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HNI Corp. (HNI)

Q3 2016 Earnings Call

CORPORATE PARTICIPANTS

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Kurt Tjaden
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Stanley A. Askren
Chairman, President & Chief Executive Officer, HNI Corp.

OTHER PARTICIPANTS

Budd Bugatch
Analyst, Raymond James

Kathryn Ingram Thompson
Analyst, Thompson Research Group LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Christy, and I'll be your conference operator today. I'd like to welcome everyone to the HNI Corporation Third Quarter 2016 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] As a reminder, today's conference call is being recorded. Thank you.

Mr. Herring, you may begin your conference.

Jack D. Herring
Investor Relations Manager, HNI Corp.

Thank you. Good morning. I am Jack Herring, Manager of Investor Relations. Thank you for joining us to discuss our third quarter fiscal 2016 results. Here with me are Stan Askren, Chairman, President and CEO; and Kurt Tjaden, 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 include additional factors that could affect actual results. The corporation assumes no obligation to update any forward-looking statements made during the call.

I am pleased to turn the call over to Mr. Stan Askren.

Stanley A. Askren
Chairman, President & Chief Executive Officer, HNI Corp.

Good morning, everyone. We'll share our assessment of the third quarter 2016, provide some thoughts on our outlook for the fourth quarter of 2016 and then give you a brief look at 2017. And then, we'll open the call up for questions.

First off, let me step back and provide some perspective on our performance year-to-date. Profit performance through the first half of 2016 was strong. We delivered a 35% increase in non-GAAP earnings per share on 5% lower sales. Then, in July, we provided earnings guidance for the third quarter and full year 2016, and we expected a slightly improving economy based on the trends and activity level seen at that time.

This included modestly [ph] strengthening up (02:10) furniture markets, continued growth in single-family housing starts at the bottom of the hard retail pellet market. It was developed during the third quarter, particularly, and the latter half of the quarter was different than we anticipated. We saw a broad-based step-down across our markets, businesses, channels, and product categories, which then did not bounce back in the quarter. This led to significantly lower quarterly results than we originally projected.

Despite the recent choppiness however, we remain focused on the long-term. I feel good about what we're doing and believe we continue to compete well. And let me add additional color here. We've been focused on streamlining our business and tightening up our portfolio, really sharpening our focus on the business. This includes simplifying businesses, product lines and business processes. In fact, in some cases, we've been willing to forego top-line growth to drive bottom-line improvement.

Our results include office furniture operating margins increasing more than 350 basis points over the past three years in a relatively slow economic environment. We've also achieved margins in our hearth business exceeding previous peak levels by 350 basis points. At the same time, we're doing all these, we've also improved our competitive position within our core markets, while also continuing to significantly invest for the long-term. We built a strong foundation for future profit growth and long-term shareholder value creation.

Our operational performance remains strong, while we continue to significantly transform cost structures and capabilities. We continue to make progress on our business system transformation initiative. We achieved a significant milestone this quarter. We successfully brought up two additional office furniture companies on the new enterprise system.

BST is one of the largest initiative company has ever undertaken as in a critical enabler to our long-term profitable growth. We remain on track with our previously announced plan to deliver \$35 million to \$40 million of structural cost savings by 2018. Related to this, we've recently announced the consolidation of an Indiana office furniture manufacturing facility into other HNI manufacturing operation. This move is expected to deliver more than \$7 million of annual savings to bring our total announced annual structural cost savings to \$16 million. We continue to work several other significant transformation initiatives. I am confident we remain focused on the right opportunities to drive long-term profitable growth.

So with that, those comments, I'll now turn the call over to Kurt Tjaden. Kurt?

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

Thank you, Stan. So for the third quarter, non-GAAP net income per diluted share was \$0.80 compared to the third quarter of 2015 when it was \$0.93 per share. Consolidated net sales decreased 5.1% to \$585 million or down 6.6% on an organic basis. Sales for the office furniture segment decreased 4.4%, or down 6.4% organically.

In our supplies-driven business, sales increased approximately 2%, or decreased by 2% on an organic basis. Sales in our North American contract office furniture businesses decreased 10%, while sales in our international office furniture businesses decreased 17%.

In our hearth business, sales decreased 7.3%. New construction sales decreased 3%, and sales of retail wood and gas products increased 3%, while sales of pellet appliances fell 38%. Non-GAAP consolidated gross margin increased by 30 basis points to 38.3%. Favorable price cost benefits were mostly offset by lower volume.

Non-GAAP selling and administrative expenses increased to 100 basis points, as a result of lower volume and the impact of acquisitions, partially offset by lower freight cost and expense timing.

Stan?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

Okay. So, as we look at the fourth quarter of 2016, we continue to expect an uncertain economic environment. Our markets remain dynamic, and we project demand will continue to be choppy. In office furniture, we expect our contract business to improve modestly, based on slightly increased activity levels. Our supplies-driven business is projected lower, and small business confidence remain subdued.

In hearth, we expect continued growth in our new construction business driven by single-family housing starts, and we project modest improvement in our retail wood and gas business, while retail pellet appliance sales stabilize near the bottom.

Let me turn the call back to Kurt for specifics on the numbers.

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

So for the fourth quarter, office furniture sales are expected to be down 1% to 4%. Organic office furniture sales are expected to be down 3% to 6%. Supplies-driven office furniture sales are projected to be down 2% to 5%, or down 5% to 8% organically. Sales in our remaining office furniture businesses are forecasted to be flat to down 3%. And within that, organic sales in our North American contract businesses are expected to be flat to up 3%. Hearth sales are expected to be up 1% to down 2%. New construction sales are forecasted to be up 2% to 5%. And we are projecting retail wood and gas sales to be flat to up 3%. Finally, retail pellet sales are projected to be down 10% to 15%.

Non-GAAP gross profit margin for the quarter is expected to be approximately 40%, and non-GAAP SG&A, which includes freight and distribution expenses, is expected to be approximately 29% for the quarter. We are now projecting the full year 2016 tax rate to be approximately 34.5%, and free cash flow for the year is expected to be in the range of \$80 million to \$90 million.

Our estimated non-GAAP earnings per diluted share for the fourth quarter is in the range of \$0.81 to \$0.91, resulting in projected full year 2016 earnings per share of \$2.60 to \$2.70. I'll remind you that the fourth quarter 2015 results included approximately \$0.05 of nonrecurring tax benefits. Excluding these one-time tax items, we expect EBIT for the fourth quarter of 2016 to be at or better than the fourth quarter 2015.

Finally, to reiterate our outlook for 2017, we continue to remain committed to providing you, our shareholders, our best current view of the business. The guidance range provided in our press release is broad, however, given the uncertainty in the economy. We expect, again, to reiterate full-year consolidated sales to be in the range of up 2% to down 2%, resulting in an initial estimate of non-GAAP earnings per diluted share for the full-year 2017 in the range of \$2.75 to \$3.15.

Stan?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

So, let me wrap it up here. Our businesses are strong and well-positioned for the future. Our brands are competing well in their markets. We continue to identify investment opportunities that will deliver strong financial returns, and I remain confident in our ability to drive long-term shareholder value creation.

So, with those comments complete, Kurt and I stand by for your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question comes from the line of Budd Bugatch from Raymond James. Your line is open.

Budd Bugatch

Analyst, Raymond James

Good morning. How are you doing?

Q

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

Good, Budd.

A

Budd Bugatch

Analyst, Raymond James

First question I guess is, has anything changed since you gave your business update? What are you seeing in the marketplace that's different than what you did when you gave your assessment of the third quarter?

Q

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

Budd, what the best comment would be is the markets have firmed up. As I indicated in my opening comments, we projected third quarter based on the trends we saw, big step-down. We see lots of volatility in certainly this year, recent years, and so you see a step-down and then you see a step backup, step-down, it's stepped down and it's stayed there. And then, as we finished out the quarter, we saw firm backup, and I think that's the significant change since we announced last.

A

Budd Bugatch

Analyst, Raymond James

Q

I'm not sure, I understand that. A firm backup at the lower level or you actually saw some increase from where it's stepped down too.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

A firm backup to where it was which is at a lower level historically, but better than the step-down.

Budd Bugatch

Analyst, Raymond James

Q

Can you quantify that at all, Stan?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

I think it's in the guidance we provided here, but it's – go ahead, Kurt.

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

No, I think that's the way to think about it, Budd. If you think back to what we've given for full year guidance originally back in July, and look at what we've given now for the full year, and you take out then what happened in the third quarter, we're kind of back with what we had – would have called implied in that fourth quarter guidance. So, overall, I'd say it's flat to minus a couple of percentages.

Budd Bugatch

Analyst, Raymond James

Q

Okay. Talk to me a little bit about what you're seeing in costs. You had a tailwind for now a few years in costs, and we're beginning to see I think the early signs of some commodity inflation, first in steel and now more recently with some things that are going in around the world in some of the chemicals that go into phone. Are you seeing the same, or can you tell us, what's the...

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

[indiscernible] (12:46). Our outlook on commodities is going to be moderately – more inflationary, moderately up. I think it's interesting to see where steel ends up. As you recall, we index steel and so we lag on the way out, but we lag on the way down. And I think, we've got a pretty good picture for first half, but I think the second half is a big picture.

And now I think the commodity picture, there's lots of sort of input cost questions and lots of supply changes as well. I don't – unless the economy picks up significantly, I don't think we're going to see a significant inflation moderate, but I think we're well-prepared to handle whatever comes based on the picture that we have in front of us, excuse me.

Budd Bugatch

Analyst, Raymond James

Q

And your last price increase was early 2016, is that right, is that when you normally adjust prices once a year or so?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Generally yes, Budd.

Budd Bugatch

Analyst, Raymond James

Q

Okay. And in the fourth quarter, what are the charges that we look and how should we think about that?

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

So, are you talking about the non-GAAP restructuring charges, Budd?

Budd Bugatch

Analyst, Raymond James

Q

Yes, sir. What charges do we have?

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

So, you would have what was filed in recently in the 8-K, we believe that was laid out for the Orleans, Indiana. There would be some with that, there would be a little bit left in Paris which is a hearth operations, which was announced earlier this year, and that we'll also have the donation of the building which we referred to in our press release. And then, we had some ongoing charges for operation – other operations transformations here in our Muscatine operations.

Budd Bugatch

Analyst, Raymond James

Q

That's all third quarter, right, or is that fourth quarter?

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

Those will all continue in the fourth quarter.

Budd Bugatch

Analyst, Raymond James

Q

So you donated a building and that charge continues into the fourth quarter?

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

There are some charges that continue in the fourth quarter with that.

Budd Bugatch

Analyst, Raymond James

Q

It was a [ph] \$1.63 million (15:03), right?

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

Right. So we're accelerating – started accelerating that depreciations, that donation will actually happen in the fourth quarter, so you'll see charges continue into the fourth quarter.

Budd Bugatch

Analyst, Raymond James

Q

Can you quantify for us what the charges are likely to be total or...

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

Total for that building or in total across all others, Budd?

Budd Bugatch

Analyst, Raymond James

Q

Well, I'll get it from you offline. I'll do it that way.

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

Yeah. It's probably easier to walk you through that, but I think at a macro level for the year, Budd, let's [ph] have it (15:37) offline, probably easier to do that.

Budd Bugatch

Analyst, Raymond James

Q

Yeah. Let's do that, and we'll talk about that. Okay. Thank you very much.

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

Thanks, Budd.

Operator: Time for one last question. And our last question comes from the line of Kathryn Thompson from Thompson Research Group. Your line is open.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Hi. Thank you for taking my questions today. I'd like to dig a little bit more into your 2017 guidance. You look at the past few fiscal years, you typically give the out-year guidance in conjunction with Q4 earnings, but you decided to move it a little bit early this year. One, what's the thought process for doing – taking that stance, the strategy? And then second, in the same spirit, you're able to give some granularity for Q4 guidance. If you could at least give the logic for the fundamental demand, gross margin, and SG&A type levers that dictated 2017 guidance? Thank you.

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

So, let me take a shot at it, Kathryn. One, I think, if you go back to last couple of years, we have actually given guidance in on this call for the full year at a fairly broad range and then updated that and narrow that range through the year, so this is consistent with our past practice.

An answer to your second one, A, we give a pretty broad range across dividends, and we said given the uncertainty across the business. But I think as we talked about there, you can get to between inflation and the structural cost actions that we've talked about, you can get to a margin assumption. We talked about our operating leverage targets of 25% to 35% across our businesses that will help you to those ranges and that would include pricing and inflation on your assumptions.

So I think the components are there. And if you look at the two segments and your view on housing and then how that trades off with what might happen in office, I think you've got the components. At a high level, that's how we come with that sales range and that earnings range. But, again, great degree of uncertainty I think as we look through the end of this quarter on how 2017 develops.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

So maybe just conceptually, if you look at, for instance, what you discussed on for Q4 for supplies sales being down and office being flat to down, I mean are you anticipating a continuation of that trend? Really, it's more of a – do you expect more – a little bit more the status quo you should expect into the back half of this year to continue into next year, or is there do you expect any type of change in that trend? And I know it's your first step at it, but it just helps us understand.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

Sure. Yeah, I understand, Kathryn. So, again, this is Stan. So, Kurt indicated, we even talked about not following best practice and not giving any guidance because it's relatively uncertain. A lot of this depends on what happens with the economy. So, we're anticipating I think a similar economy, and then I would say a relative growth against the economy is going to firm up some next year 2017 versus 2016. We should be through a lot of our sort of our – I've talked about our focus on improving the profit foundation and selecting out of some businesses and something, we should be through that and we should start to see some growth relative to the economy.

Now, if economy is down significantly, we're not projecting that we're going to just smoke the whole thing and be up big time. So we start with the – on the fundamental, which is kind of to be the same – relatively the same, we're going to roll into the first half of the year at a similar trend, slightly increasing as we finished the year out on virtually all of our businesses. Then, when you rolled in, as Kurt said, our ongoing leverage and then you rolled in our structural cost takeout and then you added some other factors, you get generally at those numbers that we laid out for you.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. Thank you. Just for the quarter, freight and distribution costs were down roughly 7% or so, was this driven by lower volumes or was this part of your overall structural expense reduction efforts, to really just trying to get a sense if this is something more structural or just something bit more a function of volume?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

We're ongoing always. So the answer, it's kind of business as usual for the most part, you will always see us driving productivity and some of it is relative last year, we were bringing up some regional distribution centers. And so maybe there was some additional cost, that's not recurring. It's no big switch or change in what we're doing, it's really more sort of ongoing productivity initiative I believe.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. That's helpful. And I know that you mentioned in your prepared comments and release this fall about closing your Indiana facility. But, as you continue to focus on, continue lean efforts and efforts to take out structural costs, what are other types of actions you may consider taking as we look towards the back half of this year and into 2017?

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

So we're always – we think about this a couple ways. So, the answer is, Kathryn, we always are working prospective, a, structural kind of, I'll call it, core productivity and then, b, structural cost takeout. And so, we came forward and announced earlier in the year, this \$35 million, \$40 million of structural cost savings by 2018. We're mid-innings on that I would say, we probably now and officially now have that. We have several other major projects teed-up to continue to take that structural cost savings out. In addition, we're just driving – continue to drive core productivity around our material flows, our information flows and just sort of running our business more efficiently.

We've got a pretty good track record over the last – well over the last 30 years, I guess. So, kind of just drying out, so I think there'll be more of that. So, there's a very intensive activity always at HNI around those sort of things, good times and bad times. I would tell you that often we are attacking structural costs when things are the best. We don't wait around [ph] things to get tough (22:49).

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

If I could add, Kathryn, to Stan's comments, what you should feel good about when we talk that \$35 million to \$40 million of structural cost by 2018 was getting roughly two-thirds of that in place next year. We are on track to deliver that. So, to your earlier question, if you think about 2017, that's well in play and well advanced to meeting that objective.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay. And final cleanup call, just related question, related to the \$35 million to \$40 million. This is all achievable regardless of – how – the \$35 million to \$40 million structural costs, is there any lever that's tied to sales trend? So, this is achievable even if sales were to drop just theoretically.

Kurt Tjaden

Senior Vice President and Chief Financial Officer, HNI Corp.

A

Yes. The answer to that question is, yes.

Kathryn Ingram Thompson

Analyst, Thompson Research Group LLC

Q

Okay, great. Thank you very much.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

A

All right, Kathryn. Thank you.

Operator: That was our last question in queue. We'll turn the call back over to our presenters for any closing remarks.

Stanley A. Askren

Chairman, President & Chief Executive Officer, HNI Corp.

All right. Well, thank you so much for tuning into our earnings release conference call. We look forward to talking to you in the future, and hope you have a great day.

Operator: And ladies and gentlemen, this does conclude today's conference call. Thank you for joining us today. You may now all disconnect your lines.

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