Herman Miller, Inc.
First Quarter Fiscal 2018
Investor Conference Call
September 21, 2017

The following document is a replication of the notes used in Herman Miller, Inc.'s First Quarter Fiscal 2018 conference call presentation. Brian Walker, President and CEO; Jeff Stutz, Executive Vice President and CFO; and Kevin Veltman, Vice President – Investor Relations and Treasurer, hosted the call. These notes represent an abridged version of the conference call and do not include the Q & A portion. Those wishing to hear the associated Q & A segment can do so by listening to the archived webcast version of the call on the investor relations page at www.hermanmiller.com.

This presentation will include forward-looking statements that involve risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. These risks and uncertainties include those risk factors discussed in the Company's reports on forms 10-K and 10-Q and other reports filed with the Securities and Exchange Commission.

Also, the financial amounts and references to internal measures mentioned today are unaudited.

OPENING – BRIAN WALKER, PRESIDENT AND CEO

Good morning everyone. Thanks for joining us today.

I'd like to start with a brief overview of our quarterly results, followed by highlights of the progress we have made during the quarter against our key strategic priorities. I'll close with a view of the current economic backdrop before turning it over to Jeff and Kevin for more information on the financial results, including the change we announced earlier this week to our segment reporting structure.

In short, the quarter reflected better than expected demand patterns as organic order growth of 8% over the prior year was a clear highlight and we finished the quarter with organic backlog up 8% over last year. Adjusted earnings per share of $0.57 met our expectation for the quarter. Our North America, ELA and Consumer segments all delivered strong order growth for the quarter. In addition to the ongoing work to transform our real estate footprint in the Consumer business by increasing selling square footage, our Consumer business also delivered its fifth straight quarter of comparable brand growth as our efforts to accelerate revenue growth across our consumer sales channels gain traction.

Gross margin was near the low end of our expectation for the quarter. This was driven in large part by strong demand for some of our more capacity constrained product categories – namely height adjustable tables and laminated storage. As we worked to keep pace with demand, we incurred additional overtime and outsourcing costs. Our operations teams have done a terrific job responding to the challenge, and while some of these pressures are likely to continue in the near-term, we are moving quickly to add capacity in key areas of our operations. We also incurred higher than normal warranty expenses this quarter. These expenses impacted the profitability of each of our segments, but had a disproportionately large effect on our Specialty and Consumer segments given their relative size. Despite this, I'm very pleased with the way in which our teams across the organization have managed overall operating expenses, which helped offset the gross margin and warranty pressures we experienced in the period. Our cost savings initiative is one of our key areas of strategic focus, and we're making good progress toward our ultimate savings goal.

Now, with that overview of the quarter, I'd like to update our progress on our five key priorities. These priorities are aimed at positioning us for the trends we see in our customer base, distribution channels, technology and the changing nature of work as we focus on driving sustainable, profitable growth for the long-term. As a reminder, the five strategic priorities that we are focused on across Herman Miller are:

- Scaling our consumer business
- Realizing the next generation of our Living Office proposition
- Leveraging our dealer eco-system
- Delivering on our cost and profit improvement goals and
- The continued commitment to product and service innovation

I'd like to focus on specific highlights of progress during the quarter on these priorities.

As we mentioned last quarter, we have brought in fresh outside perspective to challenge our thinking about ways to drive profitable growth as we scale our Consumer business. As a result of the first phase of this work, we have growing confidence that we can meet our goals for profitable growth in this business and are targeting specific work in the areas of pricing strategy, sourcing, logistics, and e-commerce. There is more work to do as we create detailed implementation plans and this effort will result in short-term costs as we develop these next steps. That said, the path forward is coming into view, and we have growing confidence that this work will contribute meaningfully to achieving our stated profit improvement objectives – namely driving Consumer operating margins toward the 10% level. We'll have more to share in upcoming quarters as we make further progress.

Our ongoing real estate transformation to expand the footprint of Design Within Reach retail studios is progressing well. In total, we expect to add an incremental 60,000 square feet of selling space by the end of May. As sales at the new and expanded studios ramp up over the first 12 to 18 months of operating, their profitability will increase as they mature and help drive operating margin expansion.

Despite our growing confidence in the long-term profit potential of our Consumer business, the operating results this past quarter did not meet our expectations. This was due, in large part, to the product warranty costs I mentioned as well as expenses arising from the bankruptcy of one of our suppliers. Aside from these transitory issues, it is also important to point out that we currently have 7 new studios, plus a new West Coast outlet, that are in that early maturing phase. While this will remain a drag on earnings in the near-term, the Consumer segment has a double-digit revenue growth opportunity that we believe can increase operating margins for this segment from 2% last year to at or near 10% over the next three years. In addition to the profitability improvement initiative and real estate transformation, continuing to increase the mix of higher margin exclusive product designs and driving growth through our catalog, contract and digital channels will also support this growth opportunity.

As we work to realize the next generation of the Living Office framework, we have been focused on adding new products and technology solutions in addition to new research highlighting the benefits of applying these concepts.

As part of this effort, bringing Herman Miller quality and innovation to a broader range of price points will create new volume opportunities for our business. The recently launched Verus task chair and a number of new desking products in the pipeline reflect product categories that we see particular opportunity to drive sales growth.

While still in the early days, our Live OS technology platform makes furniture “smart” by providing robust space utilization data, as well as wellness benefits and enhanced user experiences. This new program has strong initial momentum with two beta installations since June and several more customer sites scheduled to install in the coming months. The platform has an active sales pipeline, particularly with large corporate customers that seek to better understand how their spaces are being used. The Live OS platform will grow over time with a smart version of the remastered Aeron chair and meeting room sensors being developed for a launch in the second half of the year. These will provide further data insights for real estate professionals along with enhanced comfort and personalized experiences for people during their workday.

Moving to our cost savings initiative, we are making solid progress on our target of gross annual savings of $25 to $35 million by Fiscal 2020. During the quarter we implemented additional actions and we estimate our gross annualized savings run-rate today is approximately $15 million. Looking ahead, this effort will not only help offset the potential for wage and material inflation and fund a number of growth initiatives, but ultimately, this initiative plays a key role in our goal of increasing consolidated operating margins above 10% over the next three years.

Finally, we are advancing toward our goal of fully leveraging our dealer eco-system to, simply put, increase our share of wallet. Over the last few months, we have enhanced our order fulfillment capabilities enabling our dealers to more easily order and specify products across the entire Herman Miller group of brands, including key contract-focused products from Design Within Reach. The progress we have made in this area sets the stage for additional work planned in the months ahead aimed at further improving our digital specification tools for dealers.

With that update on our strategic priorities, let me provide some specific points about the current macro-economic picture for our business.

While order levels for the North America contract industry remain choppy from month to month, we saw a clear improvement this quarter in both the pace and consistency of order patterns across much of our business. This is encouraging, and appears consistent with what remains a fairly positive economic picture overall, supported by positive data around confidence measures, service sector employment, architectural billings and non-residential construction activity.

While uncertainty persists around the U.S. administration's timetable and approach, tax reform has the potential to be a tailwind for our business through higher employment levels and increased investment spending.

The devastation from the recent hurricanes and earthquakes in North America has the potential for near-term disruption in the impacted regions as they focus on recovery. That said, these events had little to no impact on us for the first quarter. None of our dealers in those regions sustained significant damage to their physical spaces, their people are safe and relative to the recent hurricanes the dealers have resumed operations.

On the Consumer front, Design Within Reach has studios in Houston, Miami and West Palm Beach that were impacted by the hurricanes. Here as well, our people are all safe and none of the studios sustained significant damage and have already re-opened. The concern is, of course, the impact of business disruption as the surrounding areas undergo the cleanup and rehabilitation phase. Like many in the retail space, there may be a boost in demand that comes out of this as customers receive insurance settlements and begin the rebuilding process.

For both our dealers and retail operations, there is potential that we could see some near-term demand impact as businesses and consumers begin the rebuilding process. Given the level of uncertainty tied to this issue, we have provided a broader range for Q2 revenue and EPS guidance than we typically provide.

Relative to the macro-economic picture for the North America consumer space, improved consumer spending, low unemployment, strong equity markets, historically low interest rates, and limited unsold home inventory combine to provide a positive consumer environment.

While the picture is fairly stable globally, the ELA segment will have to deal with pockets of disruption in some areas including navigating Brexit, softness in various oil-producing regions including the Middle East, and the continuing uncertainty of the geo-political climate surrounding North Korea.

Encouraged by the strong consolidated demand levels this quarter, we will continue to focus on executing on our strategic agenda for Herman Miller. We see the profitability improvement potential in our consumer business and have identified the areas that will release that potential. Our five key corporate priorities will guide our efforts as our multi-channel business continues to deliver leading designs and innovations to new audiences virtually anywhere in the world.

With that overview, I'll turn the call over to Jeff to provide more detail on the financial results for the quarter.

FINANCIAL REVIEW – JEFF STUTZ, CFO

Thanks, Brian and good morning everyone.

Before I begin, I want to cover some changes to the way we report our business results across each of our business segments. Effective in the first quarter, we moved our Nemschoff subsidiary out of the North American segment and into the Specialty segment under the leadership of Steve Gane. This change was made to better leverage the unique skill sets and capabilities of our Specialty business teams – particularly in the areas of craft wood and upholstery manufacturing – and also provides a strong fit for this segment's focus on the architect and design community. In addition to this move, we have refreshed our methodology of allocating functional SG&A expenses to the business segments. Our business has changed significantly over the past few years, and this change better reflects the utilization of these functional services across the Herman Miller group of businesses. We have also identified a pool of corporate support costs that will no longer be allocated to the reportable business segments. Rather, these costs will be tracked and reported as "Corporate Unallocated Expenses". This change more closely aligns to industry practice and provides a better reflection of how we will measure and manage our business going forward.

Finally, we have expanded our supplemental disclosure to include gross margin results for each segment to help investors better understand the financial profile of each of our business segments. Given these changes, we filed an 8-K earlier this week that provided a restatement of our segment results by quarter for Fiscal 2016 and 2017 to be comparable with this new approach.

With that bit of housekeeping out of the way, I'll now cover the results for the first quarter. Consolidated net sales in the first quarter of $580 million were 3% below the same quarter last year. As a reminder, the first quarter of fiscal 2017 included an extra week of operations. In addition, during the quarter, we made a change in our standard customer shipping terms at DWR. The change impacts the point at which revenue is recognized on product sales, in general moving it to the point of shipment rather than delivery. The effect of this is purely one of timing, but the change this quarter resulted in approximately $5 million of revenue being recognized that would have otherwise been deferred into Q2 under our previous terms. On an organic basis, which excludes the impact of this change in terms as well as last year's extra week, foreign currency movement and dealer divestitures, consolidated net sales were 4% higher than last year's level. Orders in the period of $595 million were flat compared to the same quarter last year. On an organic basis, orders were 8% higher than the first quarter of last year.

Our backlog last year included approximately $12 million in orders related to dealers that have subsequently been divested. Excluding the impact from those dealer divestitures, the ending backlog for the quarter was 8% higher than last year's level, which as Brian highlighted, gives us a nice tailwind as we enter Q2.

Within our North American segment, sales were $329 million in the first quarter, representing a decrease of 5% from the same quarter last year. New orders were $335 million in the quarter, reflecting a slight increase from last year. On an organic basis, we posted year-over-year revenue growth of 3%, while orders were 9% higher than the same quarter last year. Higher order levels during the quarter were led by medium and large projects, noting in particular that we saw a marked increase in large projects from what we had been seeing in recent quarters. Sector results showed fairly broad based growth, led by Communications, Wholesale and Manufacturing sectors, partially offset by lower demand in Business Services, Pharmaceuticals and Computer Equipment.

Our ELA segment had a relatively slow start to the fiscal year from a revenue perspective, reporting sales of $93 million in the first quarter - a decrease of 4% compared to last year on a GAAP basis, but up 3% organically. New orders totaled $109 million which is down 1% from last year on a reported basis, but up 7% organically. The year-over-year organic order growth was driven by strong activity in Latin America, Australia and Europe, partially offset by lower demand patterns in the UK, Middle East and China.

As mentioned earlier, our Specialty segment now include the results of our Nemschoff subsidiary. Sales in the first quarter within our Specialty segment were $75 million, a decrease of 5% from the same quarter last year. New orders in the quarter of $75 million were 7% lower than the year ago period. On an organic basis, net sales were 1% higher compared to the prior year, while orders decreased approximately 2%. The decrease in orders was primarily due to a year-over-year decline at Geiger in the face of a large project reflected in prior year orders, partially offset by year-over-year order growth for Nemschoff, Maharam and the Herman Miller Collection. Profitability for this segment was lower than last year tied to a number of transitory factors in the quarter. This segment bore a relatively large share of the warranty costs that Brian referred to earlier. Nemschoff also experienced a supplier quality issue during the quarter that negatively impacted their sales and operational productivity in the period.

The Consumer business reported sales in the quarter of $83 million, an increase of 10% compared to last year driven by strong growth across our studio, catalog, eCommerce and Contract channels. New orders for the quarter of $76 million were 7% ahead of the same quarter last year. On an organic basis, which excludes the impact of the change in shipping terms on net sales and the extra week last year, sales were 11% higher than Q1 of last year, while orders improved 13%. On a comparable brand basis, DWR revenues for the quarter were up by 12%. Related to Consumer operating earnings for the quarter, we estimate the additional revenue resulting from the change in shipping terms increased operating earnings by approximate $1 million for the quarter.

While operating earnings for this segment continue to be limited by the roll-out of new studio locations and other investments that we believe are necessary to support our longer-term growth potential, as Brian mentioned, we see a path to operating margins near double digits for this business over the long term. During the current quarter, we estimate the unfavorable impact to operating earnings related to the “drag” from new studios that have not reached full maturity was approximately $2 million. Additionally, warranty costs and the write-off of a claim against a supplier negatively impacted segment profitability by approximately $1.5 million this quarter.

Consolidated gross margin in the first quarter was 37.4%, which was 100 basis points lower than the first quarter last year and near the low-end of our expected range coming into the period. As we outlined in the earnings release, we faced some capacity challenges in the quarter given strong demand for certain product categories. This resulted in additional labor and outsourcing expenses necessary to meet our customer delivery commitments – a factor that we estimate reduced our Q1 gross margin by approximately 20 basis points. In addition, we continued to feel the impact of higher steel prices and experienced lower production leverage in the ELA and Specialty segments.

Operating expenses in the first quarter were $166 million compared to $174 million in the same quarter a year ago. The prior year included approximately $2 million in expenses related to dealers divested since that time. After adjusting for those items, operating expenses were $6 million below last year due to a variety of factors. The primary factor was that the prior year reflected an extra week of operations. As Brian noted, we also made good progress on our cost savings initiative, which contributed to lower operating expenses for the quarter. We also benefited from favorable claims experience for healthcare benefits and had lower incentive compensation levels compared to last year. This favorability was partially offset by higher warranty costs, increased occupancy and staffing costs related to new DWR studios and investments in growth initiatives. Net, our teams have been very focused on managing operating expenses across the organization and it is making a difference. To be sure, the walk toward our ultimate goals for profitability won’t be an even one, as required investments for growth are not necessarily linear with our cost reduction plans. However, we feel very good about the progress our teams are making, and we feel we are on track with the cost reduction plans we’ve previously outlined.

Restructuring actions involving certain workforce reductions that were announced in the first quarter resulted in the recognition of severance and outplacement expenses during the quarter. We also recognized other charges related to the consulting fees associated with our profitability improvement initiative for our Consumer business. Combined, these amounts totaled $2 million for the quarter.

On a GAAP basis, we reported operating earnings of $49 million this quarter. Excluding restructuring and other charges, adjusted operating earnings this quarter were $51 million, or 8.8% of sales. By comparison, we reported operating income of $56 million, or 9.4% of sales, in the first quarter of last year.

The effective tax rate in the first quarter was 30.5%. This compares to an effective tax rate of 32.0% reported in the same quarter last year.

Finally, net earnings in the first quarter totaled $33 million, or $0.55 per share on a diluted basis. Excluding the impact of restructuring expenses and other charges, adjusted diluted earnings per share this quarter totaled $0.57 compared to earnings of $0.60 per share in the first quarter of last year. As a reminder, the first quarter of last year included an extra week of operations. We estimate that extra week contributed approximately $0.05 of earnings per share to the first quarter last year.

With that, I'll now turn the call over to Kevin to give us an update on our cash flow and balance sheet.

KEVIN VELTMAN, VICE PRESIDENT – INVESTOR RELATIONS & TREASURER

Thanks, Jeff.

We ended the quarter with total cash and cash equivalents of $80 million, which reflected a decrease of $16 million from last year. Cash flows from operations in the period were $19 million compared to $30 million in the same quarter of last year, primarily due to a one-time contribution during the first quarter of $12 million to increase the funded status of our UK pension plan.

Capital expenditures were $25 million in the quarter. Cash dividends paid in the quarter were $10 million. As a reminder, last quarter we announced a 6% increase in our quarterly dividend rate that will be paid beginning in October. This increase brings our expected annual payout level to approximately $43 million. We repurchased approximately $11 million of shares during the quarter.

We remain in compliance with all debt covenants and as of quarter-end our gross-debt to EBITDA ratio was approximately 0.8 to 1. The available capacity on our bank credit facility stood at $388 million at the end of the quarter, which includes $150 million set aside to repay the private placement notes that are due in January 2018. Given our current cash balance, ongoing cash flows from operations, and our total borrowing capacity, we believe we continue to be well-positioned to meet the financing needs of the business moving forward.

With that, I'll now turn the call back over to Jeff to cover our sales and earnings guidance for the second quarter of fiscal 2018.

OUTLOOK – JEFF STUTZ

Thanks Kevin….

We anticipate sales in the second quarter to range between $590 million and $620 million. While the midpoint of this range reflects our best estimate for the period, we are providing a wider-than-normal range for sales and earnings this quarter to reflect increased uncertainty resulting from the recent storms in Texas and the Southeast. We estimate the year-over-year favorable impact of foreign exchange on sales for the quarter to be approximately $4 million. On an organic basis, adjusted for dealer divestitures and the impact of foreign exchange translation, this forecast implies a revenue increase of 6% compared to last year at the mid-point of the range.

We expect consolidated gross margin in the second quarter to range between 37.5% and 38.0%.

Operating expenses in the second quarter are expected to range between $172 million and $176 million.

We anticipate earnings per share to be between $0.55 and $0.61 for the period. This assumes an effective tax rate of 30.5% to 31.5%.

With that, I'll now turn the call back over to the operator for your questions.

[Q&A]

CLOSING – BRIAN WALKER

Thanks for joining us on the call today. We appreciate your continued interest in Herman Miller and look forward to updating you next quarter. Have a great day.