

Nik: Good afternoon everyone. I'm Nik Modi, RBC's HPC, Beverage, Packaged Food & Tobacco Analyst. With me today is Niko Lahanas, Chief Financial Officer of Central Garden & Pet. The company is coming off its fifth consecutive quarter of record results on the top and bottom line. And we're very happy that they've made a time to join us at the RBC Consumer Conference. Niko, how are you?

Niko: I'm great, thanks Nik, and thanks for having us today.

Nik: I bet. I like it, going big, coming live from the board room.

Niko: Yeah. Go big or go home.

Nik: Exactly, exactly. So why don't we get right into it and just kind of talk about big picture standing union. As I mentioned in my intro you've posted several consecutive quarters of record results. Your most recent quarter had 23% organic growth. Your categories have had some nice tailwinds due to the pandemic – pet adoptions, time in the garden, the move to home ownership.

Now that we're seeing some light at the end of the tunnel as it relates to the pandemic with vaccinations mounting, at least domestically, what consumer behaviors and habits do you think will stick around in the short, medium and long term?

Niko: Nik, it's a great question and it's one we get quite often. I'll kind of bifurcate our segments. As you think of pet and folks adopting pets, you've got now a new furry member of your family, or reptile or fish, in that case, that requires care and love and all that. So it's a little bit more of a commitment on the pet side.

And the way we look at it is really the install base is up, because folks have just run out and have been eager to bring a new member to their family. If you look at dog adoption, we're up like 8%, cat up 5%, and then all other animal 11%. So we feel really great about the install base. We think there's a long tail, in terms of consumables that these consumers will need going forward. So we think that the pet side is going to be a lot more robust, both near and long term.

As we pivot and look at garden, I think there are a few more things that are at work there. You've got this migration of folks leaving the inner cities and moving to the suburbs, buying homes with an acre or a half-acre or a swimming pool. We think that's a really good trend, a strong trend for garden.

As you look at last year in '20, not only do we have a lockdown, which was a tailwind, but we also had fantastic weather in '20. And so far I can say that '21 has not quite looked up to the weather that we had in '20...

Nik: Especially this weekend.

Niko: Yeah. You know, and so that definitely will play a role. But we think some of the macro trends around home ownership, suburbanization will really benefit the garden categories for the long term. So we feel really good about both of them. If you made me choose, I would probably say pet is a little bit more robust, just because you're dealing with a living, breathing animal there.

And the other thing I would say, as far as both categories, is we've seen nice participation from Millennials and Gen-Zers getting into the categories. So 57% of pet owners now are Millennials and Gen-Zs. So really, really nice.

And then even on the garden side, when you think of our wild bird business, tended to be an older population. And during this pandemic, we've seen a lot of younger folks come in and buy bird feeders and enjoy the hobby of wild bird.

Nik: Let me ask you just a follow-up on that, and I'm sure it's a question you get quite a bit. But there have been discussions and articles about as consumers go back to work, they might have to put their pets back into shelters and that obviously would affect this whole home ownership or pet ownership situation. Any thoughts around that?

Niko: Yeah. I think it's going to happen. You're going to see some segment of folks return the pets, because it's just going to be too much for them. That said, I think the work-from-home is kind of here to stay. I don't think everybody's going to go back to the office and it's going to be like 2019 all over again. I think we're going to find ourselves somewhere in the middle where you're going to have a lot more flexibility and folks still working from home. Which means they're going to be interacting with those pets more often, feeding them more treats.

So I think the install base is up. I think the consumption is up. Do I think it's going back to '19? No, absolutely not. I think it's going to be at some higher level. Will it continue at the '20/'21 level? Probably not. I think we'll see a little bit of a drop off, but again, we're very bullish on getting that install base and also the notion that work/life balance has gotten to be more flexible throughout this pandemic.

Nik: Yeah, absolutely. Maybe just kind of sticking with the garden segment. Right now we're obviously in the peak season. Mask mandates are coming off, vaccinations are ahead of schedule. Do you think there's any risk that consumers just disengage from the category because they're just out move, maybe staying less time at home, spending less time in the garden? Any thoughts around that?

Niko: I think there's going to be a little bit of a risk to that, because they're not going to be pent up the way they were last summer. And also you had really good weather in the spring and summer of last year. So I think we will probably see a little bit of a drop off.

We've seen folks wanting to travel more lately. So this last Memorial Day weekend was a big travel weekend. So I think you're going to see people out and about a little bit more, so I would expect consumption to drop off a little bit. That said, so far we've been really pleased with the engagement of the consumer. Our POS has been strong through Q2 and our sales continue to be strong.

So we think there could be a temporary drop this summer as we get deeper into the summer, weather heats up, people wanting to travel more, as it relates to last year. But again, I don't think we're going to be going back to '19 levels that we saw then. So I think that the baseline is just higher.

Nik: Yeah, and just again, sticking with the garden segment. I mean you think about the season and how extended it was last year. Now obviously you had COVID, a lot of things going on and great weather. But just given new consumers are entering the category, homeownership is on the rise, younger consumers are buying homes with gardens, I don't know if any of your consumer research would suggest that they're more active than maybe older generations. And perhaps that means the season is longer than normal going forward. Any thoughts around that?

Niko: We haven't seen that yet. I think just by virtue of the fact that we've got weather patterns in different areas of the US, I think you're still going to have the seasonality in garden. Yeah, we could see some extensions. If indoor gardening picks up, certainly that could extend into winter months and things like that. So more to come on that. We haven't really formed an opinion yet.

But I don't think that we're going to end up in a place where garden is no longer seasonal. I think that's just – spring and fall are kind of your seasons and I think we just have to live with that because of the weather that you get during that time of the year is nice and you want to be outdoors.

Nik: Yeah, no, absolutely. I mean so far, like you said, we're not off to a very good start on the weather. But hopefully things improve, at least I'm hoping for the summer. Let's talk about new households. Obviously, a lot of recruitment. You talk about Millennials and Gen-Zers.

Just across the business, are you noticing a different level of behavior from those consumers? How do you plan to keep these consumers engaged? Like I just came off of a session prior to thinks one with Nick Handrinos from Deloitte Consulting. And he was asking me, he's like do you think companies can actually maintain

those consumers that came into their portfolios or are they just going to kind of go away now that things have normalized?

And I said that has a lot to do with how the companies manage it. So I would love your thoughts around kind of what you guys are doing specifically to retain those shoppers.

Niko: And you bring up a great point because that's really, a big key is to maintain that stream of engagement with that group. What I would tell you is what we've learned over the years is they are trying to get back to basics to some extent. They want to have simplified lives and that kind of stretches across everything that you do.

What we've done is we've come at them with products that have very simple decks, in terms of ingredients. So we've got dog treats that have really mirroring the human side of food. A very natural minimal ingredient decks that really resonate with them.

They're also, on the garden side, they're very environmentally conscious. So we're working on products that are water-saver conscious, our Smart Seed grass seed. Requires a third less water. That's important to Millennials. We have a lot of R&D going on with pesticides. So trying to find more organic type solutions. Efficacy is always a challenge there. Typically you can come out with a nice organic product and then it doesn't kill what it's supposed to kill and people walk away from it. So that's a challenge.

But we think that the environment, organic, reusable are all themes that we're going to go at. I think also trying to integrate technology in some of the products. Gen-Zs and Millennials like to measure everything. And so just figuring out different angle to maintain that stream of engagement with that age group will be really key, in terms of keeping them in the various hobbies.

Nik: Very interesting. Can you just talk about your pet business composition? The sales mix, in terms of durable versus consumable. How did that change during the pandemic and how would you kind of expect that to evolve as we kind of normalize and head one to two years down the line?

Niko: Yeah, I mean we kind of – rising tide lifts all ships. So we saw everything really lift off. But your point's well taken. We did see a lot of purchases of tanks and closures. All the hard goods that you need to own and take care of a pet. And then from then, from then on forward it becomes more of a consumable play.

Our business is largely consumable, so we do – we are the largest manufacturer of fish tanks. But if you look across the whole portfolio, it's largely consumable. I

would say north of 80%. And then also depends on what's your definition of consumable. So interestingly enough, when we bought our pet bedding business, we kind of viewed that as a durable. But the more we researched it, we found out people actually buying beds every 12 to 18 months.

So it's kind of a consumable. And if you have one or two dogs, you usually have multiple beds per animal. Because they've got to sleep in various rooms. You just can't have one bed in one room. So it forced us to sort of rethink our definition of consumable versus durable. But I think going forward you'll probably see the consumables probably pick up a little bit.

Nik: Excellent. And then maybe just kind of adding onto the whole growth side. M&A, obviously pet is an incredible fragmented business, especially many of the segments you compete in. You closed on some acquisitions in garden recently. Take us through kind of your M&A strategy, priorities, how we should think about capital allocation.

Niko: Yeah, I mean our strategy is really to build scale in priority BUs, build key white spaces also, that we're not in, capabilities, and then also just portfolio optimization. And so you see examples of this in the last few deals we've done, where an adjacency would be Green Garden and that was the packaged seed business we bought.

We weren't in that business right now, but it sits in the garden segment at Depot, Lowe's, Wal-Mart. It's right across the aisle from a lot of the aisles that we're merchandising right now. So it made a lot of sense for us to get into that business. And it's a great business. So that one made a lot of sense for us.

And then if you look at DMO, again, our third pillar in M&A is to build capabilities. They had a really great direct-to-consumer capability that we wanted to distribute across our entire organization, because that's a reality that's happening too. Whether we go direct-to-consumer or we're fulfilling for the retailers, we needed to up our game in that area.

And rather than spend a lot of money and time with trial and error, we bought a business that was doing it extremely well in that process and place. And now we're going to distribute that capability across the organization here.

So we look for all those things. Specifically when we look at a deal we look for strong management teams. We want businesses that have a high barrier to entry, that have some sort of IP. We want to have a nice margin profile, something that's accretive. And a business that's growing. So those are the things we look for.

And then I would say last but not least, cultural fit. So when we bring management teams in here, we want teams that we think are going to thrive in our environment and really do well here, because we have a very entrepreneurial type of culture. And we have to make sure it's the right fit. So those would be the things we look for.

And then just building, again, building on our real growth areas. So one of our priorities would be dog and cat treat and toys. That would be a growth area. Yeah, that's kind of it in a nutshell as far as M&A.

Nik: And if I could just follow up on the DTC comment, this acquisition brought DTC capabilities. What I've observed over my coverage is that many companies have not been very successful in scaling their DTC acquisitions or capabilities across the entire business. And I mean I think I have a good understanding of why that – I mean so I'd love to know how you plan to actually scale a capability like that within the organization.

Niko: Well, we're going to be very careful. What I can tell you, Nik, is the bar is really low, because we're not good at it right now. So that's probably a good thing. But we've got a couple pilot programs going. We want to be very methodical. We're not going to just blast it out across the whole org day one. We've got one facility right now that we're working on.

And we need to prove it out. We know that this business operates profitably, but that business is largely controls and has a certain product profile. We're going to now basically lift and put it into another business that has quite a different product profile. And we all know that things don't pick, pack and ship the same way. So we really need to get the proof of concept down, see the cost savings and make sure that we can do it profitably.

And we're going to do it in a very contained environment. So it's not going to be all out across the whole org. It's going to be in a very contained space, get the proof of concept down. Once we're comfortable, then we'll probably accelerate.

Nik: And is there going to be a data element that comes with this DTC kind of scalability, meaning you're going to get all this data on all these wonderful, loyal consumers that you have, that you can leverage to increase opportunities for yourself. So how are you building that kind of backend or do you already have it?

Niko: Yeah, I mean we've got some of it in pockets, but it's a huge opportunity. And that's what I meant earlier when we talked about Millennials and Gen-Zs and having that direct stream of engagement with your consumer. And the DTC, although it's very expensive and challenging and a lot of hurdles to get over, it really affords you that opportunity to now have that engagement with the

consumer. So yeah, we are ramping that up as well. And it's going to be a huge part of really the go-forward.

Nik: Excellent. Maybe we can just talk about retail and obviously there's been a lot of dynamics at retail, out-of-stocks and streamlining SKUs. And I'd just love your state-of-the-union on how your organization is fairing in the current retail environment. Where do you feel like you have opportunities going forward?

Niko: Yeah, I mean we historically we've done a really great job with the customer. Where we need to get better is with the consumer. But we've got great relationships with the customer. As you pointed out, it's been a challenge. Our service levels are not where we want them to be. We do have some unhappy customers. And we've got to get better. We've got to get better, we've got to improve our supply chain. We've got to improve our service levels.

So that's a challenge and we know a lot of folks out there like us are equally challenged. So it just has to be better. It's all I can say is – and I think the retailers have largely been understanding about it, because they kind of see it across the whole board. But I think it will. I think as I look down into the future a little bit, we'll see what happens in September when the stimulus checks stop coming. And we've just got such an engaged and active consumer right now, that – and the categories we're in are just flying.

So it's a little bit of an embarrassment of riches, but you've got to be able to service the customer. And we're investing to do that. For folks that were on our last call, our capex is double from '20 to now. Because we have expanded capacity, because we want to be able to service those customers.

And we're also automating, because labor has been a challenge through the pandemic. And we've just got to get more efficient around what we're doing. And that will – all those things will take costs out as well as improve our service levels. So we are definitely investing in those areas.

Nik: And Niko, are those the real tuning areas? Is there anything else that has been causing the supply chain issues? Or is it really just about the labor, which hopefully will get some relief when the stimulus checks run out in September. And then just the fact that demand has been so much stronger than you or anyone anticipated.

Niko: No, it's also been raw material. I mean everyone's fighting over the same bottles and caps and glass containers. So you've got that challenge as well. You've got ocean freight which has skyrocketed, gotten much more expensive. We have under 10% of our business is sourced in China. They're backed up as well. And then finding shipping to get the product over here is a challenge. So it's really a

whole ecosystem that has kind of gone nuts. And then you can power this consumer with lots of dry powder and capital. And so it creates a, again, it's kind of a nasty cycle, but it's a high-quality problem all at the same time.

Nik: Maybe just digging a little bit deeper into the inflation, because that was my next question. And you've kind of touched on some of the items. Maybe from a raw materials standpoint, also you can give us some thoughts on where you're feeling some pressure. And then what do you think is transitory versus structural, number one? And the second is, talk to us about how you're going to offset some of these pressures.

Niko: Yeah. We're seeing inflation across kind of across the board. I would say it's particular acute in our commodity areas, such as our wild bird food. So the grains have really gone off the chart, in terms of milo, millet, inputs for our wild bird feed. Other areas where it's gone up are our fertilizer. So our NPK inputs into the fertilizer have gone up quite a bit.

And then yeah, I think some of it is going to be transitory. I think we'll know more when the stimulus kind of comes off the table. And we're already starting to see a little bit of slowdown as we lap some of this massive COVID growth. And so we're in a little bit of a catchup mode right now, which is great.

And then I'll be curious to see what happens in September when the stimulus sort of comes off the table and things slow down a little bit. I'm hoping. As far as our company, we're acting like it's here to stay. We've taken price. We have to do that, because I know the Fed has talked about transitory inflation. We can't run our business based off of that. So we've been very forceful in that way.

I would say, as I think about it more in-depth, again, I think some of it will soften; but I think other pieces of it will be here for quite a while. And we have to react to that. And I would say we've not been able to offset the cost increases with price. So a lot of that is going to have to be us finding ways to reduce costs. So become more efficient. As I mentioned, investing in automation, investing in expansion of facilities.

So we're going to have to take cost out to keep the margins whole. Because you can't, in some cases the commodities have gone up so dramatically, you'll price yourself right out of the market. And you've got elasticity issues there to worry about.

Nik: I think I saw one study – I did a joint webinar with IRI and they suggested that 30 to 40% of price mix across all of CPG in 2020 was driven by premium innovation. Which seems to be like an often underdiscussed component of pricing



that companies can use to offset inflation. So just curious what you think about that and is that in line with what you guys are doing in terms of your business?

Niko: Yeah, I mean we're looking at that. And I mean I saw the article too just recently come out showing smaller package sizes, keeping the price the same, because consumers tend to not look at weight. They just look at the package and the count. So yeah, we're definitely looking at that.

We also look at the ingredient decks. So can we change out certain higher-price ingredients for ones that haven't moved as much? So without hurting the efficacy of the product, so you still want it to work. But we've done some of that as well where we swap out ingredients. And we are looking at price pack architecture as well.

But you've got to do it, because again, I think the inflation is so dramatic, you can't price your way to prosperity, so you've got to get a little creative.

Nik: And you've been so efficient with the questions. I have one more that I wanted to kind of slip in there before we end our session. And I know you have a pretty rock solid meeting agenda. But as you engage with investors, what do you think they're missing on the story? Do you think there are any areas where the investment community doesn't really understand, that you'd like to kind of make sure they understand?

Niko: Yeah, I mean I think a few things are misunderstood. We do have the distribution business embedded in our overall business. A lot of folks ask us well, why are your margins not as high as everyone else's? That's a big reason why. And so I would say too that we're in two great categories.

Our balance sheet is rock solid, doing a lot more M&A. And there's a lot of low-hanging fruit in terms of the organic business, in terms of us taking cost out, becoming more efficient, and realizing more synergies between all of our portfolio companies. So I would say really it goes to the virtues of kind of the thesis around investing in Central.

Nik: Excellent. Well, Niko, thank you so much for taking the time and being at the RBC Consumer Conference. Best of luck for the rest of the year.

Niko: Thanks a lot Nik, appreciate it.

Nik: You bet.

Niko: Thank you.

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