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**HNI Corp.** (HNI)

Q2 2021 Earnings Call

## CORPORATE PARTICIPANTS

**Matthew McCall**

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

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

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## OTHER PARTICIPANTS

**Greg J. Burns**

*Analyst, Sidoti & Co. LLC*

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

**Steven Ramsey**

*Analyst, Thompson Research Group LLC*

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good day and thank you for standing by. And welcome to the HNI Corporation Second Quarter Fiscal 2021 Conference Call. At this time, all participants are in a listen-only mode. After the speaker presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [Operator Instructions] I would now like to hand the conference over to your speaker today, Matt McCall. Please go ahead.

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**Matthew McCall**

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

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 second quarter fiscal 2021 results. With me today are Jeff Lorenger, Chairman, President, and CEO; and Marshall Bridges, Senior Vice President and CFO.

Copies of our financial news release, 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?

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**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

Thanks, Matt. Good morning and thank you for joining us. In the second quarter, our members executed at a high level delivering substantial year-over-year profit improvement. The post-pandemic recovery continues to provide reasons to be encouraged about both the general environment and our opportunities at HNI. However, the macro

backdrop along with our strong growth also presented new challenges in the quarter related to labor availability, supply chain capacity and inflation. Our teams managed through those challenges to deliver strong results. Our two differentiated business segments are well positioned to benefit from the recovery of the cycle, multiple secular trends and numerous HNI specific growth initiatives.

We have a track record of effectively deploying capital, driving annual productivity and cost savings, and managing through macro and operational challenges. On today's call, I'll cover three key highlights of the second quarter. First, non-GAAP EPS doubled year-over-year despite increasing pressure from inflation and returning costs. Second, our Residential Building Products segment delivered exceptional performance. Third, demand in Workplace Furnishings is recovering.

I will start by providing some detail on those highlights. Marshall will then cover our third quarter outlook. I will conclude with some general comments. Finally, we will open up the call to your questions. Our first highlight for the quarter, we doubled non-GAAP EPS versus the prior year despite increasing pressures and returning costs. Non-GAAP earnings per share of \$0.40 was up 100% from the \$0.20 reported in second quarter 2020.

In the quarter, we overcame greater than expected pressures related to material inflation, labor availability and supply chain capacity. We generated 22% sales growth and our network ramped up to meet that demand. In addition, as we discussed last quarter, some of the costs related to temporary measures taken in the second quarter of 2020 returned.

Despite these pressures, we drove strong margin expansion and profit growth. Overall, the second quarter shows the power of our diversified revenue streams, our ability to react quickly to changing market dynamics, and our overall operational capability associated with our member and our culture.

Our second highlight for the quarter, we delivered exceptional revenue and profit growth in our Residential Building Products segment. On a year-over-year basis, total revenue growth exceeded 50% in the quarter and operating profit more than doubled, with operating margins expanding more than 500 basis points from second quarter 2020 levels.

From a channel perspective, new construction revenue was up more than 30% from year ago levels and remodel/retrofit sales increased nearly 90% versus the prior year quarter. Orders were equally strong in the quarter growing 53% year-over-year. As the quarter progressed, the comps became more difficult, order growth moderated, but remained at high levels. Our value propositions, growth initiatives and supply chain strength continue to resonate with homeowners, homebuyers and builders.

As we look forward, we remain optimistic about the prospects for both remodel/retrofit and new construction. Long-term demographic trends and a persisting housing supply demand and balance will continue to support a prolonged housing cycle and elevated remodeling activity. Nesting and de-urbanization trends also provide secular support and we have an outstanding opportunity to grow the category in both new construction and remodel/retrofit.

As a reminder, in new construction, two-thirds of homebuyers see having a fireplace is a must have feature of the home, but less than 40% buy one. And on the remodel/retrofit side, we estimate that only about 3% of all remodeling projects involve a fireplace.

To take advantage of these opportunities, we are driving a better connection with the homebuyer and homeowner and will continue to make investments and launch tools that will assist and influence homebuyers and

homeowners in their purchase and remodeling journeys. An example of our investment in our model home is our model home virtual tour capability, where our content and messaging seamlessly plugs into the builders virtual experience. This allows us to reach the homebuyer early in the decision process with consistent and effective content.

We have strong competitive positions in both new construction [ph] and R&R (00:06:10). Our vertically integrated business model, unmatched product depth and pricing breadth, strong builder relationships, and regional distribution infrastructure, all provide differentiation for this business. As a result, we have significant opportunities ahead of us to grow revenue in the building products business.

The third highlight for the quarter, our Workplace Furnishings segment is recovering. On an organic basis, net sales in the segment increased 9% and orders grew 32% versus the prior year period. Second quarter non-GAAP operating income grew 21% year-over-year despite the pressures discussed earlier. Our small to mid-sized customers continue to outperform as does demand in the public sector with orders in our businesses focused on [ph] these (00:06:58) markets increasing 55% year-over-year in the second quarter putting us back to pre-pandemic levels.

In addition, the North American contracting market continues to recover with orders in our contract businesses of more than 23% in the second quarter year-over-year. And in the past five weeks, contract orders were up approximately 30% versus the prior year period. Looking to the back half, we believe Workplace Furnishings has turned the corner and expect to drive revenue growth through the remainder of the year.

Recent order patterns are encouraging and are indicative of our agility, our competitive position and improving demand trends. Market demand signals indicate activity will continue to ramp in the back half. As a result, we continue to expect year-over-year revenue growth in our Workplace Furnishings segment to accelerate as the recovery in our contract business gains momentum.

Our Workplace Furnishings businesses have unmatched price point breadth, channel access and market reach. And we are investing in multiple strategic initiatives aimed at driving continued outperformance. A few examples of our growth initiatives include the December 2020 acquisition of Design Public Group. We are seeing strong momentum with DPG. Year-to-date orders are up over 40% with record bookings in May and June. DPG is also giving us more access and greater insight into the work-from-home segment and e-commerce possibilities.

Another example is our recently launched [ph] ESR (00:08:31) app. This is a mobile app we built to drive engagement with dealer sales reps. It currently provides quick access to marketing content, product information, visualization and order status updates, all from a single mobile-enabled platform. Over 600 dealer sales reps are already using the app.

We expect that number to grow as we add more capability. Additionally, we are investing to make our contract dealers more efficient and effective. This includes technology to streamline the design and selling processes and platforms to make their back office more efficient. These investments along with our existing competitive differentiators positions well to benefit from office reentry, work-from-home and de-urbanization trends.

I will now turn the call over to Marshall to provide some detail around our third quarter outlook. Marshall?

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## Marshall H. Bridges

*Senior Vice President & Chief Financial Officer, HNI Corp.*

Let's start with our outlook for consolidated revenue growth. We expect third quarter revenue to grow in the mid-20% range compared to the prior year quarter. Because of our seasonality, this outlook implies third quarter volume will be substantially above second quarter levels with sequential growth in the mid-20% range. That level of growth when combined with a general labor and sourcing environment is presenting new challenges. Our staffing levels and overall supply chain capacity are ramping up but not as fast as demand.

As a result, we expect labor and supply chain constraints will limit third quarter revenue growth versus the prior year quarter by 4 to 6 percentage points. That headwind is included in our outlook. This is a timing impact. We can solve these constraints over time. We are capturing the demand and expect that 4 to 6 percentage points of growth to flow to subsequent quarters.

Let's move to our third quarter outlook for the Residential Building Products segment. Recent order trends, new home construction activity, the outlook for remodel/retrofit demand and expected benefits tied to our multiple growth initiatives combine to suggest a revenue growth rate in the mid- to high-20% range compared to the prior year quarter. We see continued momentum in both remodel/retrofit and new construction.

Now let's shift our outlook for Workplace Furnishings, strong second quarter order trends are growing backlog and a low prior year comparable suggest a growth rate including acquisition impacts in the low- to mid-20% range on a year-over-year basis. Let's shift to third quarter profitability, compared to the prior year quarter, we expect the impact of strong volume growth to be mostly offset by cost challenges related to inflationary pressures, increased growth investments and the return of costs associated with temporary actions taken in the prior year.

While we expect operating income to be modestly higher than the third quarter of 2020, operating margins will likely compress on a year-over-year basis. We do expect margin expansion to return post the third quarter as our recent price actions take hold and [indiscernible] (00:11:35) temporary cost actions taken during the pandemic.

Finally, some comments on our cash flow and balance sheet expectations, quarter ending debt levels were approximately \$179 million, modestly higher than last quarter and down slightly from the second quarter of last year. The gross leverage ratio at the end of the second quarter of 2021 was approximately 0.9, unchanged from last quarter.

On a sequential basis, while our leverage ratio was unchanged, cash increased by more than \$24 million. We expect free cash flow to ramp up in the second half consistent with normal seasonality, and our projected cash flow provide ample capacity for continued growth investment, dividend payments, and opportunistic M&A and buyback activity.

I'll now turn the call back over to Jeff.

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## Jeffrey D. Lorenger

*Chairman, President & Chief Executive Officer, HNI Corp.*

Thanks, Marshall. Let me wrap up by stating that as we look to the rest of 2021 and into 2022, we remain optimistic about our businesses and our markets. We continue to gain momentum in Workplace Furnishings where our winning customer experiences, the multiple strategic investments discussed earlier, and our operational excellence will combine to provide a competitive advantage as the market recovers.

Recall our focus in our Workplace Furnishings segment is a combination of driving revenue growth and expanding margins. We're increasingly confident in the recovery of the Workplace Furnishings market as order strength is

broadening across customer groups, project sizes, and geographically. Our improving order growth in the quarter and over the past five weeks is encouraging.

Our unique industry-leading Residential Building Products platform is positioned for sustained long-term revenue growth. Our growth strategies in this segment continue to gain traction and we see strong demand supported by demographics and low housing inventories.

As a reminder, our focus in our building products segment is on maintaining our strong margins while continuing to drive strong revenue growth. As we move to the next stage of the recovery, we do so position to grow revenue, expand margins, and increase cash flow.

I would like to conclude by stating I am extremely proud of and thankful for the efforts of all HNI members, particularly given how hard everyone is working to overcome the constraints we've described.

We will now open up the call to your questions.

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## QUESTION AND ANSWER SECTION

**Operator:** Thank you. [Operator Instructions] Please stand by while we compile the Q&A roster. Your first question is from Greg Burns of Sidoti & Company. Your line is open.

**Greg J. Burns**

*Analyst, Sidoti & Co. LLC*

Q

Good morning. In relation to the four to six points of growth due to some of the staffing and supply chain challenges, can you just talk about where that is in the business? Is that mainly in the Workplace Furnishings or is it across segments? And also, how much of a margin impact are those constraints contributing?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah. For the third quarter, Greg, the constraints are mostly in Workplace Furnishings, and in terms of the margin impact, it's not a material driver right now. Of course, inflation which is hand in hand with these factors is a big headwind for us in the third quarter.

**Greg J. Burns**

*Analyst, Sidoti & Co. LLC*

Q

Okay. So it's not really creating efficiencies, it's just limiting your ability to produce more is really the impact here?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yes.

**Greg J. Burns**

*Analyst, Sidoti & Co. LLC*

Q

Okay. All right. And then, I guess you gave a little color on the order patterns you're seeing in Workplace Furnishings after the quarter. Can you just talk about – in the Residential Building Products segment, you did

mention that they moderated a little bit. Can you just talk about kind of [ph] where (00:15:38) ended the quarter and how we've trended into the first part of the third quarter?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah. I think what we're seeing is a little bit of noise just based on the prior year order activity. So, if you think about last year remodel/retrofit kind of tail off as early – in early stages of pandemic. And so, a lot of the reason are our growth rates in the [indiscernible] (00:16:04) remodel/retrofit sales rec actually up 90% versus the prior year.

But, if you kind of compare that to 2019 levels, our growth rate was pretty similar when we saw in the first quarter and that's continuing. We're still seeing strong order activity, but now we're starting to compare against where our orders grew in the third quarter of 2020. So the growth rate is coming down. It's more a reflection of the prior year levels and it is a change in trajectory of market activity.

**Greg J. Burns**

*Analyst, Sidoti & Co. LLC*

Q

Okay. Okay. And then in terms of some of the growth initiatives you've mentioned on the Residential Building Products side of the business, how – are you seeing the benefit of those yet in your numbers or is that still things that are in the early stages that will benefit you and [indiscernible] (00:16:58) like quantify or any qualitative kind of color you can give around the impact those are having? Thank you.

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Yeah, Greg. This is Jeff. Look, I would tell you, yeah, we can quantify. I'll give you couple examples. I would also tell you we're also early on, but we're – there's – we believe there's a lot of headroom. Some examples would be like we started aggressively going after fireplace inserts. That's one of our initial areas of focus to connect with homeowners, existing homeowners, and those are up over 90% year-to-date.

We're also seeing anecdotally much more website traffic from awareness consideration, purchase visits are up 47%, and another growth initiative is the electric category and to create awareness and acceptance of electric fireplaces, and we're gaining traction there with sales in that category up over 100%. And so even though it's early we have real tangible evidence that those growth initiatives are taking hold and start to drive the business.

**Greg J. Burns**

*Analyst, Sidoti & Co. LLC*

Q

Okay. Great. Thank you.

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Thank you.

**Operator:** Your next question is from Reuben Garner from The Benchmark Company. Your line is open.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

Thank you. Good morning, everybody. Apologies if I repeat anything. I get kicked off the call briefly earlier, but maybe just to follow up on Greg's first question to start. Marshall, can you clarify what if the labor constraints are not causing the year-over-year margin pressure? Is it entirely price cost that is leading to the near-term margin drag and that will normalize as your price increase comes through as we move into the fourth quarter?

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**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah, Reuben. That's certainly a major factor. So, in the second quarter, we had a price cost cap about \$11 million. We expect that to be \$10 million to \$15 million in the third quarter of negative price cost cap. As we move into the fourth quarter, we expect our price increases to ramp up and catch up with the inflation and be roughly neutral. So that's about a 200 basis point headwind that's going to abate as we progress into the fourth quarter.

And that's the major driver. But we also have the impact of some of the costs that are coming back from temporary actions we took last year. We're investing in growth and we've got some impact from the normalization of the variable comp and insurance programs, all of which impact the second and third quarter more than the fourth.

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**Operator:** Your next question is from Steven Ramsey from Thompson Research Group. Your line is open.

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**Steven Ramsey**

*Analyst, Thompson Research Group LLC*

Q

Hi. Good morning. Maybe to start with on the orders in delayed single family starts kind of the extending lag time between start and completion yet seeing strong orders in resi. Is that pushing out resi sales for single family into Q4 and even into early 2022, or is that not a major factor in the segment?

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**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Steven, this is Jeff. I'll take a shot at that. We don't think it's pushing out. The long-term fundamentals remain, the supply demand and balance we've talked about. Just, for instance, new home sales slowed in June. I mean that was the headline. However, building permits outpacing starts, starts are outpacing orders and builders are trying to manage their inventory right now just to manage their margins. So, we're very bullish on that and we don't think it's pushing out. We continue to see strong activity there as far as – for quite a while.

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**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Steven, just to add to that, our new construction sales were up 24% in the first quarter and we actually accelerated 31%. So we had thought it might decline a little bit from that strong first quarter growth rate because of the trends you mentioned and we just haven't seen it yet.

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**Steven Ramsey**

*Analyst, Thompson Research Group LLC*

Q

Okay. Yes, that's helpful color. Yeah. And then wanted to clarify on the cost, the temporary cost reductions coming back in, can you maybe clarify the impact of Q3 and Q4 or another way to think about it maybe at what quarter do you expect that temporary come back to be over, be completed and operating at normal?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah. There's about \$18 million of costs related to temporary actions that we took last year. They're coming back in 2021. About \$10 million of \$18 million hit the second quarter. We expect about \$6 million to hit the third and by the fourth, we only have about \$2 million left and then that's the end of it.

**Steven Ramsey**

*Analyst, Thompson Research Group LLC*

Q

Okay. Okay. Great. And then the last thing for me on the Workplace guidance for Q3, what swings that range to low high? Is it broad-based demand from here or is it the constraints that you've discussed?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

I think it's mostly constraints. We probably will see some variation in demand. But I think given that we've got that 4% to 6% buffer, it really comes down to how we manage the constraints.

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Yeah – this is Jeff. I would agree. I think the demand continues. If we look at five week quarter averages, for instance, in the contract segment, we're – for the quarter, order was up 20 – we were up 23%, in the five weeks up 30%. So it's really just guessing how we can break constraints and it's kind of all over the map with supply chain and labor throughout the value chain.

**Steven Ramsey**

*Analyst, Thompson Research Group LLC*

Q

Excellent. Thank you.

**Operator:** We have a follow-up question from Reuben Garner from The Benchmark Company. Your line is open.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

Thank you. Good morning, guys. Can you hear me?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah. We can hear you.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

All right. Sorry about that. So I don't know what I missed and what's been asked, but I'm going to do my best. The first question is kind of a follow-up. I heard Greg's first question about the cost impact or the margin impact from the constraints. And I think you've just clarified, Marshall, what that impact is to your margins in the second, third and fourth quarters. Is there – does that include the price cost drag, and if not, can you quantify what that looks like and how that you expect to sort of progress as you move into Q4 and then into early next year?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah, Reuben. Sorry, you [ph] keep getting (00:24:08) disconnected. So, when I answered just previously had to do with the returning costs related to the temporary actions we took last year. So that's one headwind we faced. Price cost is significant, right. So maybe I'll kind of cover that. So I think I mentioned that we had about \$11 million price cost gap in the second quarter and we expect that to be \$10 million to \$15 million in the third.

But by the time we get to the fourth quarter, we expect our pricing actions to catch up with inflation, even though it's continuing to go up and we'll basically be price cost neutral by the fourth quarter. So that we do expect our incremental margins to be higher in the fourth quarter than they have been here in the second and third because of that price cost gap.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

And will the incremental margins sort of return to normal less that \$2 million that you called up before, or will the sort of labor constraints and supply chain and other factors, will we need to factor that in Q4 and beyond?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah. I wouldn't expect any return to normal in the fourth quarter. There's a lot of price that we're pushing to cover that inflation which isn't creating any incremental profit, right. So that dilution is going to lower our incremental margins and along with the other items that we've already talked about.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

Got it. And then I think I heard you say that the small and mid-sized businesses back to pre-pandemic levels. I guess, one is that I hear you right. And two, it sounds like contractors really starting to accelerate. Do you guys expect that we'll get back to pre-pandemic levels maybe quicker than we would have thought three or six months ago?

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Oh, yeah. I think this is the focus on the small to mid-sized customers who is doing really well. Our order activity in the second quarter is basically back to 2019 levels. We're still running below that in contract. But as you said it is encouraging, accelerating. So I think the outlook for contract is positive but it is moving slower than the small to mid-size business segment, which is where we have a lot of our exposure. So it's a positive to us.

And I think the other positive thing is that the growth environment is encouraging. But we're also focusing on driving margin expansion in that segment. So we're pleased with the traction we're getting on our productivity and cost saving initiatives and just the improvement we're making across the board there. So that's one of our big near-term goals in addition to the recovery in the top line.

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

Got it. And last one for me, any comments or color on the home office, or I guess your e-commerce businesses that – I know we're going to start [ph] anniversary and (00:27:10) some really difficult comps there. Is that something we need to factor in or is that business remain pretty robust even a year into this?

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Yeah. Reuben, it's Jeff. I'd say that both of those aspects of our business remain robust. And there – we like our positions there and we continue to invest in both those aspects of the business. Reuben?

**Reuben Garner**

*Analyst, The Benchmark Co. LLC*

Q

Thanks guys. Appreciate it.

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Okay.

**Marshall H. Bridges**

*Senior Vice President & Chief Financial Officer, HNI Corp.*

A

Yeah.

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

A

Yeah. Take care.

**Operator:** There are no questions over the phone. I will now turn the call back to Jeff Lorenger for closing comments.

**Jeffrey D. Lorenger**

*Chairman, President & Chief Executive Officer, HNI Corp.*

Well, great. Thanks. Thank you for joining us today and have a great day everybody.

**Operator:** This concludes today's conference call. Thank you for participating. You may now disconnect.

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