Central Garden & Pet Company NasdaqGS:CENT
FQ2 2024 Earnings Call Transcripts
Wednesday, May 8, 2024 8:30 PM GMT
S&P Global Market Intelligence Estimates

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Currency: USD
Consensus as of May-09-2024 1:31 AM GMT

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### Stock Price [USD] vs. Volume [mm] with earnings surprise annotations

- EPS NORMALIZED -

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Call Participants

EXECUTIVES

Beth Springer

Friederike Edelmann
Vice President of Investor Relations

J.D. Walker

John Hanson

Nicholas Lahanas
Senior VP & CFO

ANALYSTS

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Bradley Bingham Thomas
KeyBanc Capital Markets Inc.,
Research Division

Brian Christopher McNamara
Canaccord Genuity Corp., Research
Division

Jim Chartier

Peter Lucas

Shovana Chowdhury
Presentation

Operator

Ladies and gentlemen, thank you for standing by. Welcome to Central Garden & Pet's Fiscal 2021 Second Quarter Earnings Call. My name is John, and I will be your conference operator for today. I would now like to turn the call over to Friederike Edelmann, Vice President, Investor Relations. Thank you, Frederic. Please go ahead.

Friederike Edelmann
Vice President of Investor Relations

Good afternoon, everyone. Thank you for joining Central's Second Quarter Fiscal 2024 Earnings Call. With me on the call today are Beth Springer Interim Chief Executive Officer; Nico Lahanas, Chief Financial Officer; J.D. Walker, President, Garden Consumer Products; and John Hanson, President, Pet Consumer Products. In a moment, Beth will highlight our key messages, and Nico will provide more details about our results. J.D. and John will join us after the prepared remarks for Q&A. Comments made during this call include forward-looking statements that are subject to risks and uncertainties. Our actual results may differ materially from what we shared today. We’ve described a range of risk factors in our SEC filings, including in our annual report on Form 10-K. We undertake no obligation to publicly update these forward-looking statements. Our press release and related materials, including the GAAP reconciliation for the non-GAAP measures discussed on this call are available at ir.central.com. All growth comparisons made today are against the same period in the prior year, unless indicated otherwise. If you have further questions after the call, please don't hesitate to reach out to me. And with that, I will now turn it over to Beth Springer. Beth?

Beth Springer

Thank you, Frederic, and good afternoon, everyone. Let me begin with the 3 key themes we'd like you to take away from this call. First, we delivered a solid quarter. GAAP earnings per share were $0.93 and non-GAAP earnings per share were $0.99, well ahead of prior year, and net sales were just shy of prior year. Our focus on cost management helped rebuild our margins. We grew e-commerce sales and we expanded market share across most of our pet and garden categories. Second, we're particularly pleased with our progress on the cost and simplicity program, which enables us to invest in our business and offset sustained cost increases. Our strategic initiatives to simplify our business and improve efficiency across the organization are paying off and we're commencing new projects. For example, we recently began the consolidation of 4 distribution locations into one modern facility, which will drive significant savings and efficiencies. And third, our outlook for the fiscal year is unchanged. While we announced solid Q2 results today, keep in mind that a large part of the garden season is still in front of us. Q3 last year was a record quarter and we're back to a 52-week fiscal year. For the balance of the fiscal, we expect softer consumption in durable pet product categories, lower foot traffic in key retailers and retailer pressure for price concessions to persist. Looking ahead, the 6,700 members of Team Central remain focused on executing our long-term strategy with excellence. We are confident in the strength of our business and the positive long-term trends in the pet and garden industries and we continue to make thoughtful investments that will drive our future performance. With that, let me hand it over to Nico, who will share more details. Nico!

Nicholas Lahanas
Senior VP & CFO

Thank you, Beth. Good afternoon, everyone. I'll provide more details on our second quarter results and the progress we are making on our cost and simplicity program and discuss our outlook for the year. Let's start with our second quarter results. Net sales were $900 million or 1% below prior year. Organic net sales also declined 1%. Non-GAAP gross profit increased 8.4% to $281 million. Non-GAAP gross margin improved by 270 basis points to 31.3%, thanks to cost and simplicity projects we initiated a year ago, which includes the sale of our independent garden channel distribution business and the exit of some low-margin private label pet product lines as well as moderating inflation. Non-GAAP SG&A expense of $183 million was 1% above prior year, and non-GAAP SG&A as a percentage of net sales increased by 30 basis points to 20.3%, mainly due to our recent acquisitions. Non-GAAP operating income increased $21 million to $99 million, and non-GAAP operating margin increased by 240 basis points to 11%, driven by improved gross margin. Net interest expense was $11 million compared to $15 million in the prior year quarter, driven by higher interest income from higher cash balances and higher interest rates. Non-GAAP net income was $66 million compared to $48 million a year ago. We delivered GAAP EPS of $0.93, up from $0.72 and non-GAAP EPS of $0.99. Note, the prior year number was adjusted for the February 2024 stock dividend. Adjusted EBITDA was $124 million compared to $107 million. Our effective tax rate was 23.4% compared to 23.9% in the prior year quarter due to a larger tax benefit related to stock compensation in the current year quarter. For the year, we expect a tax rate in the range of 23% to 24%. Now let me add some color on our 2 segments, beginning with Pet. Pet segment sales increased 1% to $480 million, driven by our growth in our consumables business and the recent TD DBS acquisition.
Organic net sales, which excludes TD BBS, decreased 3%, primarily due to the declines in durables across our pet businesses, in line with the softness in pet adoptions. Demonstrating the strength of our brands, branded products once again outperformed our private label, and we grew market share in many consumables and durable categories. We also grew share in e-commerce and our online business continues to grow faster than other channels, now representing approximately 25% of our pet sales. Let me highlight some of the recent dog and cat innovation supporting future growth. Paul Love, one of the TD BBS brands introduced a new line of natural dog shoes smoked in small batches over real Hickory wood called Simply Smoked. Cadet added new rawhide alternatives and premium treats to its assortment and Nylabone extended its Chewtoy lines with new flavors and fun in unique shapes such as a donut, a peanut and a pretzel. Pet segment operating income improved 13% to $63 million, and operating margin improved by 140 basis points to 13%, driven by gross margin expansion. Pet segment adjusted EBITDA was $74 million compared to $66 million a year ago. We expect consumables to continue to grow and sustain headwinds for durables through fiscal '24, in line with the softness in pet ownership. Pet Supplies household penetration has stabilized over the last several months and remains above 2019 levels, indicating that consumers remain engaged in the pet category. Long term, we expect that the consumer trends, including premiumization and humanization, health and wellness, the shift to e-commerce and favorable demographics will support sustainable growth. Moving now to Garden. Garden segment sales declined 3% to $420 million. Recall that we sold the independent garden channel distribution business, which represented approximately 5% of our garden sales. Organic net sales increased 2%, driven by growth in live plants, graphs and controls and fertilizer offsetting lower sales in Wild Bird. Non-GAAP Garden segment operating income was $62 million compared to $50 million a year ago. Non-GAAP Garden segment operating margin improved by 340 basis points to 14.8%, driven by our gross margin expansion. Garden segment adjusted EBITDA was $73 million compared to $60 million in the prior year. Consumers remain engaged in the garden category as demonstrated by the sustained higher household penetration and buy rate since the onset of COVID. While foot traffic at key retailers is down versus a year ago, it has modestly improved since the fall of 2023. Our targeted investments in consumer insights, branding, and digital capabilities support our growth. Branded products outperformed private label in the majority of our categories. We grew e-commerce sales double digits versus prior year, now representing 5% of the total Garden sales. One of the highlights of our selective investments into our consumer growth agenda is our new AMDRO packaging. Pest control is a fragmented category where consumers are overwhelmed with choices. Our new AMDRO portfolio takes the guesswork out of pest control. The new eye-catching design is bold get clean and short and simple names and relevant claims make it clear what each product does. Close to 80% of shoppers that purchased AMDRO via Amazon Display are new to the brand on Amazon, a significant KPI. Turning to balance sheet and cash flows. Our balance sheet remains strong, and our teams have done an excellent job decreasing inventories by $53 million despite the added inventory from TD BBS. Cash and cash equivalents at the end of the second quarter were $301 million compared to $61 million a year ago. Net cash used by operations was $25 million for the quarter compared to $34 million a year ago. CapEx was $9 million for the quarter, 25% less than the prior year. This quarter, we invested in maintenance and productivity initiatives in dog and cat, small animal, live goods, wild bird and grass. Total debt of $1.2 billion was in line with the prior year. Our leverage ratio was 2.9x at the end of the quarter compared to 3.3x a year ago, below our target range of 3 to 3.5x. We had no borrowings under our credit facility at the end of the second quarter. Depreciation and amortization for the quarter was $23 million compared to $22 million in the prior year quarter. We did not repurchase any of our stock during the quarter. Now let me share a few highlights of the progress we are making on our Cost and Simplicity program, consisting of a number of strategic projects across procurement, manufacturing, logistics, portfolio optimization and administrative costs, allowing us to create the capacity to invest and offset sustained cost increases. In manufacturing, we are building capabilities in safety, quality as well as our overall cost acumen at all levels of the organization. Additionally, we have commenced our first pilot of centers of excellence at 3 manufacturing sites, applying common methodology to drive improvements. We further announced the closure of a manufacturing facility in Chico, California as part of our ongoing network optimization. We are rightsizing our logistics footprint and simplifying our work processes and fulfillment strategy. We've begun to consolidate 4 locations across Georgia, Alabama and Virginia into a new facility in Covington, Georgia, enabling significant savings and efficiencies due to the optimized configuration and streamlined material flow. This step will also considerably improve our in-season on-time service and enable future growth in the Southeast region. Related to the Chico facility closure and the consolidation in the Southeast, we incurred $5.3 million of onetime costs, including $2.5 million in cost of goods sold and $2.8 million in SG&A, the majority of which were noncash. We're staying focused on this multiyear journey to reduce costs, simplify our business and improve efficiency while minimizing disruption to the business. We'll continue to provide quarterly updates on the progress we're making. The pipeline of projects to leverage our scale and deploy our capabilities across our 2 segments remain strong. As always, our goal is to augment organic growth with acquisitions, and we believe there will be plenty of opportunity to reduce costs ahead of us. And finally, turning to our '24 outlook, which is unchanged from the guidance we gave in November. We continue to expect non-GAAP EPS for the year of $2 or better post our February 2024 stock dividend. For the remainder of the fiscal year, we assume moderating inflation, softer consumption in a number of categories and lower foot traffic in key retailers and an environment of macroeconomic and geopolitical volatility. Our outlook includes modest carryover pricing to help mitigate continued inflationary headwinds. Additionally, our expectation for CapEx remains at around $70 million across both segments, driven mostly by maintenance and productivity initiatives. Our guidance reflects our belief in the competitive strength of Central, our long-term strategy and the positive consumer trends supporting sustainable growth in the pet
and garden industries. Thanks to our strong financial position and the amount available on our credit facility, we continue to be on the lookout for great growth and margin accretive acquisition targets in both Pet and Garden. This outlook excludes any impact from potential acquisitions or restructuring activities undertaken during the year, including any projects under the cost simplicity program and our recent TD BBS acquisition. And with that, we’d like to open the line for questions.

Operator

Thank you. We will now be conducting a question-and-answer session. And the first question comes from the line of Bill Chappell with Truist Securities.

Bill Chappell

Just looking at the results and just maybe trying to pair it with what you were expecting from particularly the pet category. And I know you’re expecting softness and continued expect softness, but have you seen anything different over the first 4 or 5 months that where you feel like maybe things won’t be as soft through this year?

John Hanson

Bill, this is John. It's pretty much the way we expected. Consumables are outperforming durables. -- durables remain very soft. We feel very good about our share performance, especially in e-comm, which is the highest growth channel -- as Nico stated, in pet supplies, we're seeing a flattening of household penetration, which we think is a good sign as we move forward. We do expect durables to decline for the balance of fiscal '24. And it's hard to call it, right? But at some point, it will moderate and long term we believe in the categories, we believe in low to mid-single-digit growth.

Bill Chappell

Got it. And then if I'm looking at the garden category, I mean, your largest competitor said their start of the season was very strong. They grew 8%. They said the category group was flat, implying they grew through meaningful market share in all their categories. Is that the case for you? And maybe you could -- did you lose meaningful market share? Because I know grass seed is a big start of the season and big for you. And then maybe a little bit color on -- because it's within Garden of the wild bird declines and what caused that?

J.D. Walker

Sure, Bill, it's J.D. I'll take that question. With regard to year-to-date performance, I'd say that ours is -- as you well know, our portfolio is a little different than our competitor. So their early season businesses, particularly growing media and mulch, we don't participate in a meaningful way there. We have some other categories where they don't participate in a big way. You mentioned one, bird feed. And year-to-date, we've seen consumption in bird feed lag prior year. So our overall POS for the quarter was flattish, flat and plus low single digits if you exclude bird feed. The warm weather during the quarter and really during the first half of the year was not conducive to a strong bird feed season. So that category has struggled a bit and the rest of our categories, and many of them still are in front of us. The peak consumption for those categories are still in front of us. We saw decent consumption, overall warmer weather for the quarter. I think that for a brief period in mid-March for about 10 days to 2 weeks, we saw perfect weather. And we saw strong consumption. I think most people in our categories did. That tells us that the consumer is still very much engaged in our categories and gives us confidence going forward. Yes, we're pleased with the quarter and the first half of the year, but a meaningful part of the season still lies in front of us. So that makes us somewhat cautious in our approach and outlook for the year, still many unknowns around weather and competitive activity and footsteps at retail. But I will say this, there's a lot to like, too. Our distribution, points of distribution, our total distribution points are up mid-single digits versus prior year. We are gaining share to your question in both insecticides and grass seed. 2 categories that aren't measured or packet seeds and live goods, and we know just through distribution gains that we're picking up share there as well. We have strong promotional support with the partnership of our retail partners. So that gives us quite a bit of optimism looking forward. inventory levels at retail are in good shape. So we're feeling cautiously optimistic, I'd say, about the future.

Bill Chappell

And the bird seed is just the old there's not snow on the ground consumers think the birds can find their own food?

J.D. Walker

Exactly. That's the leading driver of the issue there for sure.

Operator
And the next question comes from the line of Brad Thomas with KeyBanc Capital Markets.

**Bradley Bingham Thomas**  
*KeyBanc Capital Markets Inc., Research Division*

Just to follow up here with JD, if that's okay. I guess 2 observations. Number one, can you talk a little bit about inventory in the channel and just the timing of shipments, if there's anything that you should think about as we look to this all-important fiscal third quarter for you -- and then just as we think about the comparisons, I mean, it's interesting, your Garden organic growth was positive in the quarter, you're up against here versus being much easier earlier on. How are you thinking about that affecting the growth rate that we see in the category in the quarter ahead here?

**J.D. Walker**

All right. Thanks, Brad. I appreciate the question. So first of all, with regard to retail inventories, we feel like we're in a good position at the end of the quarter. Inventories are down low single digits at the end of the quarter. So we feel like we're in a good position. Now last year, we talked all year long about inventory destocking at retail. I think what we've seen is some correction of that this year as retailers brought inventory in, in the first 6 months of the year in anticipation of the season. So actually, shipments have outpaced consumption year-to-date for us. But inventories still aren't at a heavy level at retail. So we feel like we're in a good position. We're seeing a lot more off-shelf activity, off-shelf display activity, which drives the category at this time of the year. So again, going back to my earlier comments, I think that, that bodes well for us going forward. Now a major critical month, and it's difficult to -- I don't want to make any forward-looking statements but we still have a lot of -- a meaningful part of the season still in front of us. The first 6 months, we feel good about. But the next 6 weeks or so, will determine a lot about our path for the year.

**Bradley Bingham Thomas**  
*KeyBanc Capital Markets Inc., Research Division*

Very helpful, J.D. We're all rooting for a good spring here and early start to summer. Nico, maybe I could ask one financial outlook question for you. The first half of the year has been very strong from a margin standpoint. And if there's some momentum there, would certainly seem like earnings could be strong in the second half. Maybe could you give us a little more color on the puts and takes on margins in the second half of the year?

**Nicholas Lahanas**  
*Senior VP & CFO*

Sure. I mean, just to recap first half margins really driven by our cost and simplicity program. The moves we're making there are significant. I would say also moderating inflation. And then third, we had pretty good product mix here in this quarter. I think going forward, we still feel great about margins. We -- our inflationary outlook hasn't changed. We think it's still moderating going forward. We're continuing to work on our cost and simplicity program. I think the wild card is going to be product mix. So we have to see how that plays out in Q3 and Q4. So far, it's been very favorable. So I think as long as that plays out, we're feeling very good about margins going forward.

**Operator**

And the next question comes from the line of Jim Chartier with Monness, Crespi & Hardt. ?

**Jim Chartier**

On the pet side, what do the POS trends look like in the quarter? If you could break that up by consumables and durables, that would be great.

**John Hanson**

Yes. On the pet side, overall, the category was down on POS. We were down about with the category and essentially held a share, right? And think about it's down low to mid-single digits. Consumables outperformed durables. -- durables were down double digits. Terrible declines in Q2 were actually improved versus Q1. And then therefore, that combined with some moderate and household penetration makes us feel cup-half-full on durables.

**Nicholas Lahanas**  
*Senior VP & CFO*
And that's tracked channels. Our biggest customer, by the way, is Costco, which is not in the channel. And we feel like we really outperformed in that channel. And just to give you some color, we did take share in aquatics, flea-and-tick pet beds, small animal wild bird and dog toys in the quarter. So did a pretty good job.

Jim Chartier

Great. And then in terms of the distribution facility consolidation that you announced this morning -- is this evening. When should we expect to see the benefits of that start to flow through the income statement?

Nicholas Lahanas  
Senior VP & CFO

Probably not until next year when we go through the season because we didn't want to disrupt the garden season. It's primarily a garden initiative -- and so we'll start moving product in there in July, August, I think, J.D.

J.D. Walker

That's right. We've taken possession of the new facility, and we're starting to move product in starting this month actually, but we won't start shipping from that facility until July, August, you are right.

Operator

And the next question comes from the line of Bob Labick with CJS Securities.

Peter Lucas

It's Pete Lukas for Bob. Covered most of my questions but can you maybe remind us and give us a little color on the extent of the SKU rationalization and what has been the impact so far on '24? And how do you kind of think about what to keep, what to end?

Nicholas Lahanas  
Senior VP & CFO

Yes. We like to get rid of the low-margin stuff and keep the high -- so that's kind of where we start. But I think if you go back to what we did a year ago with our vendor partner business on the Garden side, we took out almost 5 million SKUs. So that kind of gives you a -- 5,000, SKUs. Yes. Thanks, J.D. So 5,000 SKUs very, very quickly. And we're -- that's an ongoing process. So it's really never done, particularly as we're always acquiring other businesses, and we need to rightsize them as well. So that rationalization process continues on. But that gives you an idea of the magnitude that we're talking about. And really, when you talk about kind of SKU proliferation, it's really relegated to our distribution businesses because their full-service distribution businesses. And so you do have to have a full assortment, and that's where really the SKUs can get away from you. So it was a really strong move for us on the Garden side. And on the pet side, we look at that every day so...

J.D. Walker

And Nico, just building on that, the downstream implications of removing those 5,000 SKUs, that's one of the reasons why we can take 4 distribution centers and collapse and into one now. It's removed a lot of complexity from our business and allow us to focus on the efficiencies of a smaller assortment and execute against that.

Operator

And the next question comes from the line of Brian McNamara with Canaccord Genuity.

Brian Christopher McNamara  
Canaccord Genuity Corp., Research Division

So I'm curious whether it's plagued you or helped you a lot over the last and more plays in the last couple of years over the last 3 to 4 years. So I'm curious you have weather, a bit cooler in the Northeast, but perhaps a good normal elsewhere. How did that impact the quarter in Garden? And how does that inform your guidance?

J.D. Walker

Sure. Thanks, Brian. The -- so weather is as much as -- it's a huge cause factor, the biggest causal factor that impacts our business, and it's completely out of our control, as you know. I'd say that for the quarter, weather was overall not favorable for Q2, and that's because of the headwind that it presented for our wild bird business. Some of our traditional garden businesses, the warmer weather,
that was a benefit there. But the strong sales that we saw in live goods and our package seed business and our controls and grass seed business did not offset what we lost in grass seed and that's why POS ended up flat. So weather is difficult to predict, but I'd say that that's why we have a broader portfolio and one that has counter-seasonal businesses like a bird feed, so that if weather impacts one category negatively, it often impacts another positively.

Nicholas Lahanas  
Senior VP & CFO

And in terms of guidance, I think that's why you saw us not move on guidance. We're going to hold for now because we've got the better part of the garden season ahead of us, and there's a bit of uncertainty with the weather, as J.D had outlined. So again, we feel great about the start to the year. The first half has been good, I would say, solid. But more to come and really not definitive yet in terms of what the full year outlook looks like. So I think that's why we felt good about just holding guidance for now.

Brian Christopher McNamara  
Canaccord Genuity Corp., Research Division

Great. That's helpful. And then on pet, I mean, with durables down another double digit again, is there any line of sight to that category bottoming? And do you believe anything has structurally changed in terms of pet ownership with it apparently back to preventative levels for some time now. Kind of how should we think about that at least durables returning to growth, like the time frame?

John Hanson  

Yes. First of all, I'd say it's hard to pinpoint the timing of return to growth. I would say we saw pet ownership peak in 2021, and we've seen some modest decline since then. And if you look at the household penetration of our pet supply category, it tracks really close. -- right? So we saw a peak in 2021. We've had modest declines since then. We've had leveling off, though this last quarter, which, again, we think that's cup-half-full. As we look forward, I do believe the declines will moderate. Q2 was less than Q1 actually. And as we look into fiscal '25, I think cutp-half-full we'll see some stabilization. And at some point, it will return to growth.

Nicholas Lahanas  
Senior VP & CFO

Yes. We feel like we're encouraged by the rate of change getting smaller. The other thing to keep in mind, most folks are buying their live animals in the pet specialty channel, which has been a little bit challenged in terms of good steps. So we feel like there's -- that definitely correlates. And once that channel starts to get healthier, we feel like there could be an uptake, but we are encouraged by the rate of change declining.

Operator

And the next question comes from the line of Savanna Jodi with JPMorgan.

Shovana Chowdhury  

I want -- I have a quick clarification. You mentioned that shipments off-pace consumption year-to-date, but your inventory levels are down low single digit in a good position. Just wanted to confirm that there is no pull forward from your important fiscal third quarter as a result of this...

J.D. Walker  

Yes, this is JD. That is correct. I think some of this is a correction from last year where there was significant destocking in the categories. So we're seeing inventories return to a more normal level in anticipation of the season. But we did not have any significant pull forward from Q2 -- Q3 into Q2.

Shovana Chowdhury  

So I would like to ask you like all the companies that have been reporting, they've been talking about generally higher level of value-seeking behavior amongst consumers, understandably given the higher cost of living. So I wanted to ask you, are you seeing a greater level of promotions in the environment than what you baked into your guidance or what you had anticipated starting out?

Nicholas Lahanas  
Senior VP & CFO
Well, I think that's one of the reasons we held guidance as well because we're going into the deeper part of the garden season and there could be more promotional activity. I'm not -- J.D, have you seen it as of yet. I think it's been -- there's been pockets of it, right?

**J.D. Walker**

There have been... So we're starting to -- we started to see more promotional activity towards the end of Q2 and now into Q3. I know our competitors are signaling deeper promotions. We're seeing -- I mentioned this earlier, more off-shelf activity off-shelf display activity, not just for our brands but across the lawn and garden department. So we're anticipating a competitive environment in Q3 and beyond, and we'll react appropriately. It is -- I think that's one of the reasons for our conservatism in our forecast. But I can't say that it's been anything that we did not anticipate...

**Shovana Chowdhury**

Thank you I'll pass that on...

**Friederike Edelmann**  
*Vice President of Investor Relations*

And this was our last question. So thanks for joining our call today. We're available for questions afterwards. Have a good day.

**Operator**

Yes. Ladies and gentlemen, that does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation.