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Central Garden & Pet Co. (CENT)

Q4 2017 Earnings Call

CORPORATE PARTICIPANTS

Steven Zenker
Vice President-Investor Relations & Communications, Central Garden & Pet Co.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

Nicholas Lahanas
Senior Vice President & Chief Financial Officer-Pet Segment, Central Garden & Pet Co.

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

Rodolfo Spielmann
President-Pet Consumer Products, Central Garden & Pet Co.

OTHER PARTICIPANTS

Frank Camma
Analyst, Sidoti & Co. LLC

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Jason M. Gere
Analyst, KeyBanc Capital Markets, Inc.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Hale Holden
Analyst, Barclays Capital, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Central Garden & Pet's Fourth Quarter Fiscal Year 2017 Financial Results Conference Call. My name is Tim and I will be your conference 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 call is being recorded.

I would now like to turn the call over to Steven Zenker, Vice President of Investor Relations, SP and Communications. Please go ahead.

Steven Zenker
Vice President-Investor Relations & Communications, Central Garden & Pet Co.

Thank you, Tim. Good afternoon, everyone. Thank you for joining us. With me on the call today are George Roeth, Central's President and Chief Executive Officer; Niko Lahanas, Chief Financial Officer; Howard Machek, Senior Vice President, Finance and Chief Accounting Officer; J.D. Walker, President, Garden Branded Business; and Rodolfo Spielmann, President, Pet Consumer Products. A press release providing results for our fourth quarter ended September 30, 2017 is available on our website at www.central.com, also in the website is the GAAP to non-GAAP reconciliation for the non-GAAP measures discussed on this call.

Before the call – I turn the call over to George, I'd like to remind you that statements made during this conference call, which are not historical facts including EPS guidance for 2018, expectations for new product introductions, future acquisitions, and improved revenue and profitability 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 will turn the call over to our CEO George Roeth. George?

George C. Roeth

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

Thank you, Steve. Good afternoon, everyone. It's great to be with you today. 2017 turned out to be a terrific year all around for the company. As we crossed the $2 billion mark in revenue, Central marked its second consecutive year of double-digit revenue growth and diluted earnings per share increases while significantly advancing our strategy to enable long-term sustainable sales and profit growth.

Our revenue growth for the year totaled over 12% with organic growth making up over half. Even taking out the impact of the 53rd week, organic growth was 5%. Importantly, both our Garden and Pet businesses contributed to that growth while building market share.

GAAP and non-GAAP earnings per share rose 75% and 19% respectively, benefiting from stronger sales, and our continued efforts to reduce costs to drive efficiency and increase profitability. Niko will cover the specifics around the quarter and the year in just a few minutes.

First however, I'd like to spend a few moments detailing the significant progress we made during the year around our five key strategic pillars. The first strategic pillar is to accelerate the growth momentum of the portfolio. During the year, we strengthened the growth profile of our portfolio by acquiring K&H Manufacturing, a high growth business, the largest producer of heated and cooled beds – heated and cooled dog and cat beds in the U.S. Combined with our Dallas Manufacturing Company Bedding business purchased last year, we have become a formidable player in the pet bedding category with industry-leading market share, a strong pipeline of innovation and strong revenue growth. Also last year, we purchased Segrest, the largest producer distributor of live aquarium fish, and just after fiscal year-end, we purchased a minority stake in CASCO Pet, a global leader and manufacturer of fish and small animal habitats for retail stores. These investments allow us to offer comprehensive solutions to our brick-and-mortar retail partners to draw consumers to their outlets with in-store theater and unique products in order to drive growth of our collective businesses.

Also last year, we exited the small veterinary products business early in the year to enable us to focus on other areas of growth for the company. And finally, we have planted additional seeds for future growth as we entered into several joint ventures in addition to CASCO. These include the mature seasonal business with an option to buy in attractive valuations as well as two start up pet enterprises.

Finally, I do think it's important to mention that having a diversified portfolio of products like we have at Central is a real competitive advantage, as it enables us to balance up the risk to the weather, market conditions and other forces. An example of this was in 2017, weather was generally unfavorable for our wild bird feed business, which as you might recall is in both our Garden and Pet segments. We were able to make up for that shortfall and a lot more due to the performance of our other businesses, that shows the strength of a diversified portfolio.

The second key strategic focus is to build on our strong customer relationships. We continue to partner with our customers to grow their categories profitably. We listen, are flexible and responsive in our objective and our assessments, and recommendations. Activities during fiscal 2017 included rolling out successful new private label products and associated packaging that significantly grew both our customers and our sales and profits.

Our strong execution in this area, as well as our efforts around our branded products in the lawn and garden segment, led to some meaningful recognition from two of our largest customers, Walmart and Lowe's. Both companies awarded Central, the prestigious Lawn & Garden Supplier of the Year award. And Lowe's presented Central one of three Vendor of the Year awards (sic) [Vendor Partner of the Year awards] (06:19), their highest honor to any supplier store.

Walmart additionally nominated Central for eight awards out of the 12 they presented and bestowed three upon the company. In addition to the Lawn & Garden award, Walmart recognized Central for its Innovation and H3 meaning Humble, Hungry, Hustle award. I should also note that hot off the press Petco awarded Central Strategic Initiative Vendor of the Year award in Companion Animal. We're honored by this recognition.

We continue to strive to provide best-in-class customer service and partnering with all of our customers. And these awards validate that we are executing well on all of these efforts. Additionally on the customer front, in our Pet distribution business we are rolling out a partnership with a major grocer with whom we were successful in testing an enhanced business model. This effort entails Central managing a store within a store concept. Central manages the pet supply area completely choosing assortment, shelf placement, and merchandising in the area to maximize our partner's sales and profits. Our efforts resulted in growth for our retail partner while successfully expanding our Pet distribution business. We look forward to taking this to a new level in fiscal year 2018.

The third initiative is to increase our innovation output and success rates. Central continued its progress in this important area during the year getting shelf space with new offerings in numerous categories, some of the more notable new products launched during the year included both branded and private label potting soil, and an expansion of our Quick Kill control products line in our Garden segment. In our Pet segment, we introduced the CritterHome, which builds on the success of our award winning CritterTrail product line as well as new equine wound care product using a proprietary technology.

Also during the year, Central accelerated innovation efforts by driving better coordination across our business units. For example, we're executing a joint initiative between our Garden and Pet segments, whereby our Garden controls and Pet professional teams are collaborating to produce new consumer pest control products that will hit the shelves this spring. We'll talk more about this initiative next quarter.

The fourth strategic pillar is to drive cost savings and productivity improvements to fuel growth. In 2017, Central met its long-term goal of annually cutting controllable costs by 1% to 2%, really closer to the 2%. We successfully increased efficiency by combining facilities, executed new in-sourcing and outsourcing initiatives, and increased capital spending to invest in equipment and processes at lower product costs. One key initiative was the enhancement of an additional segment of our grass seed product line which allows consumers to buy less seeds yet experience better results. Some of these savings are reinvested in demand creation activities to drive our customers' categories and build market share creating the virtuous cycle that we are striving for.

Also during the year in our garden controls and pets health and wellness businesses, we were successful in identifying new active ingredients and suppliers, enabling us in the upcoming year to produce more efficacious products at a lower cost. We will be benefiting from these actions and improved products even more aggressive marketing plans that we were planning to bring to market in 2018.

Finally, the fifth initiative is to attract, retain, and develop exceptional employees. It is an understatement to say we could not have achieved the success we enjoyed this year without the excellent execution on many fronts from our talented teammates. Winning awards for our superior customer service while at the same time delivering market share gains and profitable growth with passion and commitment is more than any leader can ask.

In addition, we filled some key senior management positions during the year which have made us stronger, Rodolfo Spielmann, joined as us President of our Pet Consumer Products and Bill Lynch came on as Senior VP of Operations. Both bring us a wealth of experience and talent and have already made significant contributions to the company's success.

Additionally, we promoted from within our Senior VP of Human Resources, Marilyn Leahy. And our talented CFO Niko Lahanas will now take you through some of the specifics of the year and quarter.

Nicholas Lahanas

Senior Vice President & Chief Financial Officer-Pet Segment, Central Garden & Pet Co.

Thank you, George. Good afternoon everyone. We issued a press release earlier today outlining our fourth quarter and fiscal year financial results. I'll be using non-GAAP numbers in some instances to make it easier to compare this year's results with the prior year.

The 2017 non-GAAP numbers exclude only one item, the sale of a garden distribution facility that generated a gain of around $2 million in our first fiscal quarter. The 2016 non-GAAP numbers exclude four items. First, a $14.3 million charge in the first quarter related to the refinancing of our fixed rate notes. Second, a $2.4 million gain on sale of plant assets in our Pet business during the third quarter. Third, a $1.8 million non-cash intangible charge in our Pet business in the fourth quarter. And fourth, a $16.6 million non-cash impairment charge in the fourth quarter, primarily related to the company's investment in an antimicrobial technology that did not impact operating income which showed up below the line in our other income expense.

I'll start with a brief summary of the year. As George mentioned earlier, we had an exceptional year in both our Garden and Pet segments. Total company revenue rose 12% with organic revenue increasing 5%, excluding the extra week in fiscal 2017. Both segments drove the growth, with Garden total revenues up 8% or excluding the extra week 7% organic growth, and Pet revenues up 15% or 3% organic growth, excluding recent acquisitions and the extra week. Total company gross margin for the year increased 60 basis points to 30.8% with both segments seeing an increase.

Operating income of $156 million was up 21% with operating margin increasing 50 basis points to 7.6%. Earnings per share rose 75% to $1.52. Excluding the items noted earlier in both years, non-GAAP operating income and EPS were up 20% and 19% respectively.

Turning to the quarter, fourth quarter consolidated sales increased 19% to $490 million with organic sales excluding the extra week rising 4%, both Pet and Garden contributed to the increase. The impact of the extra week was approximately $35 million in total revenue, of which $33 million was related to organic revenue, and $2 million from acquisitions. Consolidated gross profit for the quarter rose 21% and our gross margin increased 50 basis points to 29.6% on improvement in both segments.

SG&A expenses for the quarter increased 24% or $26 million versus a year ago, and as a percent of sales increased by 120 basis points to 26.7%. The increase in dollars is driven primarily by acquisitions as a percent of sales, the increase was due to a higher level of demand creation spend as we continue to invest for future growth and additional expense related to a contingent earn out for the fiscal 2017 acquisition.

Operating income for the quarter rose to $14 million compared to $13 million a year ago. The prior year had an impairment charge of $1.8 million that negatively impacted results. So excluding the $1.8 million charge last year and the $2.3 million charge in the current year related to a contingent earn out, operating income is up. Our operating margin including or net – or net of the aforementioned charges declined 20 basis points to 2.9% due to higher SG&A expenses. This increase was driven by our choice to invest in demand creation spending to drive future growth. Net interest expense increased slightly from $6.6 million to $7.2 million. The increase was due primarily to the extra week in this year's fourth fiscal quarter.

Our net income for the quarter was $4.3 million, and our diluted earnings per share was $0.08 compared to a loss of $5.6 million or $0.11 per share in the fourth quarter of 2016. In addition to the $1.8 million fourth quarter intangible charges that impacted SG&A expenses, there was also the non-cash impairment charge of $16.6 million last year that was reflected in the other expense line, so non-GAAP earnings per share in last year's fourth quarter, which excluded the impairment charges was $0.13.

Other factors that caused this year's EPS to be below last year's non-GAAP EPS include the other expense and corporate expense lines. We expected unfavorable comparisons in these three areas and called them out in our last two earnings calls. In this year's fourth quarter, other expense totaled $1.3 million compared to $0.2 million in the prior year quarter, which excluded $16.6 million charge. The charge is primarily due to JV investments we made in 2017. The larger of those two is currently profitable on an annual basis, but offseason typically incurs a loss.

Diving in a little deeper in the Pet segment for the quarter. Pet sales for the quarter increased 22% or $60 million to $330 million aided by acquisitions, the extra week, and strength in the dog and cat business. Pet organic growth excluded the extra week was over 3%. Pet segment operating income increased $5 million or 22% compared to the prior year, which included $1.8 million intangible impairment. Absent the impairment charge in the prior year quarter operating income increased $3 million or 13%. Pet operating margin on a GAAP basis was flat at 8.3%. Excluding the impairment charge in the prior-year quarter, Pet operating margin declined as a higher gross margin was offset by higher SG&A expenses as a percentage of sales due primarily to the contingent earn out charge related to a recent acquisition, as well as increased warehouse and facilities charges in the Pet distribution business, related to facility transition cost to support a key business model expansion initiative.

Moving on to Garden. For the quarter, Garden segment sales increased 12% or $17 million to $160 million. Excluding the extra week, Garden revenues were up around 4%, all of which was organic. Higher sales of other manufacturers products and increased sales in our fertilizer and controls product category were the largest contributors to the growth. Garden operating income for the quarter declined to $0.2 million and operating margin decreased 170 basis points to 0.2%, despite gross margin being up.

As I mentioned earlier, we increased marketing spend during the quarter in several categories to continue to drive Garden demand in the year ahead. In addition, costs related to the rest of product in the company's décor business was also a factor in the lower operating margin. Keep in mind that the fourth quarter is a seasonally small quarter for our Garden business. So increased expenditures have a magnified effect on margin changes.

Turning to our balance sheet and cash flow statements. For the quarter, cash flow provided by operations was approximately $72 million compared to $62 million in the fourth quarter a year ago. The company's inventory balance rose $20 million from a year ago and primarily reflects the increase from our recent acquisitions. CapEx was unchanged versus the prior year at $8 million. Depreciation and amortization for the quarter of $11 million was also unchanged versus a year ago.

Cash and cash equivalents including short-term investments decreased to $32 million from $93 million a year ago. The decrease reflects more cash spent on acquisitions and investments, and also CapEx in fiscal 2017 versus fiscal 2016. Our total debt was relatively flat year-over-year. We ended the quarter with a leverage ratio of 1.9 times, down from 2.2 times a year ago. During the quarter, we did not repurchase any of our outstanding stock and approximately $35 million remains available under the board approved stock repurchase program.

Now, I'll turn it over back to George.

George C. Roeth

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

Thank you, Niko. As we look ahead to 2018, we continue to be committed to our strategy, which is working. We have a long runway of opportunities and continue to stay focused on growing revenues organically by reinvesting cost savings and using our cash flow and debt capacity to add additional growth through disciplined acquisitions. We currently plan to continue our growth momentum and expect EPS for 2018 to be $1.62 or higher. We expect to continue to be aggressive in the M&A market, our guidance excludes any new M&A we may enter into during the year.

Of course earnings comparisons will be dependent on a number of factors and may exhibit quarter-to-quarter volatility versus the prior year. For instance, Q4 2018 will have one less week than in 2017. Q3 we are comping against significant 2017 Garden growth and in Q1, our expense line reflect the impact of the joint venture in a seasonal business, which while expected to be meaningfully accretive to our second quarter earnings should negatively impact our first quarter results.

Quarterly and annual results will also be impacted by a recent accounting standard that changes the GAAP requirements for the way companies are required to account for some of the impacts related to reporting expense for stock options and restricted stock. We currently believe our tax rate will be lower in 2018 due to the impact of this change. Because future stock price changes and employee exercise activity both influence the impact of this accounting change, we can't precisely estimate what this impact will have on our fiscal 2018 tax rate. This also means our tax rate may fluctuate a bit more quarter-to-quarter than it has in the past. For now we are excluding the possible impact of the new accounting rule and any potential federal tax reform in our guidance, until we have better clarity on the impact of the changes as we move through the fiscal year.

Net-net, we had a terrific year in fiscal 2017 and expect a strong execution of our strategy to continue the momentum for fiscal 2018 overall, albeit with some quarterly bumpiness. We want to thank our investors for their support. I also want to take a moment to thank our employees for all their hard work. We look forward to delivering for you in fiscal 2018 and beyond.

And now we'd like to open the line to your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Frank Camma of Sidoti & Company. Please proceed with your question.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Good afternoon guys. Thanks for taking the call.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

Hi, Frank.

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

Hey, Frank.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Hey George, appreciate the color on you mentioned a couple of things of headwinds for us to consider going into 2018 here. I was wondering about sort of some of the benefits that you might have like, well, first of all, on the earn out, will that go into next year too potentially if they exceed your expectations?

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

This is Niko, Frank. Yeah, the earn out is potentially going into next year and even the year after, but the bulk of it is behind us.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Okay. And then like how about sort of the recent changes that you – I think you've completed on the Pet manufacturing side. Can you give us kind of a flavor of that what we should expect there, and maybe what kind of improvements we might see year-over-year?

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

I guess what I would say there is the investments that we make in capital in the current year generate a return over time, so you would expect our margins to improve from those changes. However, our level of investment won't go down year-over-year because we're going to continue to invest for sustainable growth, and that means spending capital on cost savings and project moneys, and whatnot to continue to drive the cost savings for the next year. So you'll see investment levels stay at their levels currently, a matter of fact our capital spending year-over-year is roughly equivalent, but you also see the benefits from those investments showing up in the P&L over time.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Okay. My other question or area of question was really on the M&A environment. Recently you've looked more towards the Pet side of the business. Is that still your focus or are you seeing things on both side of the business, can you comment on that sort of longer term, how you approach the acquisition side?

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

Yeah. So, we're looking in both Garden and Pet on things to leverage our current capabilities and bolt-on acquisitions. The fact of the matter is there's just more opportunities in the Pet side of the business than in Garden. So we're actively looking at both. Both are in our pipeline, the majority of the targets fit within Pet, and that's just the nature of the industry.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Okay, great. Thanks, guys.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

Thanks, Frank.

Operator: Our next question comes from the line of Bill Chappell of SunTrust. Please proceed with your question.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thanks. Good afternoon.

Nicholas Lahanas
Senior Vice President & Chief Financial Officer-Pet Segment, Central Garden & Pet Co.

A

How's it going? Hey, Bill.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

Hi, Bill.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Going back to the guidance, just want to make sure I understand kind of the comparables. A year ago, George, I think you gave initial guidance, EPS guidance of at least 6% growth, and admittedly you beat that by a lot, but you said at the time that 2017 was a re-investment year, and you could see faster growth after we came out of 2017. And this year we're kind of now looking at, depending on how you look at it with earn outs, and extra week, 6% to 8% growth. So is that reasonable, or are we kind of continuing the investment year into 2018?

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

I guess what I would say is that it was $1.62 or higher which on a non-GAAP basis, I think is 8% growth. So, one could argue our guidance this year is a little bit more aggressive than last year. I would also say that you will see us continue invest over time. So this wasn't a one shot deal where we made investments in 2017, and we get a windfall going forward, that won't continue if you take that step.

So, I would say our guidance is prudent. We're only two months into the fiscal year. There's lot of unknowns, and we have garden seasons ahead of us, competitive reactions in both Garden and Pet. We are going to continue to invest for sustained growth. So I think you're going to see that be the case over time. And I think our guidance is prudent at this point.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

And just a clarification on that, for now for that $1.62 or better, are we assuming similar tax rates as last year?

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

Yes.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. Thanks. And the second question, on the Garden business you obviously had a outstanding year, took some meaningful market share. Do you believe that you can roll off of that base assuming a normal garden season?

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

A

Now, Bill, it's J.D. Walker. I'll take that question. Great question. We had a very strong year in 2017. We're proud of the year that we had. I think we're well positioned to going into 2018. You probably heard me talk before about the controllable causal factors and the uncontrollables, I think where we sit right now, George just mentioned that the lawn and garden season is still in front of us. So it'll be next spring before we fully get a grasp on how the season is going to unfold. But going into the season, things like distribution, promotional support from our key customers, our ability to execute the fall build as we build our inventories for next spring. We feel good about all of the controllables. Things like weather, we can't predict. Things like customer strategies and competitive activity will all be things that we'll react to. You mentioned that we had a strong year, we took share in 2017, and we will spend in 2018 to defend that share. But where we sit right now, we feel good about where we are with a lot of unpredictable things in front us.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

That's great to hear. And then last one from me. Just any kind of commentary on higher freight rates that we're seeing kind of across the country and how that's impacting you?

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

We haven't seen it impact us in a material way as far as across the country. Keep in mind, we do have a fairly sizable proprietary fleet as well. But overall we haven't seen that big of an impact.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay, great. Thanks so much.

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

Thanks, Bill.

Operator: Our next question comes from the line of Brian Nagel of Oppenheimer. Please proceed with your question.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Hi, good afternoon.

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

Hi, Brian.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

Hi, Brian.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Hey, congratulations on a nice year.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

Thank you.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

I have a couple of questions. First off, just I guess more just on the quarter now follow up [indiscernible] (28:02) question, but Niko just to understand better, if we look at, expense growth seemed to pick up here, I know you gave a lot of color in your prepared comments, but how should we think about, is there a way to sort of say bottom-line, how we should think about the expense growth in the fourth quarter, how much of that was one-time in nature versus something indicative of what [indiscernible] (28:22) going forward?

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

Yeah. So Brian, this is Niko. So, I'll try to bridge it for you in a bit of a qualitative sense. If you look at the P&L, top-line obviously was pretty solid. We're very pleased with the gross profit. We've got nice dollar growth, and we've got a nice margin expansion going on. If you look at the SG&A, about half the increase was due from acquisitions, so you've seen that the SG&A increased from acquisitions. Then you've got another 20% to 30% of it as investments in terms of demand creation. So very intentional, most of it being on the Garden side. Garden just came off the quarter of 12% growth. We want to see that continue as best we can, but we do have some tailwinds there, and we want to continue to drive the initiatives in the Garden business. The balance of the increase is really in that delivery warehouse storage bucket, primarily on the Pet side where we're doing some expansion work in Pet distribution around filling out our network to service that large customer we've mentioned earlier.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Okay. That's helpful. And I guess to square that with, George, your comments you've made strategically about continuing to take cost down each and every year. How does what we saw in the fourth quarter then sort of say relate to that, that longer term objective from an expense perspective?

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

I would say, and I don't have the numbers in front of me, but if you just look at the cost of goods, and the gross margin numbers, those are pretty darn good. But investments that we're making to improve our cost of goods profile as well as even in logistics and warehousing area with some of the changes we made in dog and pet will show up in the P&L in those businesses.

Right now we're making other investments for example in warehousing and logistics to expand the Pet distribution at a highly profitable customer and business model. So yeah there is a one-time quarter implication of that. But I do believe you will see over time as we make these cost changes our margins will improve. And if you look at the whole year, and I think you have in our business look at a whole year and not quarters, because we tend to have seasonal businesses. We have a lot of small numbers from time-to-time particularly if you look at particular businesses in quarters that can – you can draw the wrong conclusions. If you look at over a year, you'll see margin expansion across the board and cost savings numbers consistent with our ongoing targets.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Got it. That's really helpful. And then the final question I have just within the Pet side, we continue to, again, see a rumbling and see reports suggesting weakness or dislocation within the Pet superstore business. So I know you've also discussed this in the past, but as you think about that, I guess [indiscernible] (31:23) things that's actually happened or it's not happening, if it is happening, how much of a headwind does that become, 4% and how are you working to offset that?

Rodolfo Spielmann
President-Pet Consumer Products, Central Garden & Pet Co.

A

Hey, Brian. This is Rodolfo. I'll take that. You're right. We are seeing that a headwind – those headwinds in the Pet specialty channel. And we do have a significant presence in that channel. The exposure though has been reduced in the last several quarters, since we have been gaining share in club, grocery, and e-commerce. Okay.

Having said that, we're committed to the channel, to partner with them for long-term growth. And we're working with them in a number of different ways. The same as we're doing with our independent channels, mainly working with them to drive traffic to the stores, by leveraging vibrant and healthy aquatic, small animal, and bird categories. This is something unique for Pet specialty, and what we believe is the basis for long-term growth. And most importantly, I think we're uniquely positioned to help the channel, and the key customers who we're partnering with to return to growth long-term.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

Q

Got it. Thank you very much and congrats on again a nice year.

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

Thanks, Brian.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

Thanks, Brian.

Operator: Our next question comes from the line of Jason Gere of KeyBanc Capital Markets. Please proceed with your question.

Jason M. Gere
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay, thanks. Maybe just some kind of tacking on to the last question, could you actually say what or tell us what the growth was in online versus brick and mortar within Pet in the quarter, and just in terms of the investments that you're making to kind of, I guess kind of fuel the growth on the online business, obviously, big topic within HPC, but I would think that Pet is probably going to be a little bit more of a conversation for you than maybe the Garden business is over time? So that's just the first question.

Rodolfo Spielmann
President-Pet Consumer Products, Central Garden & Pet Co.

A

Perfect. So, hey, this is Rodolfo again, and I'll take that. So what we can tell you is we're growing share in e-commerce, and we're growing share in brick-and-mortar, everywhere, but in one large specialty customer. So if you do math on that, that means that we're well into the double-digit growth in e-commerce. And you're right, e-commerce in Pet is very relevant depending on who you read, at least 10% of the business, in Garden it's significantly smaller.

Jason M. Gere
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. And then just the other question I guess, just broader speaking, George or Niko whoever wants to answer. Just how you look at the category that you're in. Obviously, you guys have been – had a good year taking share, tough environment that's out there, lot of balls in the air, weather disrupters, things of that nature. Just wondering how you're looking at the category over the next couple of years? What are some of the drivers out there? Maybe break it down between growth in Garden versus the growth in Pet, and obviously M&A can play a role. But I just wondering so for us obviously you don't give us a top-line guidance, but last year's number was very good. So just trying to think about how you think about the category, is it expanding or do you think this is just you really kind of continuing to take share, and outplay some of your competitors?

Nicholas Lahanas
Senior Vice President & Chief Financial Officer-Pet Segment, Central Garden & Pet Co.
A

I'll take at a high level. Yeah, we do not give annual guidance, because for a smaller company, seasonal there's a lot of volatility. We do talk about longer term sales goals, and we talk in the range of the 2% to 3% probably in the higher side of that, and that's really built from – Garden, we would expect to grow around the households, so that's roughly around 1% and that's what we're seeing 0% to 1%. We have significantly grown faster than that, because we have done a terrific job of executing building share, and we expect that to continue although getting – growing share by leaps and bounds is challenging over a long period of time, but we would expect to grow share over time.

The Pet side of things, we think that's just a fabulous category. The basic consumer trends around Pet have not changed. People, when they're older, get pets, they're humanizing pets, they're spending more on their pets, particularly in pet supplies where we would benefit from that. Pet category depending on how you define it, grows roughly in the 2% to 4% range, and we would expect to continue to build share in that over time. So, we need a weighted average of that, you come up around 2%, 3% on the higher side of that. And recently it's again even higher than that, because their share numbers have been so good. So, lots of categories that will obviously grow faster over time. Consumer trends are strong. We expect to continue to grow share and don't see that changing in the foreseeable future. Does that help you?

Jason M. Gere
Analyst, KeyBanc Capital Markets, Inc.
Q

Thanks. Great. Yeah, no, no. That's great. And then the last question housekeeping just can you talk about the calendar for this year, other than one less week going back to a 52-week calendar, and that's the fourth quarter, are there any other changes that we should think about as the quarters play out? And then within the extra week that you had in the fourth quarter, can you break out generally between your own sales and sales of other manufacturers like just for modeling purposes how we should think about next year or is it pretty balanced between the two?

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

Jason. It's J.D., I'll take the first part to your question and that is other than the 53rd week, how else should we thinking about the upcoming year. The 53 week year moving from a 53 to 52, it'll flow off the timing of the ending of our quarter by a week. So in some quarters that won't be a material impact. In other quarters where you're shifting a week out of Q2, our Q2 into Q3, it will have a material impact on the quarter. So timing will – of the quarters, and we'll help you understand that as we present in future earnings calls, we'll help you understand the impact on that quarter.

Jason M. Gere
Analyst, KeyBanc Capital Markets, Inc.
Q

Okay. And within that, you're definitely seeing the sensitivity of how shipping can be pushed off between the end of one week and I guess into the next week. So you would expect that there could be some of that as 2018 kind of plays out, a fair assessment?

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

Well, I think we see that every year, right. There's always a little bit of shipment at the end of a quarter that can ship between quarters, but when you lose a week from your spring season and pick up a week at the end of that quarter in the summer, that's difficult to make up that kind of an impact on your season.

Jason M. Gere
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

I would just throw out another thing at 100,000 feet. When you look at our company, listen to how we talk about the year and our annual guidance. The quarterly numbers are volatile, or seasonal, calendar changes, some of the numbers in some of the quarters are quite small. So investment in a quarter with a small expense number can drive a big change in the margin. I just wouldn't get too hung up on the quarters and too hung up on extrapolating quarters, and we'll do as good a job as we can of talking about the year, and how we're thinking about the year and that's really the part you should be listening to, from my perspective.

Steven Zenker
Vice President-Investor Relations & Communications, Central Garden & Pet Co.

A

Jason on the branded versus the third party really, you could take the quarterly number that we put in the press release, and just divide it by 14 weeks and that would give you a rough approximation.

Jason M. Gere
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Great. Thanks, Steve.

Operator: [Operator Instructions] Our next question comes from the line of Jim Chartier of Monness, Crespi, and Hardt. Please proceed with your question.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Hi. Thanks for taking my questions. I just wanted to kind of go back to the SG&A. So I guess first, I don't know if you've mentioned this earlier, but what's the EPS benefit from the extra week in fourth quarter?

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

Around $0.01.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Okay. And how much was the SG&A impact from the extra week?

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

No. I don't think we have that number off the top of our head. I think Steve – Steve's analysis, divided by 14 is probably not a bad way to look at things on a very, very high level, but we don't have it broken that finely.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Okay. And then I just want to talk the Pet facility consolidation and the expansion, is that now complete at the end of fourth quarter, or are there any spillover expenses in the first quarter?

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

That project is complete, matter of fact the leadership team just did a tour of it.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Great. And just looking at kind of the difference in margin performance between Pet and Garden this year where Garden saw a nice 170 basis point expansion or so and then Pet was down year-over-year. How much of the margin degradation in Pet was related to the facility consolidation? And then you've done a number of acquisitions in the Pet segment over the last few years, were there any transition expenses related to those acquisitions, and do you expect to see margins from those acquisitions improve going forward?

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

So it's Niko. Yeah, absolutely. We consolidated the seven facilities into two, and we had a lot of one-time expenses in terms of making that transition happen, so that that definitely impacted our SG&A number. And you're right, whenever you acquire businesses, you go through the purchase accounting, another expense we had was the $2.3 million we called out today as part of the earn out when we bought one of the acquisitions. So, yeah, there's definitely a fair share of one-timers in that SG&A bucket. The other thing to keep in mind too is, what can really contribute to margin is our mix. If you look at – when we look at our business the last few years, we had very strong [indiscernible] (41:47) insect, flea, and tick, and fly seasons the last two years. This year was a little softer. It's still a good year, but it was on the yields of two great years. So – and that's – that's one of our higher-margin businesses, so keep in mind it's going to be mix. We had some transitions this year and then the acquisitions play a role there as well.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Okay. Also on the mix side, with the acquisitions, the branded revenue significantly outpaced the distribution revenue on the Pet side. So I would have expected that would have been a positive contributor to margins this year?

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

Yes.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Okay. And then on the capacity expansion how impactful can that be on the top-line for the Pet segment in 2018, and how much capacity were you constrained or were you outsourcing some of that to someplace else?

Nicholas Lahanas — A
Senior Vice President & Chief Financial Officer-Pet Segment, Central Garden & Pet Co.

Well, we weren't outsourcing, but we were definitely maxed out. And that business has been one of our top performers quite a few years in a row now. And we could see that we were really bumping up against the ceiling as far as the capacity. The other issue too is you've got FISMA regulations out there. And we now have state-of-the-art, beautiful clean facility that will pass all of the rigors of FISMA. So it was capacity. It was regulatory and really it gives us a nice long runway now to continue to grow that business.

George C. Roeth — A
President, Chief Executive Officer & Director, Central Garden & Pet Co.

Were you talking the dog and cat expansion or the Pet distribution expansion just to clarify because Niko [indiscernible] (43:21)

Jim A. Chartier — Q
Analyst, Monness, Crespi, Hardt & Co., Inc.

Dog and cat.

George C. Roeth — A
President, Chief Executive Officer & Director, Central Garden & Pet Co.

Okay. Good then.

Jim A. Chartier — Q
Analyst, Monness, Crespi, Hardt & Co., Inc.

And then just lastly you had a some nice private label wins in Garden in 2017. Do you expect those businesses continue to grow into 2018, and any new private label business on the horizon for next year?

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

This is J.D. I'll take that question. So for 2017, we did see two of our major customers have re-launches of their private label brands that we produce for them, so that was a tailwind for 2017. We expect those customers to continue to support the private label offerings significantly in 2018 and beyond. We're seeing other retailers interested in this space as they seek to differentiate themselves, particularly from the e-retailers. So I would expect that the retailers that are behind private label in a significant way will continue to support it in 2018 and beyond. It's been a nice business for us. It helps us leverage our branded business. It gives us a bigger control of the shelf at retail, and it creates a partnership with the retailer, which we enjoy.

George C. Roeth — A
President, Chief Executive Officer & Director, Central Garden & Pet Co.

Yeah. And I'll speak little more broadly. When you think about the company, we like the private label business. We particularly like it, and we're the low-cost producer, and we have excess capacity, which is true in many instances. It runs about 10% to 15% of our business kind of in the middle of that these days and growing.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Great. Thanks and best of luck next year.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

Thanks.

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

Thank you.

Operator: [Operator Instructions] Our next question comes from the line of Hale Holden of Barclays. Pleased proceed with your question.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Great. Thank you for taking the call. I just had one. Your leverage number now sub 2 times versus stated upper limit of around 4% for M&A. And if I just play the clock forward given your EPS guidance, all things equal you'd be less levered by the end of next year. So you're building a lot of financial capacity and I was wondering if you could just give us a refresh on capital allocation. I did hear your commentary around tuck-ins. But I'd be surprised if tuck-ins in the Pet category were big enough to move the needle or it's possible I guess I'm missing something.

Nicholas Lahanas
Senior Vice President & Chief Financal Officer-Pet Segment, Central Garden & Pet Co.

A

No, we have – you know, at the moment, we have very robust M&A pipeline. What I can tell you as far as capital allocation, right now the returns we're seeing are for the right price, we can realize a very high return on M&A. Alternatively, we have projects in-house that that are high return as well that, that can be either cost savings project or one where we're expanding the business as we did in our dog and cat business. So we have plenty of projects that are returning a very high RRR right now. So, we don't see a dividend in the future. We don't really see a whole lot of stock repurchase in the future. Those are all going to take a backseat to M&A and also internal growth and cost savings projects.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

And I'll just build on what Niko said, our first use of capital is against the core business as Niko pointed out and there's plenty of projects within the company are going to yield high returns. Then we turn to the M&A and the one fun fact I'd like to share, is there are 1,400 pet manufacturers worldwide, not many of them above $100 million in sales, but many in the $50 million to $100 million range, the types that we've been buying. And I would say our target field is quite rich. Our M&A pipeline is deep. We can't control when we make the actual purchases, but we expect to still be aggressive in the marketplace buying.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Thank you very much for the time. I appreciate it.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

A

Thanks.

Operator: There are no further questions over the audio portion of the conference. I would now like to turn the conference back over to Mr. George Roeth for closing remarks.

George C. Roeth
President, Chief Executive Officer & Director, Central Garden & Pet Co.

Yeah I'll just say, thank you everybody for attending the call. Feel great about our fiscal 2017 and looking forward to a wonderful fiscal 2018 as well. So, have a good day.

Operator: This concludes today's conference. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful rest of your day.