% organically or down 2% to up 1% in total.

Organic sales in our supplies-driven business are projected to be up 1% to 4% or down 6% to 9% when including divestitures. Sales in our remaining office furniture businesses are forecasted to be up 15% to 18% organically or up 7% to 10%, including the impacts of acquisitions and divestitures.

We expect hearth sales to be up 3% to 6%. Within the hearth segment, new construction sales are forecasted to be up 7% to 10%. We are projecting retail wood and gas sales to be up 2% to 5% and retail pellet sales to be flat to up 3% versus the prior year.

Non-GAAP gross profit margin as a percentage of net sales for the third quarter is expected to be approximately 39%, an improvement over prior year. Non-GAAP SG&A, which includes freight distribution expense, is expected to be approximately 30% of net sales. Our estimated non-GAAP earnings per diluted share for the third quarter is in the range of \$0.76 to \$0.86.

Looking at the full-year 2017, we expect consolidated organic sales to be up 2% to 5%. The net impact of acquisitions and divestitures is expected to reduce sales by approximately \$100 million. As a result, total net sales are forecasted to be in the range of minus 2% to plus 1%.

Office furniture sales are expected to be up 2% to 5% organically for the year. Sales in our hearth business are expected to be up 2% to 5%. We now expect full-year free cash flow to be in the range of \$40 million to \$50 million. This is lower than our prior estimate due to reduced income expectations and working capital timing, driven by lower incentive compensation accruals and investments in inventory. Our current best estimate of non-GAAP earnings per diluted share for the full year 2017 is in the range of \$2.35 to \$2.55.

Stan?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

So I'll wrap this up then. Our businesses are strong and performing well in their markets. Our strategies are working and we remain committed to the investments we're making for long-term growth and profitable success. We're confident in our ability to deliver profitable growth to create long-term value for our shareholders.

So, with those comments complete, we'll now open it up for questions.

QUESTION AND ANSWER SECTION

Operator: And your first question comes from the line of Matt McCall from Seaport Global Securities. Go ahead. Your line is open.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Thank you. Good morning, guys. So maybe start with the contract outlook, up 15% to 18%, I'm looking at the comp. I believe it was down 10%, 11%, but seems like that's an acceleration. I was curious about what you're seeing and maybe talk about the geographical strength or weakness, vertical strength or weakness. What's behind that shrink other than – I mean, the comp's easy, but there are some good growth on top of that easy comp.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, Matt, I mean, it's coming across the board and it's coming from many, many factors. And as you know, these things go this direction, kind of dependent on where you're positioned and I think we're in the right position. I think we've got the right value proposition. I think the teams are doing a nice job of executing. There's no specific, I think, geography or vertical to call out here and we're pleased with the results and like what we're seeing here.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

And does the pipeline indicate that this is – there's anything that's not sustainable that there's – or there are some big projects in there that would impact it, that would skew it upward or is this an indication of the health of that part of the business?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Well, I guess the way I'd answer it is, Marshall gave you the outlook which is continued very strong contract sort of segment sales and so the pipeline is good. It's a broad mix of large projects, small projects. And so we see this continuing as far as we could see which is basically through 2017. Beyond that, I'm not going to hesitate to pretend to guess what's out there, but we like a lot the momentum, we like a lot the prospects for the future.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. Perfect. The cost savings delays, I think you referenced you're pursuing stronger growth. Maybe that's what's delaying some of the savings, but can you first quantify the savings impact or the delays in Q2? Can you maybe provide more details as to what exactly is going on there? And then does the – what is the delay, \$5 million to \$6 million, due to your outlook for FY 2018 in terms of cost savings?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

So I'm going to let Marshall answer the number questions. But basically I'll explain what's happening here is, orders started off slow in the quarter and so we had a lot of operations folks that were deployed to initiating transformative moves, cost reductions, projects, consolidations, et cetera. And then we saw a significant rapid acceleration of orders and demand both in supplies and in contracts.

So what happens there is you take people that are previously working on cost reductions and consolidation, and you put them on simply getting production out. And so when that happens and you slow down moves because you need to get out what you have and you can't afford disruption, and so that's really what's transpired here, the simple sort of whipsaw of slow demand. With very rapid demand means we're redeploying resources, people and resources.

Marshall will comment on the numbers.

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah, Matt, as Stan mentioned in the call earlier, we're expecting to shift about \$5 million to \$6 million of cost savings from the second half of 2017 into 2018. And so we're still trying to develop our 2018 outlook. So we're not really prepared to talk about total cost savings, but we have talked about that \$35 million to \$40 million of structural cost reduction that we anticipated achieving and about \$15 million of that will hit 2018 now. We'd expect it that to be more like \$10 million and the other \$5 million in 2017, so that's pushed out a little bit.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay, okay. So Stan, back to what you were saying, are there – have you run any service issues because of this ramp? Has it cost you any money to service the customer because you weren't able to kind of meet your demand or – I'm kind of trying to get a handle on the top-line impact.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, I think Matt, the team is doing a nice job of managing through this. And so I think we're not seeing a degradation of service. We're seeing some lead times extend a bit, but not in an unusual way given kind of the seasonality of our business. And does it cost us money? Well, as we've said, we're deferring cost savings and it's the right thing to do to protect our customers, our dealers, our resellers, et cetera.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. But beyond the deferred cost savings, there is no incremental cost that you've experienced?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Not in a significant way. No, we're not – it's not a loss of business. I mean, certainly as they say, because we're running flat out, we're not...

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Right.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

...hitting the productivity that we ordinarily are used to, but that's not unusual for this busy seasonal sort of aspect of our business to experience that.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. Got it. I want to sneak one more in. The competitive pricing pressures, is that just typical pressures that you see from your traditional, say, contract competitors? Or is there something that's new, smaller players, newer players coming in some of these new product categories, what's the dynamic from a pricing perspective? Is this just kind of how you've always experienced it or is it some – is there anything that's different about these current pressures?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

No, I think you characterized it correctly when you say it's similar to what we've seen in the past. I mean, as you know in this contract world, it's a project-by-project sort of market-by-market local type of skirmish. And so there are different periods when you'll see competition, pricing competition go up or discounting go up. It's nothing extraordinary from where we sit. And by the way, as the guys that are pretty good at best cost reducer status, we're prepared to play whatever game needs to be played there. But it's nothing – it's not new entrants that we see or it's nothing new that's changing the competitive dynamic, just more of the same.

Matt McCall

Analyst, Seaport Global Securities LLC

Q

Okay. All right. Thank you, Stan.

Operator: Your next question comes from the line of Budd Bugatch from Raymond James. Please go ahead. Your line is open.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

Good morning, gentlemen. I guess, to make sure I understand the deeper discounting commentary, that is related to contract or is it related to supplies?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Related to contract primarily, Budd.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

Okay. And that's deeper than before – deeper than the first quarter, deeper than with the last conference call, Stan, which it's gotten more competitive?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, it's deeper than last year, okay. Somewhat and it's deeper a little bit than last time we talked, last conference call.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

And you've said that you think contract will be up 15% to 18% organically in the third quarter, is that right?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

That's correct.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

So are you the price leader here? Because that's certainly faster than the market, right?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Well, I might have raised it. I don't know, Budd. You know better than anybody here that nailing it all down is difficult. There's lots of things going on. I mean, we all compete a little differently. Our value proposition seems to be resonating well. Our execution on the sales process seems to be going well and I think everybody is working the discounting lever a little bit more aggressively than in the past.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

And just to make sure I understand, is this where – there are verticals that are stronger than others here that you're free to – that you care to disclose or is it geographical or how should we get the feeling of what's going on in the overall market here?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

For us, it's broad-based, Budd.

A

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Okay. All right. Broad-based, geographically broad-based vertical, that's the way to understand that?

Q

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

Yes, sir.

A

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Okay. You talk also about more investment, make sure I understand where are those investments. We needed to undo investments and distribution for supplies with the shift in the wholesaler environment, is that correct?

Q

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

Correct.

A

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

Yes.

A

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

And how do we think about that? Can you not only quantify it, but give us some color as to where those investments are? Are they distribution investments, new DCs, how many and over what time period are those investments likely to be made?

Q

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

You hit it right. So, as it relates to the sort of our fulfillment investments, the fulfillment models we have and we're going to invest approximately kind of \$5 million to \$10 million this year, Budd. And that's primarily going to hit F&D. And you're right, it's investment in freight, fulfillment and DC capacity.

A

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

And mostly third quarter, fourth quarter, Marshall, or how do we think about that?

Q

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah, it'll be mostly in the third quarter and the fourth quarter. There's a little bit in the second quarter as well.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

So pro rata pretty evenly?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

It'll ramp. It'll be a little more in the fourth and the third quarter and the second was the lowest.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

Okay. And investment – when you talk about investment, does that hit the SG&A line or does it hit assets?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

It's primarily going to hit, this particular investment is primarily going to hit F&D, so SG&A in the broad sense.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

So freight and distribution within the...

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

Freight and distribution, so these are period expenses?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yes.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

Got you. Okay. That's helpful. Help me if you would, Marshall, you went over the guidance and I thought you said net operating income up 39%. What was, how – go over that again if you would a little more slowly, this old man can't quite catch up.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, yeah, yeah, okay.

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah, in the third quarter, I think you're talking about gross margin we anticipated being 39%.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

Gross margin, okay. I think you said – I thought you said operating margin. That's what got me.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

No. We said non-GAAP gross profit margin is expected to...

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

Okay.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

...approximately 39%, which is an improvement over last year.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

Okay, okay. All right. Very good. And the other side of this equation is the guidance, the EPS went down by a nickel on the bottom end and I think by \$0.15 on the top end from your June pre-release, what's changed?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah, the primary driver, if you think about it, that's like a \$0.10 drop on the midpoint. But the primary driver is those delayed cost savings we just talked about. So that \$5 million to \$6 million that shifts into 2018 is a big driver, and there's a little bit of incremental competitive pricing pressure that rounds out the balance.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

And I don't think, Budd, when we did our release, we had the full visibility and the amount of resources that we needed to redeploy and to focus, to execute our current order demand and to take care of customers and so that's what's changed.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

And has there been any change in the revenue? The revenue guidance in June was I think organic, what, down 5% to plus – down 2% to plus 5%, is that right?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

But there has really been no change to our outlook for revenue guidance for the year.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.



Okay. I thought that the – when I had the divestiture of Artco Bell and some of the dealers, \$180 million of an adjustment and you said \$100 million, so maybe a little maybe offline, Jack would go over for us how those adjustments look, either backwards and forward, so make sure we got the right number, so we can do our model correct?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.



Yeah, so there's Artco but we also have some dealer kind of ins and outs, some acquisitions of dealers and some divestitures of dealers. And so when we talked about the \$100 million, we're including all of that. So its \$100 million impact for the full year reduces net sales.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.



Okay. And, Stan, the last question for you is, we've got a doubling of earnings in three to five years, it's kind of a long-term outlook for HNI which is certainly impressive. Is any change to that at all, any change you're thinking or maybe it's next four to five years or has that spread out at all?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.



Yeah, I think it's a great question. But I mean, the answer is no. It hasn't changed. That's we say three to five because these things, these challenges and these opportunities come and go. And so I would say we're as optimistic – I'm actually more optimistic about the outlook than I've been and we get these changes. I think we have to respond. I think we understand how to grow the top line. We know how to get after cost. We know how to manage our assets efficiently and it's a little bit of call out, a different play on the line. But we're in great shape for this.

Does it go out from three years more like five years? Well, today, if you ask me, I'd say it's, you said it more or like four to five, but stay tuned if we keep rocking and rolling on the contract that double-digit top line growth, then maybe it's more like three years. And so I continually feel great about the prospect of doubling earnings every three to five years, timing comes and goes and I'm pretty cheerful by the way about not getting nailed down. Is it three years, is it four years, is it five years, because it is so dynamic out there. We're in multiple businesses with lots of good competitors and we adjust and I think we feel great about the investments and about our capabilities as an organization to continue to drive long-term profitable growth.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.



Okay. And I guess last for me is trying to understand what are the non-GAAP adjustments looking forward to in the third and fourth quarter? And we got restructuring and got transition costs. Do we know what they are or what you're planning?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.



It's difficult to estimate those, Budd, given all the ins and outs, but based on what we know now, I would estimate that we expect \$3 million to \$4 million of sort of restructuring and transition for the third quarter and \$4 million to \$6 million in the fourth quarter.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

Okay. So \$3 million to \$4 million in the third and \$4 million to \$6 million in the fourth. Okay. And that's what your guidance is based on or is it – your non-GAAP has got to have, I guess, a midpoint of each of those. Is that what you're looking at?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Well, the non-GAAP numbers would not include those, so if they vary, it won't have an impact.

Beryl Bugatch

Analyst, Raymond James & Associates, Inc.

Q

Okay. All right. I got you. All right. Thank you very much.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Thank you, Budd.

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

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Hi, thanks for taking my questions today. I wanted to circle back up on your North American contract sales, up 9%. And as you said earlier, you're looking up mid to – mid-teens or so for contract volumes in Q3. And this again is an environment where you're seeing greater discounting. There had been some leadership changes from my understanding within your organization. So how have leadership changes or changes in the sales, how your approach to sales impacted this? And also given that you are clearly outperforming the industry, what are the broad buckets where you're seeing greater traction? Thank you.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, great, Kathryn. So to the first question here, I mean these – the results that we're seeing in the contract business due to the selling cycle are really the result prior to these leadership changes. The leadership changes are for lots of different reasons, sometimes it's succession, sometimes it's development. So they weren't made due to performance. And so I would say the growth that we're seeing is not related.

Now, I'd also say, the leadership changes hopefully will continue to accelerate that growth in the future, but not an impact on current state. Again, where we're seeing this growth is really broad-based. So our contract business competes well in the mid size sort of client. We've talked to you about our value proposition well, or our value proposition position. I think we're positioned well there. And so it's just a lot of different factors that are coming

together, that are leading us to win a lot of great business right now, big, small business, different geographies, different sectors, different verticals, whatever term you want to say.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. Again, once again, in the office segment, if you could break out between supplies contract, can you share at least directionally how margins trended between supplies and contracts, particularly we understand that there is a disruption going into supplies. But when you look at the overall performance in the quarter, getting a better understanding of how the contract versus supplies operating margins are trending?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah, Kathryn, there is not a major trend there between the two parts of office furniture.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

It's more like are supplies margins improving or did they take a step back or contract margins improving or did they take a step back versus last year?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah, well, our results versus last year are down, so it'd certainly be down consistently between those two sides.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. All right. You may have answered this earlier in the call. Apologies, I came in a little bit later. But could you give an update on the pace of your direct orders as you ship that supplies business model to more direct orders?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, we're really just starting that, Kathryn. So it's just ramping up. It's not noteworthy at this stage. It's coming online as we expected and we've expected, as Marshall indicated, to ramp up third quarter and fourth quarter. It's just starting to get rolling now.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. And now that you gave – you outlined a few factors that impacted the full-year guidance, about cost savings shifting into 2018 in addition to discounting the market, but how much of a factor, if at all, did inflation play into lowered 2017 guidance range?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Yeah. Kathryn, we are expecting significant inflation around the 5% level for the full year. But as it relates to our prior expectations, we had most of that in there – there is a [ph] \$1 million or \$2 million (30:27) more inflation versus our prior expectations, but the big drivers are the cost savings delay and the competitive pricing.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. Perfect. And then once again, not to beat a dead horse with discounting in the market, but it would be helpful if you could clarify what areas or if it's more small orders or if it's being more competitive with larger orders in terms of what is driving, where you're seeing the greater pockets of discounting in the market?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, I mean, I guess what I could say is it's in the contract segment and it would typically be the larger projects are seeing more competitive pricing. A lot of the smaller projects by nature don't get the same sort of shootout at the O.K. Corral that some of the large stuff does.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. All right. Thank you for taking my questions today.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Thank you, Kathryn.

Operator: And your final question comes from the line of Greg Burns from Sidoti & Company. Please go ahead. Your line is open.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Hi, good morning. In terms of the supplies business, what percent of that business is wholesale now?

Marshall H. Bridges

Chief Financial Officer & Vice President, HNI Corp.

A

Greg, approximately 20% of supplies-driven business runs through wholesalers as we sit now.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. And I just wanted to better understand, what's driving this shift? Is this being driven by wholesalers moving to other suppliers or is it being more driven proactively by you and your customers?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Well, first off, it's the large customers are looking for more efficient ways to fulfill their furniture requirements and we're responding to that. Second, the wholesale model is challenged as you see secular decline in supplies and sort of the electronic office. You see them searching for a more productive future, a more productive financial picture and that's leading them to take actions to change how they fulfill furniture, who they fulfill furniture to, et cetera. We simply are responding to both customers and to our channels. The wholesalers are important customers to us. They play a valuable role. We see them playing a valuable role. Our best guess is that's shifting due to just sort of industry dynamics in more efficient and effective ways of fulfilling furniture requirements.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. And then lastly, can you just maybe give a little bit more color on how you expect this shift to benefit HNI once you have it fully implemented in terms of your direct fulfillment capabilities. I would assume there's a little bit of a margin hit upfront, but maybe what are some of the broader benefits that you'll see from this move?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Well, I think we're – we will be more connected, more closely connected to actually the purchasing customer, the customer who is reselling and fulfilling the end user requirements. I think it will allow us to more fully capitalize on our lean capability of linking and leaning supply all the way through from sort of – in last mile delivery to production scheduling, et cetera. You're correct. In the short-term, there is a financial hit. In the long-term, we're always pretty optimistic about our ability to wring cost out and find efficiency in the supply chain to make the economics work.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. So do you see this connection with the customers like an opportunity for you to gain market share in the supplies market over time?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah, I think if we provide a better experience and a more efficient sort of fulfillment model, we're going to get more business and we believe we can do that.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. Thank you.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Thank you.

Operator: And we currently have no more questions in the queue at this time. Mr. Herring, I turn the call back over to you.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

This is Mr. Askren. So thank you very much for tuning in. We appreciate your interest in HNI and we look forward to speaking to you in the future. Have a good day.

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

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