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HNI Corp. (HNI)

Q3 2020 Earnings Call

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Greg J. Burns

Analyst, Sidoti & Co. LLC

Steven Ramsey

Analyst, Thompson Research Group LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Lisa. And I'll be your conference operator today. I would like to welcome everyone to the HNI Corporation Third Quarter Fiscal 2020 Results Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] As a reminder, today's conference call is being recorded.

Thank you. Mr. McCall, you may begin your conference.

Matthew McCall

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

Thank you, Lisa. 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 third quarter fiscal 2020 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.

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

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Good morning, and thank you for joining us. Our members delivered another solid quarter in an environment that remains challenging. And again, our results demonstrate much of what is unique about HNI. As we look ahead, we are prepared to confront the near-term macro challenges, and we also see opportunity and signs that our strategies are gaining momentum.

You will notice some changes to our normal quarterly earnings report and call format. Specifically, we have included more detail around our third quarter results and fourth quarter expectations in the release. This allows us to focus our call commentary on the key highlights of the quarter, the key issues and opportunities going forward, and our strategic efforts aimed at pursuing long-term revenue growth, margin expansion and free cash flow generation.

Now, I will start with four key highlights from the third quarter. First, our Residential Building Products segment delivered strong year-over-year growth. We generated 9% year-over-year revenue growth in the third quarter, or 8% excluding the impact of acquisitions. This is a substantial improvement from the second quarter 6% year-over-year revenue decline. Our third quarter order patterns indicate these positive volume trends should continue. Orders increased 13% year-over-year. And consistent with most new home construction and remodeling indicators, order growth remained strong throughout the quarter.

Our unique model in this business continues to provide a competitive advantage. Our focus on operational excellence, our vertically integrated structure, and our investment in regional distribution centers have allowed us to take advantage of accelerating demand. We are competing better than ever in the space, and we continue to drive strong financial returns with third quarter operating margins expanding 270 basis points year-over-year to a third quarter record of 19.6%.

The second highlight of the third quarter was our Workplace Furnishings segment, delivered solid profitability despite continued recessionary pressure. In general, customers remain in a holding pattern and third quarter revenue was down 27% year-over-year. However, the segment still was able to generate a profit of nearly \$17 million in the quarter.

We are seeing some signs that demand activity is becoming less bad in this segment. Orders in Workplace Furnishings, excluding eCommerce, declined 25% year-over-year in the third quarter. This was an improvement from the 35% order decline in the second quarter. Furthermore, order declines moderated as the quarter progressed. This trend is encouraging, but we are not expecting a dramatic improvement over the next couple of quarters.

Orders in our Workplace Furnishings eCommerce business increased 35% year-over-year in the third quarter. That is strong growth but it is lower than the triple-digit order increase we generated last quarter. Much of the moderation in order rates was expected and was a result of tougher comps and supply constraints. We did see September orders re-accelerate, and this improvement is a result of a continued strong demand environment combined with our improving inventory positions.

Our third highlight for the quarter was we continue to smartly manage our costs and expenses. We reported a decremental margin of 19% in the third quarter. This is better than our previously communicated target of 25%. Also, recall we were up against a strong prior-year comp in the third quarter, as our productivity efforts and cost management drove a 50% incremental margin in the third quarter of 2019. We continue to manage through the near-term recessionary environment in the Workplace Furnishings segment, while remaining focused on our long-term strategies.

Finally, our fourth quarter – our fourth highlight of the quarter was continued strong free cash flow generation. Our balance sheet strength and cash flow outlook provide ample flexibility to navigate through the period of softness in the Workplace Furnishings, while maintaining our key growth investments in both segments.

I will now turn the call over to Marshall to provide some additional details around our fourth quarter outlook.
Marshall?

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

Good morning, everyone. Let's start with the outlook for our Workplace Furnishings first. In the Workplace Furnishings segment, we expect fourth quarter year-over-year revenue declines to be in the mid-teens. That's better than what we've seen over the last two quarters and is based on three factors. First, as Jeff mentioned, we have seen year-over-year order declines trend less bad. As we stated in the press release, Workplace Furnishings orders were down 25% for the third quarter and the declines moderated as the quarter progressed.

Second, we are expecting more growth from our eCommerce business, given the continued demand strength along with our improving supply position. And third, our fiscal calendar has an extra week this year, which we expect will add 4 percentage points to 7 percentage points of growth to the quarter. I should note, it also adds cost. So this growth delivers lower incremental margins compared to true organic growth.

Shifting to our fourth quarter outlook for Residential Building Products. Recent order trends, housing construction activity, and the extra week support fourth quarter year-over-year growth rates in the mid- to high-teens.

Moving on to profitability, we would also like to emphasize what we're expecting for decremental margins. For the full year, we expect decrementals to be less than 20%. This implies meaningfully higher decremental margins in the fourth quarter, primarily driven by unfavorable business mix, accelerating investment levels and the impact of the extra week. We continue to target decremental margins of 25% over time.

Finally, I'd like to make some comments on our cash flow and balance sheet. Since the early days of the pandemic, our teams have focused on driving free cash flow. As a result, our free cash flow through the first three quarters is tracking 70% ahead of prior year levels, despite lower profitability. We ended the quarter with \$109 million of cash in the balance sheet. That balance is more than quadruple the balance from the end of last quarter.

We've reduced our net debt by 65% or nearly \$123 million. And our gross leverage ratio is 0.9x, well below our debt covenant of 3.5x. So we have substantial financial flexibility and a high quality balance sheet, and we're not expecting any meaningful capital structure stress.

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

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Thanks, Marshall. The past six months have demonstrated how much of what is exceptional about HNI. And I believe this experience has helped HNI become a stronger company in many respects, which will serve us well as we move forward.

As I looked at 2021 and beyond, I would like to call out a few items. First, we remain excited about the prospects for our Residential Building Products segment. Our unique vertically-integrated model with more than 20% of revenue coming from our owned installing distributors along with our recent success in managing through the spike in demand surrounding the pandemic puts us in a strong position as we move into 2021.

We have ramped our investments in this business to better market directly to homebuyers and consumers in both the new construction and remodel/retrofit markets. Our belief is that increased marketing in what has long been an under-marketed industry will provide revenue upside that may not be fully appreciated. This will add to what is already a strong cyclical backdrop, as indicated by low housing inventory and increased household formation. And we will also benefit from encouraging secular trends such as urban flight, larger home sizes, and increases in homeownership. In summary, we believe the revenue growth opportunity in this segment is strong, and we will continue to invest aggressively to grow this addressable market and the categories in which we compete.

Second, while we remain cautious near term, we expect Workplace Furnishings revenue to continue to recover as we move to a more supportive environment. Looking ahead to 2021, we expect the challenging first quarter as we lap pre-COVID conditions. However, moving through the year, we expect more companies to return to offices. While those return dynamics will likely take many forms, each will support improved demand.

Longer term, we see positive trends emerging that line up nicely with our competitive strengths. Specifically, we are particularly well-positioned to benefit from increasing work-from-home demand. Our unmatched price point breadth, our product depth, and our distribution capabilities put us in a strong position to benefit from elevated work-from-home activity.

A recent example of our efforts in the home office space is a win with a large enterprise client. Their employees, which number in the tens of thousands, will be able to choose home office furniture from a preset selection of our products. There are many more opportunities like this in the pipeline.

We are also uniquely positioned to benefit from trends tied to de-urbanization or urban flight. This trend should lead to more satellite offices away from city centers and in smaller markets. These are markets that play to the strength of our go-to-market models and where we have strong competitive positions.

Next, we believe densification of office space, which was a headwind for this segment for years, will stabilize, if not reverse in a post-COVID world. Finally, we believe office space layouts will change. While the exact layout of the office of tomorrow remains up for debate, it will not look like the office of yesterday. Change is good for our Workplace Furnishings businesses.

Third, our cash flow outlook is encouraging and our balance sheet will remain strong. Marshall discussed our cash flow and balance sheet outlook. As we look toward 2021, our targeted uses of cash continue to be ongoing dividend support; we have not cut our dividend in over 65 years of paying it; investment in growth opportunities and M&A in both Workplace Furnishings and Residential Building Products; and finally, opportunistic share buyback.

In conclusion, I'm extremely proud of all of our HNI members and of the company's collective focus and ability to adapt over the last six months. 2020 has presented and continues to present challenges that were unforeseen just a few short months ago. However, as we emerge in this period, we will do so a stronger company, well-positioned to grow revenue, expand margins and generate cash flow.

We'll now open up the call to your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from the line of Reuben Garner from The Benchmark Company. Your line is open.

Reuben Garner

Analyst, The Benchmark Co. LLC

Thank you. Good morning, everybody.

Q

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Good Morning.

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Reuben Garner

Analyst, The Benchmark Co. LLC

Maybe can we start with the fourth quarter decremental margin outlook. You mentioned business mix and increased investments. I guess, can you elaborate on those two a little bit? Where are you seeing the mix impact? Obviously, you're going to get a benefit from the Building Products business growing and the office business declining. What mix are you referencing? And then on the investment side, can you just go into the detail into which businesses that would be – where those investments would be and then the anticipated benefits of those, as we move into next year?

Q

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

Yeah. Sure, Reuben. So maybe the mix issue first. So I think we talked about this in the last call that we're seeing increased government mix in the Workplace Furnishings business and that typically comes with a little bit lower profit profile. So that's the business mix we're referring to there. The investments are interesting. We're expecting to invest \$5 million to \$7 million incrementally in the fourth quarter, and about a third of that is in the hearth business, around our marketing efforts and category expansion initiatives. And the other big item there is investments in digital and data analytics, which include things like eCommerce infrastructure, apps for our trade partners, visualization tools and things like that, and the rest is really around operational productivity.

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Reuben Garner

Analyst, The Benchmark Co. LLC

Okay. Thanks, Marshall. And the investments that you're making to grow the category in hearth and just grow the business in general, are you already seeing benefits from this? I mean, the third quarter 8% organic growth, the low-double digit kind of implied organic growth for the fourth quarter. I mean, that definitely seems higher than any other inside the homebuilding product categories, at least, that we've seen that need a contractor in the house. Can you just talk about kind of the end markets there versus maybe some of the internal initiatives that might be driving faster growth?

Q

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Yeah. Reuben, I'd say, first and foremost, as I said in my remarks, it's really the initial growth based on our model. I mean, we have just a strong vertically-integrated model that has been very responsive to the market and broad

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product depth and price point. So that'd be point one. Point two is the market – the investments in category expansion and basically consumer awareness are really just getting going. So they are starting to, I think, show some signs. But for the most part, those are going to be outward-looking investments that probably pay back more middle to late next year. So, net-net, the model itself is strong in the short term and the investments are well underway to continue that growth going forward.

Reuben Garner

Analyst, The Benchmark Co. LLC

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And, Jeff, you mentioned, I think, that there was – that the growth opportunity for the category was maybe underappreciated. Do you have a target for how much faster you can grow than the market over the next couple of years? When I say the market, I mean, if I've told you that housing was going to grow X percent and R&R was going to grow Y percent, what kind of a growth above the categories can you see in your building products business?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

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Well, Reuben, we don't really look at it that way. It's a good question. I think what we're talking about is 68% of homebuyers say, a fireplace is a must-have and 40% actually buy one. So that's really what we're focused on. We're focused on growing the addressable market through that effort. And that's – and how that's going to translate, I mean, there's a bunch of trajectories there, but the bottom line is, we're going to move that 40% up to 68% in a perfect world through those efforts. And then the other thing, we got existing homes in the remodel space. We got 30 million older gas and wood burning units installed and need of an upgrade. And so, we know where those units are at, where many of those units are at. And we're increasing our efforts there to ramp replacement activity. So those are the two big awareness plays.

Reuben Garner

Analyst, The Benchmark Co. LLC

Q

Great. And then, switching gears a little bit, I'm going to sneak one more in about the home office opportunity for you guys. I guess, can you, one, touch on and elaborate on the eCommerce supply constraint. I think you mentioned accelerating growth in the fourth quarter. So can you tell us maybe how you're getting around those?

And then you mentioned in enterprise, can you tell us how that's set up? Is the customer buying furniture for their employees to use at home and is it the same products that you would normally sell into the office or is this the things that you're selling through the eCommerce channel like through the Amazons and Wayfairs of the world? And thanks and congrats on the quarter. Good luck navigating through the rest of the year.

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

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Yeah. Let me hit the eComm supply first. I mean, basically, we were in a really strong position, but the business was so robust, we stocked out some of our top running SKUs and we're reloading those as we speak. I think even – if you look, there's a lot of supply constraint, [ph] the support (00:19:44) constraint, container constraint, there's still a lot of that out there but we've been able to – we got out it early, we've been able to get into a pretty solid stock position going into the fourth quarter. So we think, for the most part, those constraints will subside.

And then the question on the...

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

Enterprise client.

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Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

...enterprise client. Yes. That – first of all, let me just say, we're seeing all kinds of discussions and those types of opportunities take all different kinds of forms. Some clients provide a stipend. That's what happens to be the case here. And they will be products that aren't so much. These are more core Workplace products, commercial products from some of our companies not, what I would call, core eComm Amazon-type products that are going into that program, in particular. But like I said, those are all over the map. But there's a lot of discussion there and we are seeing those start to land.

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Reuben Garner

Analyst, The Benchmark Co. LLC

Great. Thanks again, guys.

Q

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Yeah. Thanks, Reuben.

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

Steven Ramsey

Analyst, Thompson Research Group LLC

Hey. Good morning. I guess to start with a quick follow-up on that eComm inventory issue. Did that inventory cause lost sales or did that push what would have been sales into orders and that benefits Q4?

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Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

No, Steven, it's all – in that world, it's a lost sale. They move on to another SKU or they may be – they back out and [ph] live (00:21:30) to relook later. But it doesn't operate like the core business where it [ph] just get lead (00:21:36) times out and then pushes.

A

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

And then Steven, I would point that this was pretty common in that segment...

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Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Yeah.

A

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

...that demand was so strong that a lot of players in the space had similar issues to what we've experienced.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

All right. Great. Okay. And then, I think, for eComm, as you think about the next 6 to 12 months in moving this business forward and people start going back to the office to a larger degree, does that shift your investment priorities and maybe discussions internally as you start to think about this business being a greater profit contributor than what it already is over the next one to two years as the pandemic impact [ph] stays (00:22:28)?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

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Steven, I think what I would say is it's going to continue to – we're going to continue to invest in this business. It's going to continue to be a big part of our kind of go-forward model. I think at this point, it's been incremental up to pre-pandemic. And now I think it's [ph] also going to settle (00:22:49) out in the long run as incremental business.

I do believe that the vast majority of employees will ultimately [ph] settle (00:22:59) out working, some at the homes, some at the office, and both are going to require furniture in both locations. And so the way we look at that business is it's – we're going to continue to invest in it. It will become core, more core over time and support kind of where we believe the future work is headed.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

Excellent. Okay. And then thinking about – switching to the resi market regarding Q3's results and the Q4 outlook, can you discuss if there is any mix impact or temporary cost reductions driving margins there? And then discussing the ability to drive high-teens margins in resi, long term, offset by some growth investments that were already discussed, maybe discuss why Q3 was so much better than expectations, even as you make those investments and how that plays out over the next two to three quarters.

Marshall H. Bridges

Senior Vice President & Chief Financial Officer, HNI Corp.

A

Sure. Yeah. Steven, as it relates to the margins in Residential Building Products, there wasn't really anything abnormal in the third quarter. We just had really strong volume. And of course, we had adjusted our cost structure for a much lower volume level that came in much stronger. So, that's the big issue there.

As we move forward, margin expansion is really not our goal. We really want to grow this business. Jeff talked about our efforts to create awareness and grow the category. So, we can continue invest pretty strongly there. But we'd expect to be able to hold margins at levels like we've seen here recently. They're very strong, really getting good ROIC. And the recent results really reflect the strong operational model we have there combined with some healthy market.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

Great. Then last quick one on the resi market, how is the performance of the recently acquired distributors compared to expectations or acquisitions over the past couple of years, and then what is the pipeline like for more deals going forward?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

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Yeah. I think the performance is – I think it does a great job with those. The performance is in line as we modeled and as we expected, and they're in some nice markets for us. And we are continually looking across the network to see where it makes sense to continue to add those to our owned network.

Steven Ramsey

Analyst, Thompson Research Group LLC

Q

Excellent. Thank you.

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

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Thanks.

Operator: Our next question comes from the line of Greg Burns from Sidoti. Your line is open.

Greg J. Burns

Analyst, Sidoti & Co. LLC

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Good morning. In terms of the order patterns on the office side of the business, can you just talk about maybe where if anywhere specifically, you saw the improvements? Was it on the HON kind of [ph] build (00:26:10) supplies business or more of the contract Allsteel side of the business or maybe it was across broad based, but can you talk about that, please?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

A

Yeah. Let's talk of Workplace first thing, excluding eCommerce. So what I tell you there is that we didn't see a lot of difference between the contract business and the small to mid-sized business or the HON businesses, as you mentioned. But we were down – orders were down like 35% in the second quarter. And we progressively got better as we move through the quarter. So we exited September down in the high-teens. I'd tell you that the last five weeks, we're in the low-20s. So it's consistent with our outlook that, A, it's going to moderate, the declines will moderate in the fourth quarter, but, B, we're not expecting it to come back really quickly in either side of the business to your original question, Greg.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. Great. Thanks. And I think you mentioned what that extra week added – will add in terms of your growth outlook for the fourth quarter for the Workplace. But I don't think you quantified that for the Residential Building Products. How much is the extra week adding to the outlook for that part of the business?

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

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Maybe the extra week is for both businesses, it adds 4% to 7% for both businesses.

Greg J. Burns

Analyst, Sidoti & Co. LLC

Q

Okay. Okay. Great. Thanks. Okay. Thank you.

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

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Thanks.

Operator: And we have no further questions in queue. I'd like to turn the call over to Jeff Lorenger for closing remarks.

Jeffrey D. Lorenger

Chairman, President & Chief Executive Officer, HNI Corp.

Thank you again for joining our third quarter call. We continue to be excited about what is ahead. We look forward to speaking with you next quarter. Have a great day.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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