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Central Garden & Pet Co. (CENT)

Q4 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Central Garden & Pet's Fourth Quarter Fiscal 2020 Financial Results Conference Call. My name is Victor and I'll be your operator for today. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to turn the call over to Friederike Edelmann, Vice President, Investor Relations. Please go ahead.

Friederike Edelmann
Vice President-Investor Relations, Central Garden & Pet Co.

Thank you, Victor. Good afternoon everyone. Thank you for joining us. With me on the call today are Tim Cofer, Chief Executive Officer; Niko Lahanas, Chief Financial Officer; J.D. Walker, President, Garden Branded Business; and John Hanson, President, Pet Consumer Products. Our press release providing results for our fourth quarter and fiscal year ended September 26, 2020, is available on our website at ir.central.com. Also on the website is the GAAP to non-GAAP reconciliation for the non-GAAP measures discussed on this call.

I would like to remind you that statements made during this conference call, which are not historical facts, including EPS and other guidance for 2021, expectations for new capital investments, product introductions and future acquisitions are forward-looking statements subject to risks and uncertainties that could cause actual results to differ materially from those implied by forward-looking statements. These risks and others are described in Central's Securities and Exchange Commission filings, including our Annual Report on Form 10-K expected to be filed tomorrow. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events or otherwise.

Now, I'll turn the call over to our Chief Executive Officer, Tim Cofer. Tim?

Timothy P. Cofer

Chief Executive Officer & Director, Central Garden & Pet Co.

Thank you, Friederike. Good afternoon, everyone, and thanks for joining the final earnings call of our fiscal 2020. Before we dive into the specific results, I wanted to provide some thoughts on the year and why I'm more confident than ever in our company and the industries in which we operate.

This has been an extraordinary fiscal year. COVID-19 tested the world and our business in ways we could not have predicted, and presented the most challenging operating environment in our company's 40-year history. And yet despite the uncertainty that the coronavirus continues to present each day, our people have seamlessly navigated the challenges and opportunities, and we have delivered the strongest year in our company's history.

These historic results were not by happenstance, they are a result of the continued dedication of our people, the strength of our industries, unparalleled consumer demand and the early results of our long-term strategy. Over the past fiscal year, I've been proud to witness how our teams prioritized the safety and well-being of their colleagues while also responding to the constant changes to ensure our business can continue to run efficiently and with excellence.

It's been a chapter that has reinforced our commitment to our employees and their unwavering dedication to each other and our consumers. I continue to be sincerely grateful to our employees for their commitment, creativity and collaboration I've seen throughout the year. Together with our customers and supply chain partners, they've done a tremendous job to ensure our business operates as safely and as seamlessly as possible in these challenging times.

This fiscal year also reinforced the resilience of our industries. We saw record consumer demand and expanded consumption across both Pet and Garden. New consumers found comfort in adding pets to their families and investing in their gardens while we saw increased spending from existing consumers. Lastly, we were able to respond to the needs of the business and pivot to meet the changing environment thanks to early wins in investments from our Vision2025 strategy, including evolving core capabilities like eCommerce and digital marketing.

Consumers increasingly turned to eCommerce to purchase products for their pets and gardens and we were able to respond and deliver. As consumer spending habits continue to evolve towards online, omni-channel and digitally-led solutions, these investments and new capabilities should position us for continued success.

I'm confident that our exceptional employees, our commitment to consumers and customers, our attractive and resilient industries and our ongoing dedication to innovate, grow and deliver will take us to even greater heights in the years ahead. We look forward to sharing more about the industry trends and tailwinds and how our new strategy will specifically address these opportunities at the company's first Investor Day next week.

Now, let's quickly turn to our results for the quarter. As you know, typically Q4 and also Q1 are our smaller quarters. This year, I'm proud to announce that after a record third quarter Central delivered another record quarter with respect to both net sales and operating profit. Net sales for the quarter increased 25% compared to Q4 2019. This strong growth was entirely organic driven since we have now lapped our recent acquisitions. In addition, gross margin increased to 29%, an improvement of 150 basis points compared to the prior year, primarily driven by a favorable mix of product sales and pricing. This culminated in the record Q4 earnings and EPS that we announced in our press release.

As I mentioned in my opening reflections, I could not be more proud of our teams and all they have overcome this year to achieve our company's strong results. Net sales for the year increased 13% versus prior year. The increase was largely driven by organic growth of 11% with broad strength in both segments and to a smaller extent by our 2019 acquisitions, Arden and C&S.

Now, let's take a deeper look at both of our operating segments, first, our Garden segment. We reached two milestones this year, $1 billion in net sales and $100 million in operating profit. Weather patterns have been the best we've seen in many years and were almost ideal for gardening. We saw record gains in our distribution business, controls, fertilizers and live plants.

In addition, the garden industry continues to benefit from consumers spending more time at home, caring for their lawn and gardens and making their outdoor spaces even more enjoyable. We believe that some of the increased consumption among existing consumers as well as new consumers entering the category will potentially extend into the future similar to the patterns experienced in prior recessionary environments.

Additionally, while garden products have historically been underpenetrated in eCommerce, partly due to the bulkiness of many products, we saw a clear acceleration online in 2020. We believe this trend is here to stay which further confirms the importance of our strategic focus on eCommerce and digital marketing.

Next, turning to the Pet segment, we saw record gains in pet consumables, distribution and animal supplies and health. The pet industry is also experiencing benefits from consumers spending more time at home due to COVID-19. Increased pet ownership continues to be a fundamental driver of the strength. And this gives confidence in the mid- to long-term growth prospects of the pet industry.

Similar to Garden, our Pet segment enjoyed a significant acceleration in eCommerce. We are working closely with our retailers and distributors to meet the dramatic increase in online demand. Our eCommerce business now represents about 20% of total Pet Consumer brand sales, a significant increase versus prior year. All indications suggest this shift in consumer behavior is lasting and we are increasing our investments in this strategic focus area. All in all, also a great quarter for our Pet segment.

It's worth noting that despite our outstanding results, our supply chain remains stressed due to the tremendous increase in demand for our Pet and Garden products. This challenge first presented itself in the third quarter when demand skyrocketed across our business. We expect continued pressure on our supply chain in fiscal 2021.

In addition, we are facing higher key commodity prices, freight and labor costs and increased spending on the necessary and ongoing safety measures for our employees. As with the entire country, we are seeing our COVID cases on the rise in recent weeks, and we have further enforced our employee and supply chain safety protocols to ensure we are doing our part to help prevent the spread of COVID. Together with our suppliers and customers, our teams are hard at work to identify creative ways to meet consumer demand, expand our capacity across numerous businesses and prioritize the health and safety of our employees.

In closing, I want to once again thank every Central employee for their hard work that went into making this quarter and our fiscal year such an extraordinary success. I'm looking forward to sharing more about our long-term strategy and our framework to deliver sustainable, profitable growth next week at our Investor Day. I encourage you to join us on Thursday, December 3 at 1:00 PM Eastern Time at ir.central.com.

With that, let me turn it over to Niko, who will share more details of our Q4 and fiscal year results. Niko?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, Tim. Good afternoon, everyone. Net sales for the year increased to a record $2.7 billion, up 13% driven largely by organic growth. Acquisitions, namely Arden purchased in our second quarter of 2019 and C&S which we closed in our third quarter of 2019, together added $58 million of net sales in the year.

Our overall organic growth of 11% was attributable to both segments with most of the growth coming from our distribution businesses, dog treats and chews, wild bird feed as well as controls and fertilizers. And as Tim mentioned, growth in both segments was aided by gains in eCommerce. These benefits were partially offset by the impact of exiting fashion decor pottery in the fourth quarter of 2019.

Consolidated gross profit for the year increased 13% to $797 million also driven by strength in both segments. Gross margin grew 10 basis points to 29.6%, thanks to net favorable product mix partially offset by higher COVID-19-related costs. SG&A increased 8% to $599 million but declined 100 basis points to 22.2% as a percentage of net sales. The decline as a percentage of net sales was largely driven by pandemic, reduced promotional opportunities and travel. Operating income for the year increased 30% to $198 million and our operating margin grew 90 basis points. EBITDA for the year increased 25% to $253 million, driven by favorable product mix and overhead efficiencies partially offset by increased costs for key commodities, labor and freight.

Other expense was $4 million compared to other income of $200,000, primarily due to a $3.6 million non-cash impairment charge in the third quarter of fiscal 2020 in conjunction with two of our joint venture investments that were impacted by the COVID pandemic. Net interest expense landed at $40 million, up from $33 million a year ago, driven primarily by lower interest income due to lower market interest rates.

Our net income increased 30% to $121 million and diluted earnings per share came in at $2.20, an increase of 37% over the prior year. Our tax rate for the year of 21% was lower than the 22.3% rate a year ago, thanks to a lower blended state tax rate. I'm also pleased to report that our operating cash flow for the year of $264 million was an increase of $59 million from $205 million in the prior year.

Turning to consolidated financials for the quarter, fourth quarter consolidated net sales increased 25% to $676 million. We now lapped our most recent acquisition, so the entire increase was driven by organic growth in both the Garden and Pet segments. Consolidated gross profit for the quarter rose 32% to $196 million and our gross margin increased 150 basis points to 29%, thanks to favorable product mix and pricing.

SG&A expense for the quarter increased 24% versus a year ago while as a percentage of sales it decreased by 20 basis points to 25.3%. Operating income for the quarter was $25 million compared to $11 million a year ago, and operating margin increased 170 basis points to 3.7%. Net interest expense increased to $11 million from $8 million in the fourth quarter of the prior year. As our tax rate was lowered, the fourth quarter tax rate of 6.9% was also lower than in the prior year quarter due to the year-end true-up activity.

Our net income for the quarter was $14 million and our diluted earnings per share was $0.25 compared to $0.04 in the fourth quarter of 2019. Shares outstanding decreased to 54.5 million from 56.6 million in last year's fourth quarter. As you will recall, we bought back approximately 2 million shares to about 53 million in the first nine months of the fiscal year.

Now I'll provide some insights into the segments starting with Pet. Pet sales for the fourth quarter increased 22% to $434 million on strengthened dog and cat distribution as well as small animal supplies and consumables. The Pet segment's operating income was $40 million, an increase of 28% compared to the prior year quarter, and Pet operating margin increased 40 basis points to 9.1%. Pet margin improvement was driven by favorable product mix partially offset by increased supply chain costs, including commodity inflation and COVID-related costs. Pet EBITDA increased 25.1% to $49.5 million.

Moving on to Garden, for the quarter, Garden segment sales increased 31% to $242 million as favorable weather and strong consumer demand drove increases in distribution, controls and fertilizers, wild bird feed and live plants. As mentioned earlier, all the growth was organic as we lapped our Arden acquisition in the third quarter of 2020.

Garden segment's operating income for the quarter increased to $10 million, and operating margin increased 400 basis points to 4.2%. Garden margin improvement was largely driven by favorable mix, pricing and some volume-related efficiencies partially offset by COVID and inflationary cost pressures. Garden EBITDA increased to $13.5 million compared to $3.7 million in the prior quarter.

Now to the balance sheet and cash flows. For the quarter, cash flow provided by operations was approximately $175 million compared to $112 million in the fourth quarter a year ago. The increase was primarily driven by improvements in working capital. CapEx for the quarter of $16 million was up over 50% compared to the prior year, reflecting our heightened focus on increasing capacities. For the year, CapEx totaled $43 million compared to $32 million in fiscal 2019. We anticipate continued higher levels of capital spending in fiscal 2021.

Depreciation and amortization for the quarter increased to $16 million, up from $14 million in the prior-year quarter. Cash and cash equivalents, including short-term investments, increased to $653 million from $498 million a year ago.

Total debt was $694 million, relatively unchanged from last year. Subsequent to fiscal year-end, we issued $500 million 4.125% senior notes due October 2030 which we used to redeem all of our outstanding $400 million 6.125% senior notes due in 2023. The remainder of the proceeds was used for fees and expenses associated with the transaction and general corporate purposes. We ended the quarter with a leverage ratio of 2.2 times, down from 3.1 times a year ago. We had no borrowings under our $400 million ABL line at the end of the year.

Now turning to our 2021 outlook. In fiscal 2021, we are – we anticipate strong second half headwinds as we lap an almost ideal gardening season and COVID-19 tailwinds. We must also take into account the recent increase of COVID cases among our workforce, marrying the increase not just across the country but the entire world. Further, we anticipate continued pressure on our supply chain related to increased demand levels, which in 2020 manifested in a outstripped capacity, some sourcing challenges like bottles and caps and heightened labor and freight costs.

In response, as Tim mentioned, we have an accelerated investment to expand our capacities and continue to pursue creative sourcing solutions and efficiencies. We currently expect CapEx spend to be in the range of $70 million to $80 million in 2021, a meaningful increase over 2020. We also began to see inflationary pressure in key commodities in the second half of 2020 and we expect those to continue in 2021. While we are working to offset these increases with pricing, it is unlikely that we'll be able to fully offset the impact in 2021.

Beyond accelerated capital investments, as we continue to make progress against our new strategy, we are planning for sizable additional spend to drive profitable growth and further build out our eCommerce capabilities. Fiscal 2021 is looking to be an investment year on many fronts, especially when compared to pandemic-dampened spending levels of 2020. Another anticipated impact on our 2021 EPS is a higher more normalized tax rate as compared to the 21% we saw in 2020 somewhere in the range of 22% to 24%.

In addition, we anticipate incremental interest expense in the range of $0.14 to $0.16 per share in the first quarter of 2021, related to recognizing the impacts of the call premium and unamortized debt issue – debt issuance costs and one month of double interest on the debt being retired. All said we currently expect 2021 GAAP EPS of $1.90 or better which translates to adjusted EPS of $2.05 or better excluding the incremental interest expense I just mentioned.

As always, our outlook excludes any impact from potential M&A activity undertaken during the year. It is important to note, we are currently expecting very different dynamics in the first half of fiscal 2021 as compared to the second half. COVID is expected to be a tailwind in the first six months, but together with ideal gardening season we saw in 2020, will likely turn into a headwind in the second half. Supply chain and inflationary pressures as well as capacity expansion efforts are likely to impact us throughout the fiscal year while pricing, commencing in the new calendar year, should somewhat offset these headwinds.

And finally, more normalized promotional and T&E spending levels are projected to be headwinds as we entered the new calendar year. Accordingly, as we look towards the first quarter of fiscal 2021, we expect Q1 GAAP EPS to be below the prior year quarter largely driven by expenses related to our debt refinancing and the dynamics I just described.

In conclusion, despite fiscal year 2020 being a challenging year for all of us, it was also a record year for our Garden and Pet businesses. Our company remains strong, well-capitalized and well-positioned to grow in the years ahead. We look forward to virtually seeing you next Thursday on our Investor Day to talk more about our exciting future.

Now let's open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Ladies and gentlemen, we will now have our question-and-answer session. [Operator Instructions] Our first question comes from William Reuter with Bank of America. Please proceed with your question.

William Michael Reuter
Analyst, BofA Securities, Inc.
Q

Good afternoon. My first question is, is there – I understand that this question I'm going to ask is challenging, but is there any way for you to think about what you believe favorable weather may have contributed to Lawn & Garden sales in the fourth quarter, so if we were to somehow try and normalize that for the back half of the year?

J.D. Walker
President-Garden Branded Business, Central Garden & Pet Co.
A

Hi, William. It's J.D. I'll take that question. It is difficult to assign a number to that. There are a number of different causal factors that impacted the business in Q4, weather being one. Certainly, we saw an extended season and continued ordering. Our customers stayed in the business throughout the summer which very much engaged and we also saw the consumers very much engaged. So an increase in household penetration continued to drive the business during the quarter.

We did have some headwinds. At the same time, we had – as mentioned, we had some supply chain challenges, keeping up with demand. But people staying at home, some of the leftover remnants from COVID, some of the impact from COVID, we certainly saw that during the quarter. So we had so many causal factors. It's difficult to assign a specific number to weather. It certainly was favorable for us, but I'd be speculating to put a specific number on it.

William Michael Reuter
Analyst, BofA Securities, Inc.
Q

Yeah. I understand it's tough. Okay. So in terms of – you mentioned that you have a challenge in terms of your employees and COVID. Are there certain of your facilities that are closed right now or are there some that you are having such a shortage of employees that are able to work that you're actually not able to operate at the capacity you'd like to right now?

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.
A

Sure. I'll take that, William. Thanks for the question. This is Tim Cofer. Overall, we feel, I would say, as good as anyone can feel in this pandemic environment. We are clearly not immune to the COVID situation. And I would say even of late if I talk beyond the quarter and just the last few weeks, similar to what you've seen across the United States, we are seeing an increase in positive cases in our workforce.

The good news is, to your question, we are through the quarter having all facilities still operational. We have had temporary shutdowns, William, across our facilities be it a manufacturing facility or a distribution center. We've had temporary call it one day, half day and a couple occasions more than a day where we've gone and done a full shutdown, done a deep clean and then bring people back to work. So we're treating it very much case by case.

The hotspots you see broadly in the United States, given our footprint, we have a broad footprint really from coast to coast, north to south, we are seeing more cases in those hotspots that you see. As I said in my prepared remarks, we've also reinforced our safety measures ensuring obviously all the right PPE. And then with regard to our non-frontline workers, the overwhelming majority of those continue to work from home. And obviously, that gives us additional reassurance on their safety. So that's the overall color on our situation.

William Michael Reuter
Analyst, BofA Securities, Inc.

Q

That's great. That's very helpful. And then just lastly for me, historically, you guys have been very disciplined. You try to pay 6 to 9 times. Seems like multiples are way higher than that right now and you've got a ton of cash. I guess, how do you try and balance that maintaining discipline with regard to paying what type of multiples might be reasonable at this point versus the fact that you do have so much cash.

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

Yeah. Well, look, first of all you said it in your question. I mean, we will remain disciplined buyers. And at the same time, we acknowledge the premise of your question that given I would say the overall interest in our industry's garden and pet, some of the additional dynamics with private equity, etcetera, prices can go a bit higher these days.

Next week, I encourage you to join us at our Investor Day. Both Niko and I will talk more about our M&A strategy, kind of our priorities in the M&A area, and I would say we are definitely willing to pay a higher multiple than the range you quoted for the right asset in core and adjacent categories if it, in particular, has the attributes of growth accretive and margin accretive to our portfolio.

William Michael Reuter
Analyst, BofA Securities, Inc.

Q

Great. Very helpful commentary. Thanks a lot.

Operator: Thank you. Our next question comes from Bill Chappell with Truist Securities. Please proceed with your question.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Thanks. Good afternoon.

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

Hey, Bill.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Hey. Just was interested, as you talk of M&A, a lot of these M&As for the company over the past three, four years have been focused on expanding and not only M&A but I guess new business has been on private label, both I guess in Pet and in Garden. And I know you already had a pretty sizable business in private label Garden anyways.

So, at the same point, we're hearing a lot of in the pandemic consumers trading up more towards brands and away from private label that's trusted or they have more discretionary spending or what have you. So can you maybe help us understand how that's impacted your business? I mean have you seen consumers trading – I mean growing faster at your brands versus private label? Has it affected margins? Are you looking to maybe deemphasize private label and focus more on brands as you go forward? Any color there would be great.

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

Sure. I'll start and the others can jump in as appropriate, Bill. I think certainly in fiscal 2020, we've seen broad-based growth. So, as you look at our business, Bill, you've followed us for some time, I'll break it into three buckets: Our branded business, our private label business and our distribution business.

In all three cases, we saw a robust growth. And you're within single digit type of differences between the three. I do think – obviously branded business, in general, I think is the greatest point of competitive advantage and the greatest opportunity to build margin and favorable mix over time. You would know that our distribution business in particular is one that while it's a nice asset to our business and provides many sources of a competitive advantage of course it is margin dilutive.

From a private label standpoint it really depends on the exact customer and category. Not in all cases is it dilutive. It's really on a case by case basis. So, overall good strength across. I actually like the fact that we've got this broad portfolio that plays heavily in branded, call it two-thirds of our business in branded and then the other third in private label and distribution. But we're seeing growth in all three parts of our business on both the Garden and the Pet side. Any other color, guys?

J.D. Walker
President-Garden Branded Business, Central Garden & Pet Co.

A

Tim, this is J.D. I just build on your comments. I would say that it does vary by customer. And I think we're uniquely positioned because we do have the branded – we're a branded manufacturer, a private label manufacturer and a distributor to really provide unique and differentiated solutions for each retailer. So depending on what their goals and objectives are, we take a category management approach. And I think that's one of the reasons why we've seen growth across all three segments of our business.

John Hanson
President-Pet Consumer Products, Central Garden & Pet Co.

A

Yeah. And just – this is, John, and just to build on that, in the Pet business, we saw a strong double digit growth across branded, private label and distribution again. So feel very good about the mix and our capabilities in all three.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Got it. And then I guess related, and maybe this is something you'll talk about more [indiscernible] (00:33:21) about more next week, but is there a thought about long-term margin goals or is – are you running three kind of distinct, different businesses where it's more about just growing the top line and less – and the mix will fall where it does?

Nicholas Lahanas
Chief Financal Officer, Central Garden & Pet Co.

A

No. I mean, Bill, this is Niko. The way we view it is, and we'll get into this more next week when we talk in depth about our financial algorithm, we're always looking to expand margins. And really that's really how the P&L is going to work best really in relation to our algorithm where the bottom line has to grow faster than the top. In order to do that, we need to expand margins. So we go into every planning cycle with the intent of expanding those margins. We've not set goals to the Street in terms of where we'd like to be. But I think it's more of a continuous improvement mindset where every year we're looking to expand those margins across all of our businesses.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Got it. And...

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

And...

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Go ahead. I'm sorry. Go ahead.

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

Yeah. And, Bill, to your point, and building on what Niko said, I mean we will give you a little more color next week on what those focus areas are, what those drill sites are. We'll give you some very specific examples of some in-flight initiatives in that arena. And for me, it's about generating that cost savings really to do two things. One is to drop it to the bottom line and expand those margins. And the other is to create a more of a virtuous cycle where we can invest more in those brands and in those positions. There is opportunity to invest more to drive organic growth, and we'll talk about both those things next week.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Great. And then just last one for me, is there a way as I look at kind of the non-GAAP $2.20 you did this year to the non-GAAP $2.04 or better taking some kind of drop next year. To bridge that, how much of that is coming from higher reinvestment versus how much of that is just tough comps?

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

It's a number of things, Bill. It's not only – where I would start is, yeah, we're going to be comp-ing a record year for us. And then as we look into 2021, it's really going to be an investment year around CapEx as well as more promotional spend and then there's the uncertainty with COVID, the vaccine, the timing of which what will be the consumer behavior based off of having a vaccine. We also had an incredible weather year for Garden and for some of the Pet businesses as well.

And then the other piece, too, is we are seeing inflation on the horizon. We started seeing it in 2020. We're seeing it materialize in 2021. We took some price. We have plans on taking price in 2021. But you know the timing of that can get tricky. So you don't always get your price increase right when the inflation hits and so we're seeing that happen. So all of those sort of headwinds caused us to land at that $2.05 or better mark. I couldn't really disaggregate it for you in terms of how many pennies each bucket is at this stage.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Got it. Thanks so much.

Operator: Thank you. Our next question comes from Peter Grom with JPMorgan. Please proceed with your question.

Peter K. Grom
Analyst, JPMorgan Securities LLC

Q

Hey. Good afternoon, everyone, and congrats on the results. And I hope you all have a happy Thanksgiving later this week. So, Tim – and maybe we'll get to more of this next week, but I was hoping you could share a little bit more around the brand building and eCommerce capabilities that you mentioned in the press release on your 2021 outlook. I mean is there anything you can share on what you plan to do differently, brands or categories that you are maybe more focused on now than you did before, and then just kind of how these investments frame your long-term outlook for the business?

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

Sure. Well, again, Peter, to your point, hopefully you'll get a little additional incentive to tune in next week, we are going to be talking more about it. And I'm going to give some real specifics as well as John and J.D. as they take you through their businesses. But let me give you a little bit starter today. I think when you talk about eCommerce, I start with the – really the concept around capabilities.

So one of the things we're doing this year is – in fiscal 2020 and we'll continue obviously into 2021, is making sure we've got the right people to begin with and we'll talk to you and give you some very specific examples of new hires that we've done in our organization to augment that capability, and then really training and development. So I'll give you some specifics next week around a kind of broad organizational upskilling effort we're doing around managing the eCommerce flywheel.

As you would well know, this is a company that has enjoyed great success over the last four decades, primarily through a distribution and brick and mortar-based model. And so there are some pivots that are required organizationally across sales, across marketing and supply chain to be sure that we're a future-proofed company in these areas. And so we're going to be investing in some real capability building and upskilling.

Then it's around investment and resource intensity. And I think we're getting a much better handle around relative ROIs, around ROAS of our investment, around improving our content on a number of our businesses, optimizing pricing, getting the assortment right, understanding the different assortment needs in the eCommerce channel or BOPIS, etcetera, versus traditional brick and mortar.

So that gives you a sense. I think next week we'll give you some specific examples. And John and J.D. will give you some examples of what they're doing in both digital marketing and eCommerce as well as some ambition that we've set for ourselves. So a lot more to come. But back to Niko's earlier answer to Bill's question. Part of that guide for next year is to give us again a little bit of room for that investment. I continue to feel after more than a year at the desk that it is wise for us in the long-term to continue to bit by bit invest more against our brands and invest more in some critical capabilities in these areas of digital marketing and eCommerce.

And then finally you ask about brands, we're definitely getting sharper. Not all of our brands are created equal. Not all of our brands have the same I would say right to win and kind of competitive moat. And we are beginning to get more specific about which ones we will disproportionately invest in. Obviously, I'm going to be a little bit more guarded in the early days about sharing that for competitive reasons. But over time you'll see that manifest as well.

Peter K. Grom
Analyst, JPMorgan Securities LLC

Q

Great. Thank you.

Operator: Thank you. Our next question comes from Brad Thomas with KeyBanc Capital Markets. Please proceed with your question.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Hi. Thanks for taking my question. Congrats on a great quarter, great year here. Looking forward to next week. I wanted to first maybe drill on the gardening side and was curious maybe, J.D., if you could share any details as you're talking to your retail partners about how they, at this point, are planning for next spring and how you're thinking about the sell-in process and how promotions might be different for your retail partners in the next spring?

J.D. Walker
President-Garden Branded Business, Central Garden & Pet Co.

A

Sure, Brad. Thanks for the question. I'll be glad to take that. The – I'd say that the retail partners – our retail partners are signaling that they're going to be aggressive going into the spring. I think that certainly they've enjoyed a strong year as we have in our categories. So they're planning for that again next year. I think that – what they're signaling for the most part is setting the stores early, making sure that they're ready for the season earlier initial shipments. So I think they'll come out of the gates very aggressive and we're looking forward to that. We're preparing for that. Like us and what we've said today they're not really sure what the second half of the year looks like, so they're not extending any guidance or direction beyond the first – beyond the spring season. But I do believe that they plan to be very aggressive coming out of the gates and that's across the board, all retailers.

Now, if weather cooperates...

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. Thank you.

J.D. Walker
President-Garden Branded Business, Central Garden & Pet Co.

A

...then I think we'll be in great position.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. Thanks, J.D. And if I could ask a question, John, on the Pet side. I was wondering if you could just give an update on how business is performing on the consumables versus items that are maybe more durable or discretionary. I think one might be able to argue that there's an installed basis, an increased ownership of pets and that there's perhaps a longer tail and more recurring revenue to achieve, and I was just curious your observation how those different sides of your business are performing?

John Hanson
President-Pet Consumer Products, Central Garden & Pet Co.

A

Yeah. Certainly, the 4% increase in pet ownership has been a terrific tailwind for us, and it continues to drive our business, and we expect that to be able to carry through much of the first half until we start lapping that in the back half. Relative to consumables, it's been very strong. Dog and cat, small animal consumables have been very strong. And we would expect, going forward, for a lot of that to be sticky as pet ownership maintains higher levels than they were pre-COVID.

Is that helpful?

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Very helpful. If I could squeeze – that's very helpful, John. Thank you. And if I could squeeze one more in for the group or anybody that wants to tackle it, obviously, we're seeing a number of inflationary pressures bubble up in the country. And I was wondering if there is any way to quantify that in terms of perhaps what level of price increase you need to get through to offset what you're starting to see on the inflationary side?

Nicholas Lahanas
Chief Financial Officer, Central Garden & Pet Co.

A

Yeah. It's varying. What I can tell you from a macro standpoint, we still see challenges on the labor and freight front. Some of the grains have gone up fairly dramatically, high single digit, low double digit type of increases in certain grains. But that's kind of what we're seeing on a more macro level. I'll kick it over to our segment heads to get into more detail in terms of what they're seeing.

J.D. Walker
President-Garden Branded Business, Central Garden & Pet Co.

A

Sure, Niko. This is J.D. I'll take that, Brad. In terms of commodity cost pressures that we're seeing, Niko touched on grains, particularly its millet, milo and sunflower where we're seeing the most acute increases for various reasons. Millet, was a poor harvest in the millet. Milo, we're seeing increased demand from China and that's having some cost pressures on us. And the industry's moving. We're having to take cost there, not just us but everyone in the category, and we're seeing those costs being implemented now at retail. The cost increases will go into effect in January.

The N, P and K that go into our fertilizer products, we're seeing some slight deflation there, no escalation in pricing. We feel like we're in a good position for the upcoming season. That market may move in the spring as the ag market starts to plant their crops, but by then, we will have produced most of ours for the season. So we feel like we're in a good position there.

And then last in grass seed, it varies by variety. We're seeing deflation in some of the varieties of grass seed and inflation in others. But by and large, I think our only pain point here is for the most part in bird feed. And we're taking pricing there. And our pricing – sometimes, we have to take surgical pricing in order to ensure that we're covering our margins and producing and making a profit in the category.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

That's all very helpful. Thank you all so much.

Operator: Thank you. Our next question comes from Carla Casella with JPMorgan. Please proceed with your question.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

Hi. Your inventory levels were a little bit lower than we expected. I'm wondering how much of that might be because of the supply chain issues? And if you have a sense for whether the supply chain issues will cut – like cut your sales for the coming quarter or how much you could fall short because of supply chain issues?

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

I'll start and I can kick it over to the segment heads, J.D. and John, Carla. You're absolutely right and we mentioned it in our prepared remarks that we have had supply chain challenges primarily in keeping up with this robust and, quite honestly, unprecedented spike in demand. I would say we've gotten our arms around the majority of it as we've turned into fiscal 2021. But some of those challenges and some of those shortfalls are going to continue into fiscal 2021.

There are a number of places in our businesses where once we saw that and felt like it was quite a trend, the business heads, John and J.D., our various general managers, Niko and I, began to get pretty aggressive in capacity expansion plans that will begin to manifest themselves in fiscal 2021. And that's in a number of key growth businesses on both the Pet side and on the Garden side. So with a portfolio as large and complex as ours, the mileage varies across the patch. But there's no question that capacity and inventory challenges continue here into fiscal 2021. J.D., John, any additional?

J.D. Walker
President-Garden Branded Business, Central Garden & Pet Co.

A

Sure, Tim. I'll build on your comments up. There's no questions inventory's down versus where we'd like it to be and that's for a couple of reasons. One, we have had some supply chain challenges, as mentioned, but also because consumption remained incredibly strong. So while we are straining to keep up, the demand for the product is still there as well. And I would say that our teams are doing some – going through heroic efforts in order to maintain the product – or build the product and maintain our fill rates at an acceptable level. We're catching up. Our in-stock levels are improving day-to-day. We feel like we'll be in good position. And again, we're in an off-season now, but year-over-year demand is still pretty strong.

But for the upcoming season, we feel like we'll fix most of the issues. There still may be a lingering issue or two where there's an imported product or where components are difficult to get. But that's not just affecting us, it's affecting other suppliers as well. By and large, I think – we feel like we're in good shape, and it's based on the heroic efforts of the team.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

[indiscernible] (00:50:03)

John Hanson
President-Pet Consumer Products, Central Garden & Pet Co.

A

Yeah. This is John. Go ahead.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

I was just going to say on the working capital front, given what's going on with inventories also, let's say, your payables are a little bit higher, I'm wondering that should normalize, so we could see a bigger use of working capital in the coming quarters as you rebuild inventory and pay down payables. Is that – am I reading that correctly?

Nicholas Lahanas
Chief Financal Officer, Central Garden & Pet Co.

A

Yeah, and that's quite intentional. We are focused on our cash conversion cycle. So we are taking a harder look at inventory receivables and payables. And you can see the result of that, the cash flow being up around 29% on the year. We have a real imbalance in our receivable and payables, and we're looking to balance that out a little better going forward.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

Okay. Great. Thank you.

Operator: Thank you. Our next question comes from Karru Martinson with Jefferies. Please proceed with your question.

Karru Martinson
Analyst, Jefferies

Q

Good afternoon. Just wanted to get a sense of the product inventory at retail. What are retailers having on their shelves right now and is that part of that pull forward here why we feel very comfortable with that stronger first half of the year?

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

John, J.D.?

John Hanson
President-Pet Consumer Products, Central Garden & Pet Co.

A

Yeah. Sure...

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

Go ahead, John.

John Hanson
President-Pet Consumer Products, Central Garden & Pet Co.

A

Yeah. From a Pet side, demand continues to be extremely strong. So we're working through each customer and the best way to service. As Tim mentioned, we've added a – we continue to add capacity as we get into fiscal 2021 and we'll continue to work that. We do see our demand – our fill rates improving and that will continue to improve, but through the first half really driven by the pet ownership, consumer demand is going to remain strong and retail inventories are a bit challenged because of that from the Pet side.

J.D. Walker
President-Garden Branded Business, Central Garden & Pet Co.

A

And on the Garden side, while year-over-year our inventories are up slightly, our inventory metrics lag consumption. So we wish we had more inventory in the store and I think that – it goes to my earlier comments around product supply and just the demand for the product. So, by and large though if you're asking are we too heavy going into the season? We're certainly not that. We wish we had more on the floor.

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

That's right.

Karru Martinson
Analyst, Jefferies

Q

Okay. And then when we look at the kind of the stressed supply chain that you spoke to, when we look at the investments that are going to need to be made, where do those fall into the cadence of next year when we look at that CapEx spend? And then what's kind of the return, does the bottleneck get addressed next year or will this carryover into the subsequent periods?

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

A

Yeah. Well, I mean, of course, first is no one has a crystal ball, right, in terms of how long will this type of extraordinary demand continue. But if we take our best guess, which is obviously through the front half as we lap the initial onset of the COVID pandemic, we're expecting continued robust demand. And then as we lap into the back half, we see that softening, and perhaps a little bit more on the Garden side given – in addition to the COVID impact. As we've shared with you, it was, we think, an almost ideal gardening season this year.

Therefore, that's what we've put in kind of our long range forecast to help us get to the answer of your question, which is how does that capacity to demand ratio kind of shake out? The incremental capacity that we have invested in in the last quarter and a half, and we will continue to invest in in fiscal 2021, I think in Niko's comments, he guided to a rather large CapEx number that you heard of $70 million to $80 million. It will differ by business unit. We'll have some that are literally coming online as early as late Q1 into Q2, that incremental firepower of capacity. Some will come in more in the call the late summer-fall, so towards the end of the year. And some won't be operational given lead times and the extent of building and automation until we actually enter into fiscal 2022. So it differs by product line but I do feel good that we are taking the steps now to really have the type of firepower to grow and to capture upside demand going into 2021, 2022 and beyond.

Karru Martinson
Analyst, Jefferies
Q

Thank you very much guys. Appreciate it.

Operator: Thank you.

Friederike Edelmann
Vice President-Investor Relations, Central Garden & Pet Co.
A

And we have time for one – yeah. So, we're done. Okay. That was the last question.

Timothy P. Cofer
Chief Executive Officer & Director, Central Garden & Pet Co.

Well, very good. I want to thank everyone for joining us today on our earnings call. I also want to wish everyone a safe, happy and healthy Thanksgiving holiday. And I encourage everyone to please join us next week, December 3, 1:00 PM Eastern Time at our Investor Day, ir.central.com. Thanks everyone.

Operator: Ladies and gentlemen, this concludes today's webcast. You may now disconnect your lines at this time. Thank you for your participation and have a great day.