07-May-2018

Central Garden & Pet Co. (CENT)

Q2 2018 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
Chief Financal Officer, Central Garden & Pet Co.

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

Howard Machek
Chief Accounting Officer & Senior Vice President, Central Garden & Pet Co.

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

OTHER PARTICIPANTS

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

Brian Nagel
Analyst, Oppenheimer & Co., Inc.

David Westenberg
Analyst, C.L. King & Associates, Inc.

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

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Hale Holden
Analyst, Barclays Capital, Inc.

Bill Baker
Founder & President, GARP Research Corporation

Carla Casella
Analyst, JPMorgan Securities LLC

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to Central Garden & Pet's Second Quarter Fiscal Year 2018 Financial Results Conference Call. My name is Sherry, 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 conference call is being recorded.

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

Steven Zenker

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

Thank you, Sherry. 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 second quarter ended March 31, 2018 is available on our website at www.central.com, and contains the GAAP to non-GAAP reconciliation for the non-GAAP measures discussed on this call.

Before I turn the call over to George, I would like to remind you that statements made during this conference call, which are not historical facts including adjusted EPS guidance for 2018, expectations for new product introductions, future acquisitions and future revenue and profitability as well as the expected impact of the recent tax reform act 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 filed on November 29, 2017. 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, everybody. I'm happy to report that our second quarter was a solid one, and we are very pleased with our growth trajectory; most significantly in the second quarter, we had strong organic revenue growth from both our Garden and Pet segments. Overall, company revenues rose 8% with organic sales up 6%. Our focus on investing behind and executing against our organic growth as the top priority continues to pay dividends.

We have said in the past that we expected our sales and profit growth metrics would be bumpy, and we've seen this play out over the past two quarters. Top line comparisons versus the prior year this quarter were easier than last quarter.

Also, acquisitions are expected to continue to add to our overall growth although the contribution from acquisitions can vary significantly from quarter-to-quarter. A case in point would be our newly acquired Bell Nursery business, which is highly seasonal in nature. So, I guess, when I'm saying is, you shouldn't extrapolate one quarter's growth over the entire year, you would be best served to focus on what we are saying about our view for the full year.

We believe that we had superior organic growth in Q2 because we are clear on our strategies for both our segments and our execution has been strong. Specifically, our Garden Group continued to drive competitive advantage and execute with excellence with our retail partners.

To start the current garden season, we gained distribution including a launch for our new AMDRO Quick Kill Mosquito lines, increased share of our shelf behind existing items both branded and private label and secured the promotion and display support that position Central for share gains when the season hits its stride.

We are sensitive for the fact that POS for the categories running behind a year ago due to poor weather, and we are managing spending accordingly. More significantly, we continue to make progress against our long-term strategic efforts to enhance and leverage our lowest cost producer sales.

For example, in grass seed, we continue to make progress for improving our production efficiencies by bringing more of our seed enhancement process in-house. In short, in Q2, we were pleased with our results against the variables that we control and the sales and profit figures reflect that success.

What we can't control is weather and the timing of the breaking of the garden season across the country. We think strong consumption when the weather is favorable with signals that demands there. We're told by retailers that we continue to outperform the category. So, we're gaining share and are strengthening our competitive advantage and financial position. How POS plays up for the rest of the year will ultimately determine how much of the gain from Q2 we retain.

In the Pet segment, we grew strongly ahead of what we believe our categories are growing. Our organic strength and e-commerce club and mass including our store-within-a-store concept for pet distribution business within the large grocery chain. We have also leveraged our increased capacity in our dog and cat business to introduce new private label chew products and a new line of products for the pet specialty channel, while also growing distribution behind new items for our CADET dog treat brands. Similarly, leveraging the new capabilities on small animal beddings, we continue to expand the Kaytee Clean & Cozy line behind new features and are gaining share.

In our DMC pet bedding business, we tested the new Sealy branded bed line directly with consumers with very positive response, which we'll now span with key customers. We continue to be focused on upgrading our products and innovating behind new items, receiving three innovation awards at the Global Pet Expo, the largest pet show in the U.S.

Finally, M&A in an important part of our growth strategy in financial algorithm. In the quarter, acquisitions added $9 million in revenue including a full quarter of K&H and a small contribution from one of our newest purchase at Bell Nursery.

A few things about Bell. This acquisition brings us into the live garden goods space, an area in which we did not participate before. The category is growing faster than the overall lawn and garden industry and it is a fragmented category where opportunities to grow are plentiful. A leader in the mid-Atlantic region, Bell is known for its quality products and skilled merchandising force. For Central, adding Bell gives us a best-in-class plants and flower grower that complements our garden business. We also plan to leverage the business and its formidable merchandising force to help gain synergies with our existing products in-store.

The other acquisition we announced since our last call is General Pet. This was a strategically important acquisition as it enables Central Pet distribution to obtain a missing piece of its now large national footprint. The Midwest was an area where we didn't have facilities, and this enables us to offer nationwide solutions to our vendor partners, expand the store-within-a-store concept more easily, and even explore the veterinary channel for additional growth opportunities.

We have had a strong relationship with the Merar brothers who've run General Pet for a number of years. They and other senior management will be staying with business. The acquisition closed on April 2, so there's no impact from General Pet in our Q2 financials.

From an operating income perspective for Q2, both the Garden and Pet businesses performed as well or better than expected with Garden driving the growth as compared to the prior year. We expected Pet operating income to be down versus last year, due in part to timing issues and mix. This is consistent with our message that results by quarter could be bumpy and to stay focused on the total year estimates and results.

As we have said in the past, we are looking to sustainably grow the company and drive top line organic growth with an eye towards increasing overall profit. So, while we seek to improve margin over time, we will make tradeoffs to win more market share or support lower margin units to leverage market opportunities. We will also invest in cost savings growth ahead of the benefit even if it means it might result in a lower overall margin for the company or a particular segment for the short-term.

For example, integrating facilities on businesses can lead to an increase in short-term costs. Additionally, it may also be a lag to the expected savings from the initiative due to working through issues like older higher valued inventory, which we saw in our dog and cat business in the quarter. Another specific example of short-term fluctuations was the expansion of our Pet distribution business, where one-time expenses have depressed margins in the near term but are expected to expand over time.

Another specific example is integration of acquisitions. Right now, we are readying plans to invest in moving part of our K&H and DMC businesses to a new facility in the Phoenix area. By doing so, we expect to enjoy lower logistics and operating costs going forward while positioning the business to handle the growth that we expect in the future.

Now to be clear, we fully expect margins to continue to expand over time, when looked at on a full year total company basis. While there are gives and takes, the overall bottom line EPS growth was strong. The company's EPS of $0.86 for the quarter increased 28%, aided by higher volume as well as a lower tax rate due to a change in the federal tax laws and recent changes in accounting standards around non-cash equity compensation expense. As well, the increase in income from the company's joint venture investments. The positive impact of these changes more than offset increase in interest expense. Combined with 6% organic growth, we are pleased overall with the quarter and are on track for the fiscal year.

Now, I'll turn it over to Niko to go over the financials in more detail.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, George. Good afternoon, everyone. We issued our second quarter press release with our financial results earlier today. I'll dive in some of the details and give you some color on what transpired during the quarter.

Central's earnings per share was $0.86 for our second quarter, up 28% from $0.67 over the same period a year ago. Our second quarter sales rose 8% versus the prior year to $613 million with organic growth up 6% being the primary driver, both Garden and Pet had relatively easy top line comparisons versus the prior year.

I should point out that much like the statements we made on our last call when we said first quarter organic sales growth was not indicative of the entire year, neither is the 8% growth of this quarter indicative of what we expect in the second half of the year. Comparisons are a bit more challenging for organic growth going into quarters three and four. Of course, our total revenue growth will benefit in the second half due to the inclusion of our two newest acquisitions, Bell Nursery and General Pet.

Consolidated gross profit rose $11 million and our gross margin decreased 50 basis points to 31.7% impacted by a number of factors, including mix in our Pet segment, timing and higher material and transportation costs.

SG&A expense for the quarter increased 8% or $9 million versus a year ago, and as a percent of sales was flat at 21%. Company operating income for the quarter increased 3% to $66 million. Operating margins declined 50 basis points to 10.7% due to the lower gross margin.

Turning now to the Pet segment. Pet segment sales for the quarter increased 8% or $23 million to $322 million with organic sales rising 6%. The increase was driven by organic growth in a number of different businesses offset to some degree by lower sales in our animal health business. The weakness in this business was principally timing related in part due to unfavorable weather, which impacted our fly and mosquito control businesses.

This mix change had an unfavorable impact on Pet's operating income and margins, as these higher margin areas had less volumes to offset fixed costs and the mix of business during the quarter shifted more towards wild bird feed, aquatics and the sales of other manufacturers' products. These areas typically carry lower margins than our animal health business.

So, in total, Pet segment operating income for the quarter decreased by $2 million or 5% compared to the prior year to $33 million. Pet operating margin decreased 140 basis points to 10.2%. In addition to the mix issues and lower volumes in the animal health business, expenses related to our continued rollout of our Pet store-within-a-store concept and one large customer, as well as higher material and transportation costs were also dragged on margin.

Turning now to Garden. For the quarter, Garden segment sales increased 7% or $20 million to $291 million with organic growth of 6% and was driven by the strong sell into the season that George mentioned earlier. Most major Garden categories experienced growth with several up double digits.

Garden's operating income rose to $51 million from $46 million in the second quarter of last year and operating margin increased 50 basis points to 17.4% in large part from cost reduction initiatives, which more than offset higher raw material costs. Mix was a positive factor for Garden margin, as the company sold a higher percentage of products and produce versus sales of other manufacturers' products compared to a year ago.

One other thing to mention is that Bell had a negative impact on operating profit and margin for the second quarter. But it's expected to have a meaningful positive impact on Garden's third quarter revenue and profitability.

Moving back to our consolidated results; in the second quarter, we had other income of $2 million (sic) [$1.5 million] (00:13:44) compared to expense of $1 million a year ago. The change is principally due to the seasonal nature of our largest investment, which typically has its highest earnings in our second fiscal quarter. As of the end of fiscal Q2, we lapped the date that we acquired a stake in this company.

Net interest expense increased $3 million to $10 million, primarily due to incremental interest expense on our new notes that we issued in December of 2007. Our tax rate for the quarter was 20.3% as compared to 37.1% in the second quarter a year ago. The decrease includes a reduction in the federal tax rate and the favorable impact from the changes in a recent accounting standard around non-cash equity compensation expense. The impact of the latter is likely to vary quarter-to-quarter, depending on among other things the market price of our stock and employee option exercise activity.

Turning to our balance sheet and cash flow statement. Cash at the end of the second quarter was $132 million, up from $6 million at the end of the second quarter last year. The increase reflects the inclusion of the proceeds of the debt offering we closed in December of last year, partially offset by our Bell Nursery acquisition at the end of the quarter. Keep in mind that seasonally this is typically the peak of cash needs for inventory buildup for the garden season.

Total debt was $691 million versus $496 million last year, up due to the December of 2017 debt offering. Our leverage ratio at the end of the quarter was 3.2 times compared to 2.5 times a year ago, well within our target range. We also had $354 million of availability on our credit line at the end of the quarter.

For the quarter, cash flow used by operations was $70 million, down from $83 million in the second quarter a year ago. CapEx was $9 million versus $14 million in the second quarter of 2017. The decrease is really timing versus a year ago, and we expect CapEx activity to pick up in the second half of the year and is expected to total $40 million to $45 million for the year.

Depreciation and amortization for the quarter was $11 million, up from $10 million a year ago, primarily due to recent acquisitions. During the quarter, we did not repurchase any of our outstanding stocks and approximately $35 million remains available under the board approved stock repurchase program.

Now, while we can't control weather, we can't control how we execute our plan to grow revenues and market share over time. We feel good about the successes we've achieved in getting on shelf and our plans from other products to drive consumer takeaway. As POS, hopefully, catches up in the coming weeks, we remain confident on our ability to continue to drive sustainable growth across the entire company.

And now, let's open the line to questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, we'll be conducting a question-and-answer session. [Operator Instructions] Our first question is from Bill Chappell with SunTrust Robinson Humphrey. Please proceed.

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

Q

Thanks. Good afternoon.

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

A

Hi, Bill.

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

A

Hey, Bill.

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

A

Hi, Bill.

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

Q

Hey. A couple questions. Just trying to understand the guidance and how weather plays into that. And just had the weather been normal, would the numbers be even higher or in terms of looking at the guidance, are you assuming that it comes back in as a normal season in terms of the outlook for the rest of the year? Just trying to understand kind of how much – because it certainly was an unusual past three months for what we've seen from Scotts and from Spectrum and others and just trying to understand, what impact it did actually have on your numbers?

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

A

Yeah. Bill, I'm not going to break it down by pieces. I'll speak in generality. So, we manage for rest across the number of variables, the garden season being one part of it. So, as we think about our guidance, we think about scenarios on what could go right and what could go wrong. As you know, we tend to be conservative. And I would say that's one factor that we consider among a number of factors.

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

Q

Okay. So, but there could be further upside if it normalizes, I guess, over the next month, month-and-a-half?

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

A

Yeah, I'm not going to jump in on that. Sorry.

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

Okay. Switching to the other products on the Pet side, should we look at this quarter as kind of a full realization of the grocery train initiatives in terms of being the category manager there, and is that a nice run rate going forward or is there still more to come and as we kind of get to the full ramp in the fiscal third quarter.

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

Yeah. Hey, Bill. This is Rodolfo. I'll take that one. We still have at least three quarters to go on that one. While we're finalizing the work to integrate that that customer with a store-within-a-store concept, then we need to lapse that growth year-over-year. So, you will see us mentioning that for at least three more quarters.

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

Okay. Great. And then, last one for me. Just in terms of, you talked about CapEx being more back-end loaded. Did we see meaningful benefits from some of the CapEx last year in terms of margins? Or is that also kind of some of the synergy margin improvement from last year and [ph] you force (00:20:15) acquisition is that still to come? I guess, in particular, I thought this is the year we should see some pretty meaningful synergies out of Segrest? I don't know if we – it's tough to tell whether we saw that this quarter, whether that's still to come?

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

Segrest speaks to acquisitions, I thought you're asking about CapEx, but if I'm thinking about CapEx – well, let me just stick to CapEx for a second. If you look at fiscal year-to-date our margins are up. We believe our low-cost producer activities are generating benefits. Some of those low-cost producer activities, as I said some of the benefits are delay as we work through older inventory for example. So, it's going to be bumpy, but we would expect margins expand over time driven by our low-cost producer activities.

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

The other thing the CapEx allowed us to do was increase capacity. So, a lot of the growth we're having right now in dog and cat is due to the CapEx and the ability to take on more volume.

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

Got it. But, and again you said CapEx should be still up this year versus last year?

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

Yeah. Yeah, it's going to be in that $40 million to $45 million range, and I think last year we were about $45 million so.

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

Flattish again.

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

Last one for me. You might have said this, but effective tax rate for the full year now?

Howard Machek
Chief Accounting Officer & Senior Vice President, Central Garden & Pet Co.
A

This is Howard. The effective tax rate that we're expecting is about 27% before we start doing the discrete items. Remember that we have the revaluation of our preferreds and we have the impact of the adoption of the stock compensation. So, with those probably all in, we're looking at something closer to 11% probably in that range.

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

Got it. Got it. All right. Thanks so much.

Operator: Our next question is from Brian Nagel with Oppenheimer. Please proceed.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.
Q

Hi. Good afternoon. Thanks for taking my question.

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

Hi.

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

Hi, Brian.

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

Hi, Brian.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.
Q

So, the first question I had, maybe just further clarification on the gross margin in the Pet category in the quarter. You discussed this in prepared comments, but my question there is, if we look at that decline, which has been rare on any historical analysis of your numbers, how much of that was one-time in nature isolated to the current quarter versus what we should expect to see maybe in coming quarters?

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

Hi, Brian. This is Rodolfo. We expect that the margin in Pet to be down year-over-year on this quarter. And in fact, we did a bit better than our plan. As George mentioned before, this is absolutely not indicative of the year. By far the largest driver for us was mix among the units and not margin.

Let me give you a few clear examples on that. Pet distribution, which is a normal distribution business will carry lower margins than our third line, delivered strong growth behind the store-within-a-store concept we mentioned in the last call and while very accretive to Pet distribution, it does affect mix negatively in the whole business.

We also mentioned our animal health business that got affected by the late arrival of the summer affecting the mosquito and also the timing of the flea and tick season. We also mentioned about our timing issue with equine, which creates absolutely no challenge for the year. So, all-in-all, as we mentioned, vast majority was mix and it was expected.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.
Q

Got it. And that's helpful. Thanks.

Operator: Our next question – oh, you have another one? Go ahead.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.
Q

I was going to slip my thought, I didn't want to interrupt there. My second question I had just with regard to the savings from the now lower tax rate, how should we think about what Central's doing with that savings versus redistribution flowing to bottom line, potential share buybacks that type of thing?

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

Well, the way we're thinking about deploying our capital is first and foremost against our core business to drive organic growth and then M&A, and we think those are the ways we're going to spend the capital going forward. So, I wouldn't be looking for any share buybacks in the near-term.

Number two, the way I would think about how we're going to invest our money is, we are looking and spending against the core business, opportunities to do that versus necessarily taking all the bottom line. We often may invest back in our employees. Those are two areas that we're looking hard and fast at, and we have set aside money to invest back in the business and our people as part of our forecast going forward.

Brian Nagel
Analyst, Oppenheimer & Co., Inc.
Q

Got it. Thank you.

Operator: Our next question is from David Westenberg with C.L. King & Associates. Please proceed.

David Westenberg
Analyst, C.L. King & Associates, Inc.
Q

Hi. Thanks for taking the question. So, Amazon announced they're doing store-branded dog food. And I know dog food is a small portion of your business, but can you talk about the potential impact across the online channel of Amazon doing this? And then can you talk about some of the relationships that you have with online retailers generally in pet products maybe outside of pet food?

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

Okay. So, this is Rodolfo, again, taking that one. We won't comment specific on any customer, and as you mentioned, pet food is pretty small for us. Having said that, now taking the more relevant question about the shift to e-commerce, and how is that impacting the business. We want to be where the consumer want choose us to make the purchase, and we are absolutely agnostic on which channel that is. We have started to invest in e-commerce over a year ago and our growth is very strong and ahead of the categories in which we compete.

Having said that, we're still supporting and this is the important piece on us. We support all the channels where the consumers choose to buy. That means, we're growing in club, we're growing in mass, we're growing in e-commerce and we are supporting the pet specialty customers who love to start driving growth, sorry, if the traffic there to the stores. So, all in all, as I said, we will follow the consumer wherever they go and we're ready for that.

David Westenberg
Analyst, C.L. King & Associates, Inc.
Q

Got it. Well then, can I may ask maybe a follow-up to that then. Can you talk about just on the online channel, if you see more opportunity in the near-term in branded or on the distributed products side?

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

Yeah. We believe in both to be very honest. So, we're seeing strong growth in our branded business across all the categories where we compete. And same as in brick-and-mortar, growth in private label does not mean that the growth in the branded will diminish. So, we actually seem close to growth cap and we are planning to participate in both.

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

Yeah, and I'll just kind of speak for the whole company. If you think about private label, we like to continue private label where we have a low cost producer and with excess capacity. Consumer purchase behavior is a tailwind for private label, that's clearly not the major leader in most categories, but it is growing faster than branded business, and we're going to participate there.

David Westenberg
Analyst, C.L. King & Associates, Inc.
Q

Got it. Thank you. And then, can you talk about what you're seeing in terms of acquisition multiples across the space? I'm actually thinking more on the Pet side. And just with the two acquisitions in the quarter, I know they were huge in terms of the amount you borrowed, but does it impact kind of what you're looking at on the acquisition side? Thank you.

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

So, as far as acquisitions, I mean, we're looking across both segments. We still love both segments, both Pet and Garden. Bell obviously being in the Garden segment. What you'll see is, there's just more fragmentation over on the Pet side. So, you've got more companies, more buyers, more sellers, so there's more activity there. It has a little better tailwind, but the Garden side is still very attractive to us, in particular, if you look at how well our

Garden business is executing, the management team there is top notch and we want to support and augment that. So, we like both segments.

Multiples as far as they go, they continue to be all over the map. It all depends on what type of situation you're in, whether it's in auction, whether you have an exclusivity there, small, large, depends on the size, the growth, the margin profile. So, they're all over the map. We continue to be value buyers of growth businesses. I mean, if I were to characterize us, we are value buyers of growth businesses.

David Westenberg
Analyst, C.L. King & Associates, Inc.
Q

Got it. Thanks. And congrats on a good quarter.

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

Thank you.

Operator: Our next question is from Jim Chartier with Monness, Crespi & Hardt. Please proceed.

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

Hi, Jim.

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

Hi. Thanks for taking my questions. Of course, I was wondering if you could give us some ballpark size for the Bell Nursery acquisition and then the General Pet distributor as well in terms of revenues.

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

Well, I can tell you what we paid for Bell, which we've disclosed is that $62 million. We have not given out the size of the business on General Pet or Bell, nor do we typically for our standalone businesses. I will tell you they're in the sweet spot of the $50 million to $100 million range that we've typically been buying.

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

Great, thanks. And then any acquisition, one-time-ish acquisition costs in second quarter that we should be aware of related to those deals?

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

Yes, there were. There were some one-timers with respect to Bell. There's always one-time costs around legal and travel and things like that, but there was a fee involved with Bell.

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

Okay. And then on the K&H, DMC transition to Phoenix. When does that project start, and then how big is that project than relative to the consolidation that you did in New Jersey?

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

A

The Phoenix has already started with K&H. We always find the leases in Phoenix, so we're moving and preparing the facilities. In size wise, the business is smaller than dog and cat. So, obviously, the players will be smaller than this dog and cat one. And how long will it take? We're starting with K&H then following with DMC. I would assume that this is right between three and four quarters of the year.

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

Q

Okay. And then on the New Jersey consolidation, have you started to see leverage and improving margins from that consolidation?

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

A

I'd say couple things in that front. First and foremost, we now have the capacity to produce the demand and chase new business, and you're seeing that business go quite nicely. We are seeing improvements in what I would call apples-to-apples making the same item with lower operating costs, however as I noted in my introductory comments in some cases, we're working through old inventory and you're not seeing that flow through complete with the P&L yet.

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

Q

Will we start to see the lower cost inventories next quarter?

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

A

I have to go back and check on that. So, I would say soon, I can't give you the precise date.

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

Q

Okay. And then in the press release, it said the part of the lower Pet margin was related to your higher costs in anticipation of higher volumes for the store and store rollout for pet distribution. So, kind of relating back to the earlier question, should we see that business ramp even more and so the distribution sales for Pet should actually accelerate over the next couple of quarters as that is rolled out to more and more stores?

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

A

I think we had also said that the rollout will continue over the next three quarters. And as we speak and we have already said some of that, but we continue to put in the facilities in place to make sure that that's possible.

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

Q

Great. Thanks, and best of luck.

Operator: Our next question is from William Reuter, Bank of America Merrill Lynch. Please proceed.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Hi. I hopped on a little late, so I hope I didn't miss this. But previously you'd been talking about trying to reduce costs by about 2% annually. I guess, in light of what we've been seeing with inflation of raw materials and freight, can you talk about where we are, and I assume we're probably going to see a headwind this year. What type of headwind we might see for those items?

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

A

So, the way I would say is, we do target 1% to 2% from really more like 2% of controllable cost reductions, I would say we're on track to do that. When we talk about cost reductions, we talk about it in three buckets. One bucket is to avoid pricing that our competition is not going to take. Second bucket is to invest in growth on the business. And the third bucket is to make sure we're improving our margins and our margins are growing over time.

Obviously with headwinds, that makes that more challenging, as a lot more of the cost savings need to go against making sure that you're covering your commodity costs and think the garden group benefited from their low cost producer efforts and hence we're able to still grow margins in the quarter. Obviously, Pet had some mix challenges and also had some cost changes as well. I would say that we're probably going to have to take some pricing and actually have taken some pricing in some selected cases and cannot rely strictly on cost savings. So, make sure there are margins stand over time.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

I guess, the cost savings that you expect to take are those which you were just referring to. Will they be enough to offset the input cost increases that you've been seeing over the last period of time?

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

A

As I said, if we want to do three things expand our margins, invest in growing our businesses and not take all the pricing that we potentially would have to take, the cost savings – we have our cost savings we have now, but this year we probably are going to have to take pricing down on top of the cost savings in order to meet that goal. And we've already taken some pricing and are in the process of taking additional pricing.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Okay. And then in terms of your customers, can you talk about what you're seeing in terms of the growth of e-commerce versus brick-and-mortar?

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

A

I was just saying general e-commerce is growing faster than brick-and-mortar, particularly if you look at the Pet side of business, the Pet Specialty channels have been declining and their declines have accelerated versus prior year, although are kind of stabilizing at a rate of decline now. The e-commerce is very clearly growing faster on both the Garden and Pet side, although on the Garden business e-commerce is fairly de minimis at this point in time.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Okay. And then just lastly, if I missed this I apologize, but did you – obviously your Garden sales were pretty strong particularly given the late start to the season. Did you give an estimation of what the dollar amount of sales that may have been pushed back to later in the season or any sort of a weather quantification?

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

A

William, this is J.D. I'll speak to that. First of all, great question because it's Garden-related and I finally get a chance to speak. So, the season has been delayed. Typically, Q3 and Q4 would represent about 60% of our consumption, our POS for the year. This year I expect that number to grow because it has been a delayed season. I think that's been widely reported, but from the middle of March through the end of April, that six-week period, the weather was just not conducive. It was unfavorable weather across all markets, every retailer's reported that to us as well as other people in our same space that have reported publicly.

We experienced the same thing. The good thing is that we've seen – is over the last couple of weeks, we've seen an uptick and consumption has picked up significantly. So, we feel much better. A few weeks ago, we would have been probably a little more concerned. We're much more cautiously optimistic right now about the rest of the year.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Perfect. I'll pass to others. Thank you.

Operator: [Operator Instructions] Our next question is from Hale Holden with Barclays. Please proceed.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Thank you for taking the call. I just had two questions. As a lateral to Bill's question on garden season pickup, we've seen some of the mass channels move seasonal assortments faster than they would have in the past if the sales aren't there. Is there any risk that the Garden season gets truncated by some of your customers or is this just sort of an extension out in time?

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

A

From what we're hearing from the trade right now, and it's a concern of ours as well, we want to make sure that they're staying in the game. What they're telling us, they are committed to staying in the game, particularly the big box stores. So, we haven't seen any knee jerk reaction to the slow start, and I believe all of them have expressed confidence that the season is still in front of us. So, if weather remains conducive, meaning, if it doesn't get too hot too quickly in the summer months, we could have an extended season.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Got it. And then, in the opening scripts, you alluded to a new private label push in Pet Specialty. I was wondering if you'd just give us a little bit more color on what that was or a sense of the size or even what the product was?

Yeah, I can't. That's confidential information on what customer we're working with and specific items. I'll just say, we're as interested in private label on the Pet side as we are on the Garden side. We have reasonable sized businesses on both sides of the shop. And again, we're a low cost producer and we have excess capacity and our customers are working with us. We continue to make private label items on both sides.

Hale Holden
Analyst, Barclays Capital, Inc.
Q

Okay. Thank you very much.

Operator: Our next question is from Bill Baker with GARP Research. Please proceed.

Bill Baker
Founder & President, GARP Research Corporation
Q

Hi. Thanks. I have one small question and one bigger question. I guess the bigger question is, it was interesting to hear you talk about how weather had affected the mosquito and tick business downwards, and I'm aware that the tick business is more of a Mid-Atlantic, Northeastern sort of thing. And so, then when you sort of jump over to the Garden side, you do sell a lot of grass seed and that sort of stuff in that region and it performed relatively well. And I'm wondering, so just maybe I'll just throw in a last sort of thought just this last weekend, I decided I was going to go out and buy a couple of 40-pound bags of your patch product and I went to Walmart and they're sold out. There's nothing there. I go to Lowe's and there are stacks and stacks of Scotts as there was at Walmart and there's an empty bin for you guys with one broken bag that I got a 50% discount on and somebody had thrown a Scotts seed bag in there.

And I'm thinking either you have an incompetent manager in the Mid-Atlantic area or you can't sell in enough to meet demand and you're gaining market share. Or maybe it just doesn't signify anything at all. Maybe it's just some sort of regional discrepancy is – how am I to think about that Garden business? And you talked about point of sale and maybe how the next quarter could be better. I didn't see any point of sale displays, at any of those stores. I'd like to know kind of like how – it looks to me like you're probably getting a lot of demand but you're having trouble satisfying it at least in my region.

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

So, Bill, you gave me a lot of material to work with.

Bill Baker
Founder & President, GARP Research Corporation
Q

I'm sorry. I went on and on.

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

No. No. No. It's okay. It's all right.

Bill Baker
Founder & President, GARP Research Corporation

Q

Very anecdotal, very anecdotal and little localized stuff that probably doesn't reflect the national situation.

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

A

Well, thank you for first of all being a consumer of our products. We think – we appreciate that. I'd say that what you're experiencing in a more rapid sell-through of one brand than another is what we're seeing in the market share as well, that's indicative of market share. Off shelf locations is disappointing to me because I'd like to think that I know that coming into this year we had our strongest support ever in terms of promotions and off-shelf display support from our key retailers. But we are seeing high demand, there's no doubt about it. On any given weekend and there's pent up demand. So, when you have a period of time when the weather has been before as we've had and then the weather breaks in markets, you're going to have incredible pent up demand that's what we've seen and it's difficult to have enough holding power in any one store to satisfy all customers.

Having said that, we're constantly working with the retailers to gain additional locations, but rapid sell-through is going to show through in their computer reports, which will lead to replenishment orders for us, more secondary locations for us. But I think what you're seeing on a very limited basis is what we're seeing across the country not sell through, complete sell through of inventory, but rapid sell through of our products.

Bill Baker
Founder & President, GARP Research Corporation

Q

Yeah. I concluded it was a positive, but I'd like to see closer ties to the stores and then point of sale and all that. So, but it looked very positive and it looks good to me for 3Q. So, Yeah.

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

A

I was just going to add to that, when you have just across some of the bigger box of stores, thousands of stores I would think that that's not indicative of the – it does not pervasive across the entire chain.

Bill Baker
Founder & President, GARP Research Corporation

Q

Yeah. I agree.

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

A

Yeah. Okay.

Bill Baker
Founder & President, GARP Research Corporation

Q

I agree. I visited other stores in the past and they look completely different from my local area. The minor question then if I can just follow up, the Garden distribution business was down. Do you have any comments about that?

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

A

Yes. Some of that is timing. The Garden distribution business for us over the last few years has grown very rapidly. We knew we had a pretty strong comp against the Garden distribution business from the same quarter prior year. It was all slightly. I expect this next quarter to close ground on that. So, Garden distribution without facing our branded business, we're pleased with really the mix right now with our branded business strengthening and the Garden distribution business kind of leveling off of it.

Bill Baker
Founder & President, GARP Research Corporation
Q

Okay. Great. Well, thanks for your answers.

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

Thanks. Appreciate it.

Operator: [Operator Instructions] Our next question is from Carla Casella with JPMorgan. Please proceed. Hi, Carla. Your line is live. Would you like to ask a question? Please check and see if your phone is muted?

Carla Casella
Analyst, JPMorgan Securities LLC
Q

Hi. Can you hear me now?

Operator: Yes, we can.

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

Yeah, we can.

Carla Casella
Analyst, JPMorgan Securities LLC
Q

Okay. Sorry about that. The rollout that you're doing with one major retailer on the pet side, did you say where you are in the process, at what phase and how long that would be until you're fully rolled out?

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

So, the way it worked, we have been working with this retailer for several years. So, we had our percentage of the stores. And then with garden we'll go region by region taking more stores over. In Q3, we'll finish most of the big regions then it will be pretty minor. So, as you can see this going forward, you'll have again another bigger effect in Q3 and that this is wraparound effect in the rest of the year.

Carla Casella
Analyst, JPMorgan Securities LLC
Q

Okay, great. And then on the Pet specialty side, what percentage of your total pet sales is going into that Pet Specialty channel now and how do you see that transitioning over time?

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

A

We don't give the percentages by channels. What I can tell you is that our exposure is significantly lower today than where it was two years ago mainly because of our strong growth in the club, mass and e-commerce business. Having said that, we still believe specialty will be critical for the health of our categories. And we have shown with our positions and our innovation how committed we are to continue driving this channel.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

Okay, great. Thank you.

Operator: We have reached the end of our question-and-answer session. I would like to turn the conference back over to George for closing remarks.

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

I just want to thank everybody for attending the call. And have a great day.

Operator: Thank you. This concludes today's conference. You may disconnect your lines at this time. And thank you for your participation.