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Q4 2021 Kimball International Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. At this time, I would like to welcome everyone to the Kimball International Fourth Quarter and Full Fiscal 2021 Earnings Conference Call. As with prior conference calls, today's call, August 4, 2021, will be recorded and may contain forward-looking statements as defined under the Private Securities Litigation Reform Act of 1995.

Actual results could differ materially from the forward-looking statements. Risk factors that may influence the outcome of forward-looking statements can be seen in the Kimball International Form 10-K. During today's call, the presenters will be making references to an earnings slide deck presentation that is available on the Investor Relations section of Kimball International's website. On today's call are Kristie Juster, CEO of Kimball International, and T.J. Wolfe, Executive Vice President and Chief Financial Officer.

I would now like to turn today's call over to Kristie Juster. Ms. Juster, you may begin.

Kristine L. Juster ***Kimball International, Inc. - CEO & Non-Independent Director***

Thank you, everyone, for joining us to review our Fourth Quarter and Full Year 2021 Results and discuss our business outlook. I am pleased to report that we ended a challenging year on a high note. Robust growth in fourth quarter orders from our Workplace and Health end markets indicate that these markets are in recovery and that Kimball International is positioned well to benefit from the industry upturn.

Let me begin by covering the key takeaways from our fourth quarter performance on Slide 3.

First, this was the first quarter since the onset of the pandemic that revenues from our Workplace and Health markets increased year on year. Workplace and Health accounted for 80% of our fourth quarter revenues and their expected double-digit growth in fiscal 2022 will boost these two end markets to at least 85% of our total revenues next year.

Second, order rates in our Workplace and Health markets improved progressively throughout the quarter, and this momentum continued into July, indicating a pickup in the conversion of bidding activity into orders. Our strong year-over-year orders were led by Workplace and Health day-to-day bookings as we anticipated. Our leading indicator metrics quoting activity in markups in both Workplace and Health increased at strong double-digit rates compared to Q3 levels. Another indication of better market conditions ahead. We are pleased with the consistent and continued development of orders in both Workplace and Health.

Third, we reported a considerable sequential increase in our gross margin in the fourth quarter, although not as high as we had initially expected due to continued inflation. T.J. will discuss this in more detail later in the call.

Fourth, we continued to gain traction in the choices we have made in our Connect 2.0 strategy, both in driving share in our targeted end markets and exceeding our full year cost savings targets by over 10%. And lastly, we are very pleased with our progress on the stage one growth priorities for the Poppin acquisition. In summary, the fourth quarter represented what we believe is an inflection point in our business and confirmed our clear path forward to future growth.

Now let's review Kimball International end markets and their relative positioning with respect to business recovery. Beginning with Health on Slide 4. As we have shared, this market continues to ramp well post-COVID, reflecting the faster return of health administrative workers, increased public funding, and expansion of areas such as behavioral health, academic medical centers, and specialty hospitals. Fourth quarter sales to the Health market increased 16% year-on-year, and orders were up over 60%, all driven by a 53% increase in the number of orders and a 13% increase in order size compared to Q4 last year. Our key differentiators in this market are our dedicated health brand Interwoven, our team of experts with extensive industry knowledge and experience, our focus on connecting with selected 32 health systems, our partnership with the Fed government health sector, such as Veterans Affairs, and our full access to the Kimball International multi-branded portfolio.

We have just concluded a proprietary research project that has given us tremendous insight to the future of healthcare delivery from industry leadership in design, health systems, and doctors and nurses. The results confirm the importance of the physical environment in Health. Over 72% said a hospital environment plays a key role in determining patients' health outcomes. 90% said they need a more flexible environment, and 90% also said they were planning construction in the next 3 years. The trends changing the interior environments range from blending in the benefits of telehealth, the importance of non-clinical areas in behavioral health, the need for our caregivers to work in an efficient and comfortable environment, and of course, the required flexibility of space and adaptability of furniture. The results in Q4 and the future indicators continue to give us confidence in our investment in focus and Health.

Now let's move to Slide 5, where we begin our discussion of the Workplace market, which represents the largest portion of our business, and where we also see firm indications that a market recovery is underway. In the fourth quarter, we experienced a 27% year-over-year increase in Workplace orders, led by Education and Commercial. And we're pleased to report that the 26% sequential increase in Workplace orders featured a considerable increase in demand for Poppin products. Our fourth quarter day-to-day business was significantly ahead of last year's fourth quarter. And while large project sales are still lagging to last year, our return to learning and educational buying season orders ramped up 30% year-over-year and reached pre-pandemic levels for K through 12 for fiscal year 2021.

On Slide 6, we share our outlook on the future of work, which is very consistent with our beliefs entering last quarter. The new forming hybrid model will be the center of the Workplace strategy. And although unique to each company, the principles of attracting and retaining talent through flexibility in a highly collaborative space that is a centralized hub for teamwork, community, and culture are highly consistent. For future success, employers will need to entice staff back to work with wellness in mind, create comfortable human-centric spaces, focus on elements of connectivity and socialization, and offer continued freedom and flexibility for focused work.

As return to work continues, employees expect a more hybrid level of furnishings, merging the comfort of home with the durability of the office. Kimball International's portfolio, together with our recently released new product introductions and our best-in-class lead times support our confidence in our ability to gain share as the industry moves to furnish the blended office with comfort. We believe the office will become more important than ever in attracting, developing, connecting, and motivating talent.

Our multi-branded selling approach, our expertise in the ancillary open space product portfolio, and commitment to winning in secondary markets is proving to be an exciting path as the industry ramps. Our broad portfolio of brands provides options for our dealers to provide tailored solutions for their customer, depending on their specific needs and budget requirements. Today, over 85% of our Workplace products are in the ancillary category, which are ideally suited for the collaborative atmosphere of a new office environment. And approximately 80% of our Workplace business is derived from secondary markets where office reentry is taking place at a faster rate than in larger metropolitan areas.

Now to Slide 8 for an update on Poppin, which we see as a transformational transaction for Kimball International, bringing proven digital and direct expertise into our portfolio. Revenue increased sequentially by 42%, and bookings have increased sequentially by 16%, and that should be recognized in the next 2 quarters. We are seeing the return of projects with a higher average order value closer to Poppin's pre-pandemic metrics. The Poppin digitally-driven B2B commercial furnishings direct business model is leading out of COVID at a faster rate than our traditional channel. This significant growth has come from core Poppin showroom markets in major metro areas, reigniting the model that we recognized at acquisition. As well as our stage 1 priorities are well underway, we have identified 3 of the 10 markets for Poppin showroom expansion in scope for fiscal 2022. These locations will be in secondary markets, leveraging our talent and long-standing relationships.

PoppinPro reflected on Slide 9 is the dealer program we officially launched in late May, providing full access to Poppin suite of products, new categories, and services to over 1,000 existing Kimball International dealers. Our team has spent the past 2 months educating the dealer network, and early indicators show strong traction to our internal plan. We are also excited about the two new categories of

PoppinPod and PoppinSpaces, each providing flexibility and adaptability in an open-space environment for individual, private, and group use, all in line with the strategy of where Kimball International excels in the market is forming.

Now moving to the Hospitality market's Q4 performance and how we are thinking about for 2022. As we have shared, we expect Hospitality will be the last to ramp, with no significant sequential sales improvement until end of fiscal 2022. Fourth quarter sales decreased 35% year-on-year, and we are managing the business very carefully as margins remain constrained due to high freight costs. With longer lead times and a need for large group business travel to return, we will take a similar approach into fiscal 2022, managing our cost, increasing our mix of more profitable custom products, partnering with our customers, and preparing for growth as the market returns.

To wrap up, the timing, composition, and speed of the market recovery in Workplace and Health is tracking broadly in line with our expectations, and we continue to gain confidence our strategy is setting us up for growth in fiscal 2022 and beyond.

Now, I will turn the call over to T.J. Wolfe, our Chief Financial Officer, to provide a financial review of the fourth quarter, talk about inflationary dynamics we are experiencing, and share our guidance for our fiscal 2022.

Timothy J. Wolfe ***Kimball International, Inc. - CFO***

Thanks, Kristie. Good afternoon, everyone. I'll spend the next few minutes providing more details on our financial performance during the fourth quarter of fiscal 2021 and our expectations for the upcoming quarter and fiscal year 2022. As Kristie noted, we are confident the recovery is now underway, and while we expect some short-term supply chain and inflation challenges, we are confident that the strategies we have put in place over the past year have set us up for a year of growth in fiscal 2022.

Let's start on Slide 10 with the key financial highlights. Net sales were $146.2 million in the quarter, including a $12.5 million contribution from Poppin compared to $156.1 million in the prior year and $138.7 million in the prior quarter, making this the first quarter of sequential organic revenue growth since the onset of the pandemic. I'll talk in more detail about each end market in a moment but as expected, our growth in the quarter came from Workplace and Health, which account for approximately 80% of total sales with Hospitality remaining at depressed levels.

Gross margin was 30.6%, a 190 basis point sequential improvement in the third quarter. These results were below our expectations, mainly due to an inflation-related increase in our LIFO reserve that reduced our reported gross margin by 150 basis points year-over-year. This quarter's gross margin was also impacted by higher domestic and ocean freight costs and raw material inflation. The price increase we implemented in March partially offset these negative pressures, and we recently announced a price increase effective in October that should further mitigate the impacts from inflation. I should note that we've begun to experience some modest production constraints driven by supply-chain disruptions related to the availability of certain raw materials and shipping containers, which have extended product lead times. We expect these issues to normalize over the next 2 quarters, having no impact on full year sales, but resulting in a revenue shift from first quarter to second quarter. I'll provide more detail on Q1 and full year guidance in a moment.

Selling and administrative expenses were up $7.6 million to $49.2 million, reflecting the inclusion of expenses related to Poppin. Excluding amortization from the Poppin acquisition totaling $1.7 million as well as SERP adjustments, acquisition-related charges, and CEO transition cost, adjusted selling and administrative costs were $46.5 million or 31.8% of sales compared to $39.9 million or 25.5% in the prior year. Our total transformation savings in the fourth quarter amounted to $5.5 million, bringing our full year cost savings to $22.3 million, ahead of our $20 million projection. A portion of these transformation savings have been reinvested to support our growth strategy as we exit the downturn.

We recorded a tax benefit during the quarter compared to a 27.6% tax rate in the year ago quarter, benefiting EPS by approximately $0.09 per share. This was driven by a certain permanent book to tax differences, including the Poppin earn-out adjustment of $11.6 million or $8.6 million net of statutory tax, which we recorded during the quarter. The earn-out adjustment represents a change in the fair value estimate of the contingent liability we recorded in conjunction with our acquisition of Poppin and reflects the impact of a longer-than-anticipated decline in demand due to the pandemic. This liability will continue to be revalued in subsequent quarters based upon financial projections. As we previously stated, we expect Poppin to be EBITDA positive by the end of fiscal year 2022.

Fourth quarter 2021 GAAP net income was $7.4 million or $0.20 per diluted share, including the after-tax contingent earn-out gain of $8.6 million. This compares to $9.2 million or $0.25 per diluted share in the year ago quarter. Excluding this onetime item as well as after-tax intangible amortization expense and restructuring charges totaling $2.9 million, along with acquisition-related costs, among others, adjusted net income was $2.1 million or $0.06 per diluted share compared to $10.7 million or $0.29 per diluted share in the year ago quarter. Adjusted EBITDA was $2.9 million compared to $19.1 million in the fiscal 2020 fourth quarter.

Revenue and order trends by end market are provided on Slide 12. Net sales in Workplace and Health, which accounted for approximately 80% of total sales, increased 2% and 16%, respectively. Workplace orders increased by 27%, reflecting the Poppin acquisition as well as overall improving business trends. Within Workplace, we saw particular strength in the Education vertical as well as Commercial being driven by a return to the office in many markets. Orders in the Government vertical also increased over the same period.

Health orders were up 64%, validating our belief that this end market would show the earliest recovery. Hospitality net sales and orders remain at depressed levels, and while we see long-term value in this market, we do not expect significant activity to return until the end of the fiscal year. Our total backlog at the end of the quarter was $141 million compared to $130 million in the prior quarter and $151 million at the end of the prior year. Although our total backlog remains below pre-pandemic levels, it is important to note that the combined Workplace and Health backlog was $99 million at the end of the quarter versus $92 million at the end of Q2 fiscal year 2020, the most recent pre-pandemic quarter.

Switching to the balance sheet and cash flows on Slide 13. We ended the 2021 fiscal year with total available liquidity of $107.6 million, representing cash and the unused portion of our credit facility. Full year operating cash flow was $27.3 million compared to $29.8 million a year ago. Full year capital expenditures were $19.5 million, just slightly below our expectations of $20 million. The majority of our CapEx was invested in manufacturing equipment to drive our operational excellence programs and investments in new technology. In fiscal 2021, we returned $16.8 million of capital to shareowners in the form of dividends and share repurchases.

We are also taking this opportunity to initiate full year guidance for fiscal year 2022, reflecting our expectation for a significant business recovery. As you can see on Slide 14, we expect year-over-year revenue growth of approximately 15% to 20%, increasing progressively throughout fiscal 2022, with the highest year-on-year comparisons taking place in the second half. Similarly, we believe gross margins will increase sequentially throughout the year with more pronounced gains in the second half.

Capital expenditures, net of disposals, will total approximately $25 million, with the increase driven primarily by the construction of our new warehouse in Jasper, offset by the sale of our existing site. Operational excellence projects are expected to result in cost savings of approximately $10 million in fiscal 2022, and we expect our full year effective tax rate to be in the range of 25% to 27%. We will continue to invest savings back into the business to support accelerating future growth. These investments include the opening of three new Poppin showrooms in fiscal 2022, as Kristie mentioned earlier, increasing our marketing and promotional spend and building our sales force, which will result in higher S&A spend than in fiscal 2021.

Based on our backlog of $141 million at the end of the fourth quarter, with approximately $75 million scheduled to ship in the first quarter of fiscal 2022, current order trends as well as take into account the production capacity constraints I noted earlier, we expect first quarter fiscal 2022 revenue to grow mid-single digits year-over-year. Sales in Workplace and Health end markets are projected to increase high-single digits, offset by continued softness in Hospitality. First quarter gross margin should be in the range of 31% to 33%, and S&A expenses will increase slightly from the Q4 2021 level.

With that, I will turn the call back to Kristie for her closing remarks.

Kristine L. Juster ***Kimball International, Inc. - CEO & Non-Independent Director***

Thank you, T.J. Turning to Slide 15. What I am most proud of in 2021 is we have taken this time to make bold moves to further set up Kimball International for sustaining growth and value creation. We have reorganized into four end market business units. We have created a multi-branded selling organization. We have expanded our expertise and commitment to health, we have continued to focus on our new product pipeline, delivering at a 25% vitality rate. We have delivered a third year of exceeding our cost savings targets. We have purchased a digitally native and direct business. And all along, we have kept our commitment to our culture of caring and purpose of creating possibilities. And while there are certainly challenges on the horizon, we are confident in the industry upswing and in our guidance for fiscal 2022.

In closing, I'd like to take a moment to comment on our company-wide ESG summary report that we published on June 24. We have a long-standing commitment to being responsible stewards of the environment, maintaining a diverse and caring culture, and having strong corporate governance practices. As part of our journey, we are reaffirming our commitment to a more sustainable future and making a difference in the communities we serve. Our ESG strategy features five interconnected marquee areas that focus our resources on areas where we believe have the most social and environmental impact, as shown on Slide 16. We very much look forward to reporting our practices and progress on a continual basis and want to encourage you to read our Kimball International ESG summary report.

With that, I'd like to open the call for questions and turn the call back to the operator.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from Rudy Yang with Berenberg.

Rudy Yang ***Berenberg***

So my first question is on the price increase you announced for October. I guess, how did that compare in magnitude with the one you've previously issued in March? And would any more even be considered in the future?

Timothy J. Wolfe ***Kimball International, Inc. - CFO***

Sure. I would characterize the October price increase as a similar magnitude to what we took in March. And again, as a reminder, the price increase will go into effect October 1, but its impact won't be fully felt until our fiscal Q3, so the quarter beginning January. So, yes, very similar. And then I think as far as when you look at the pricing landscape for the remainder of the year, I think we'll continue to monitor inflation, continue to monitor input costs and labor inflation, and then make decisions throughout the year as those dictate.

Rudy Yang ***Berenberg***

Great. Super helpful. And then kind of as a follow-up to that, regarding the 150 basis point reduction in gross margin, could you help us better understand the shortfall there and kind of expectations for future impacts? And then how should we think about the drivers of the sequential margin recovery over next year and how much price increases would be driving that?

Timothy J. Wolfe ***Kimball International, Inc. - CFO***

Sure. So I think when you look at this quarter, the 190 basis point expansion from the prior quarter was below the expectations of 300 basis points. And we called out the 150 basis point year-over-year decrease related to the LIFO reserve. And really what that is, is just the fact that the inflation is being immediately reflected in our P&L in real-time as it comes in. And we see that as a headwind that will continue on for the next several quarters. The price increase will offset a significant amount of that. But that was really the shortfall, was that the impact of inflation in the current quarter was above our expectations. And then when you look at the gross margin evolution for fiscal year 2022, we talk about the fact that we see sequential improvement throughout the year. And really, that's going to be driven by in great part by our price increases, which will go into effect in October, along with the recovery of operating leverage as volumes begin to grow and the continuation of our operational excellence programs. So those three things will contribute to the margin expansion, which will be offset again by inflation that we expect your experience for the next several quarters. So that's sort of the waterfall that takes you from last year to fiscal 2022.

Rudy Yang ***Berenberg***

Okay. That's super helpful. And then my next question is kind of on order trends and conversations you've been having with customers. So I guess, has there been any concerns you've been seeing regarding the Delta variant? And then is de-intensification of workspaces still what customers want and I guess, are conversations right now even about kind of catering to social distancing at all?

Kristine L. Juster ***Kimball International, Inc. - CEO & Non-Independent Director***

Sure. I'll take that, Rudy. So let me start with the Delta variant and just kind of the work that we've done over the past few weeks to make sure we're understanding and learning about any impact to the business. So first thing I would say is we have not seen any change to our early indicators at all. So we are watching those very closely. And so we have not seen a change in that area. I will say we do respect that companies are making very unique choices. You hear that very much in the market of all the different types of decisions that people are making. When we talk to our dealers, the amount of activity that our dealers are ramping up for is quite intense. But as you talk about kind of de-intensifying the workspace, the thing that we do here is more about the hybrid work environment and making sure that the workspace is set up as more of a collaborative environment and managing through the workforce with more flexibility. So that is definitely the dominant theme, and that has not changed at all. That's been very consistent since we reported last quarter. And so we see everything staying on track. But I will also say we reacted very well during the pandemic, we have all of our protocols in place, and we are ready to react to anything that we see in the market.

Rudy Yang ***Berenberg***

Great. Super helpful. And then last question from me. In the past, you've disclosed sequential changes in your order rates within secondary markets. So I'm just wondering if you still have a number for this quarter or if there's any other color you can provide around secondary market sales during the quarter?

Timothy J. Wolfe ***Kimball International, Inc. - CFO***

Yes. I think one of the things, Rudy, that we begin to see is we still see strength in secondary, but this quarter, we actually saw metro markets ticking up significantly quarter-over-quarter. I think the large metro, that's really just the fact that they were so depressed and had seen no recovery that you really began to see them truly opening up and unlocking in this prior quarter. So I think we still hold that thesis that our strength in secondary markets will benefit us, but you did see large metro markets begin to pick up and accelerate in the past quarter, again, just due to the comps.

Operator

(Operator Instructions) Our next question will come from Tom Maher with Hilton Capital.

Thomas B. Maher ***Hilton Capital Management, LLC - Portfolio Manager***

A sort of follow-on question in terms of margins. When you guys discussed the inflation issues, I'm just kind of curious, I mean, obviously, there's freight pressure and then raw materials, and not trying to put too fine a point on it, but was it more raw material cost inflation or was it freight issues because some of those seem to be perhaps a little more transitory?

Timothy J. Wolfe ***Kimball International, Inc. - CFO***

Sure, Tom. So for the quarter, freight, actually, had the largest impact. And then second would be raw materials. So I think, again, as you say, freight, both ocean freight and over-the-road trucking, we do see those as transitory and having the ability to moderate. So one of the things that we think about is when we look at our pricing plans and when we implement price increases, the thing that we're trying to do first and foremost is offset what we think might be the stickier elements of inflation. Try to cover as much as possible. But, yes, the biggest impact was in the higher freight expense year-over-year.

Thomas B. Maher ***Hilton Capital Management, LLC - Portfolio Manager***

Okay. And then as I look at the progression through next year in terms of gross margins, and I apologize for not knowing this, but in terms of sort of the manufacturing inefficiency running below sort of potential output, how much will that sort of just naturally improve the margins on its own or is that sort of not the right way to think about it for you?

Timothy J. Wolfe ***Kimball International, Inc. - CFO***

No, it is. I think in order of magnitude if we just kind of cast, and I mentioned in Rudy's question, kind of the three elements. As far as margin expansion or protection, price would have the biggest impact. And then both operational excellence and the recovery of leverage, to your point, those would be relatively equal. So I think in kind of order of magnitude, I think price first and then operating leverage and cost savings as being similar magnitude.

Thomas B. Maher ***Hilton Capital Management, LLC - Portfolio Manager***

Okay. That's great. And then I know it's a little ways out but in terms of the Hospitality market, any thoughts on when that market does sort of relaunch? Is it going to be with a revamped product line or what do you have to do once they're finally back to health, where they're looking to order? Any kind of thoughts on that.

Kristine L. Juster ***Kimball International, Inc. - CEO & Non-Independent Director***

Yes. I'll mention the Hospitality market. The market is still operating the way that it has historically. We don't see any dramatic change in that market. It's just at significantly lower levels than we've had. The area that we are focused on is expanding the custom business versus the program business. So that's one of the initiatives of the team, and I think they're doing a really good job of that, and we'll see that play out in our '22 financials. The biggest indicator that we're kind of waiting to come to fruition is kind of large group business travel. We are seeing smaller group individual business travel picking up. We've seen personal travel pickup, but we have not seen large group dynamics starting to pick up, and that will be kind of the true turning point of that Hospitality market.

Operator
Thank you. I'm showing no further questions in the queue at this time. I would now like to turn the call back over to Ms. Kristie Juster for any closing remarks.

Kristine L. Juster ***Kimball International, Inc. - CEO & Non-Independent Director***
Great. Thank you, Sheri, and I want to thank everybody for joining us on the call today. As we think about entering 2022, we feel very good about the defined set of choices that we've already made during the '21 pandemic, and we do feel that it has set us up to excel as we enter '22.

I want to thank all of the Kimball International employees for just their incredible commitment and diligence as we work through that amount of change in the middle of the pandemic. As we look at the early indicators and the orders that we're seeing across Workplace and Health, we feel very confident that the market is returning and that we have a bright future. So we look forward to sharing our progress with everybody in -- going forward and enjoy your evening. Thank you.

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