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Central Garden & Pet Co. (CENT)

Q4 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Central Garden & Pet's Fourth Quarter and Fiscal Year 2019 Financial Results Conference Call. My name is Devin 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 is being recorded.

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

Steven Zenker
Vice President of Investor Relations, FP&A and Communications, Central Garden & Pet Co.

Thank you, Devin. Good afternoon, everyone. Thank you for joining us. With me on the call today are Tim Cofer; Central's new Chief Executive Officer; Niko Lahanas, our Chief Financial Officer; Howard Machek, our SVP-Finance and Chief Accounting Officer; J.D. Walker, our President, Garden Branded Business; and John Hanson, our President, Pet Consumer Products.

A press release providing results for our fourth quarter ended September 28, 2019 is available on our website at www.central.com. Also on the website is the GAAP to non-GAAP reconciliation for any non-GAAP measures discussed on this call.

Before I turn the call over to Tim, I would like to remind you that statements made during this conference call which are not historical facts, including EPS and other guidance for 2020, expectations for new capital investments and product introductions, future acquisitions, and improved revenue and profitability are forward-looking statements subject to risks and uncertainties that could cause the actual results to differ materially from those implied by forward-looking statements.

These risks and others is described in Central's Securities and Exchange Commission filings, including our Annual Report on Form 10-K filed today. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events or otherwise.

Now I'll turn the call over to our new CEO, Tim Cofer. Tim?

Timothy P. Cofer

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

Thanks, Steve and good afternoon. It's a pleasure to be here with all of you today on my first earnings call as the new CEO of Central Garden & Pet. Given that I'm only a few weeks into my tenure here at Central, I'm going to defer to our CFO, Niko Lahanas, to review the results for the quarter and the year. But before turning it over to Niko, I'd like to say a few words about why I came to Central and my initial observations about the opportunities on how we can unlock our company's potential.

I've spent the first six weeks immersing myself in all things Central, our business, our brands, our customers, and our employees. I had embraced an aggressive onboarding agenda, traveling coast to coast conducting in-depth business reviews, touring many of our facilities, meeting key customers and listening to a great deal of feedback from my Central colleagues. As a result of these engagements, I've developed a keen appreciation and respect for what Central has built, and an even greater enthusiasm for our potential moving forward.

In my 30 years of consumer products experience, I've had the privilege to lead many different businesses here in the United States and across the globe. In my most recent role as Chief Growth Officer of Mondelēz International, I led all consumer and customer facing functions, including corporate and M&A strategy, insights and analytics, marketing, sales, e-commerce, research and development, quality, and innovation. In partnership with the Chairman and CEO of Mondelēz, I led the development and execution of the company's growth strategy, which resulted in accelerated top line growth, with continued margin expansion.

My other general management experience includes P&L President roles at Oscar Mayer Foods, Kraft Pizza Company, Kraft Foods Europe, and Mondelēz Asia-Pacific, Middle East, Africa. Although these previous efforts were not in the Garden or Pet industries, I already see many commonalities with Central's customers and consumers.

As I joined Central, I'm impressed by its many strengths. Central is a leader in both Garden and Pet industries with a robust portfolio of strong brands, private label offerings and distribution businesses. 2020 marks 40 years since our Chairman, Bill Brown, founded Central, and it's clear to me that our growth through acquisition model has created value for our shareholders and meaningful scale advantages for our company.

Today, Central has a broad route to market, unique distribution capabilities, a strong reputation for quality products and superior customer service and an efficient supply chain. And I can say that since coming here, I've been very impressed with our entrepreneurial culture, our talented employees and our empowered business unit structure. All of these strengths gives Central a good foundation for the future. Looking ahead, I'm already seeing ways we can improve the business and better capitalize on our opportunities.

I've only been here for six weeks, but here is my early read. First, we need to better balance consumer and customer. We need to strengthen our consumer muscle through marketing, branding and innovation. Next, while we've made good progress over the last several years engaging the presence online, it's clear that we need to invest even more aggressively in expanding our digital agenda and strengthening our e-commerce capabilities. Third, in addition to organic growth, M&A remains a compelling opportunity to expand our scale and strength in both core and adjacent categories. Given Central's strong balance sheet, we're in a good position to evaluate and pursue value-accretive and cash-generative acquisitions in businesses that are additive to our overall platform.

And finally, I believe we can improve the consistency of our executional excellence at Central by enhancing discipline, monitoring the right KPIs, and ensuring our incentives are driving the right behavior. In partnership with our board and our leadership team, I plan to flesh out my initial perspectives, informed by further conversations with all of Central's stakeholders over the next several months.

What I can say is that I anticipate 2020 will involve significant investment in growth drivers and capital expenditures in order to take Central to the next level and position our platform to grow sustainably in the years ahead. Sometime in the spring, I will share with you an update on our long-term strategy and the implications for 2020 and beyond.

In closing, I want to reiterate my excitement about joining Central and my confidence in the value of the platform and our ability to unlock its full potential. I am and all of us at Central are committed to working to drive real value for our shareholders.

With that, I'll now turn it over to Niko, who will give you a more detailed view on our 2019 results.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, Tim, and good afternoon everyone. Our press release for our fourth quarter and fiscal year financial results was issued earlier today. For fiscal year 2019, sales increased 7.6%, due in large part to acquisitions. Bell Nursery and General Pet were part of our first and second quarter results, and while their inclusion added sales, they did reduce margins and overall profitability. In fiscal 2019, we purchased Arden in our second fiscal quarter and it aided both sales and profits. Finally, we closed on C&S in our third fiscal quarter and that was a small sales and profit contributor for the year.

Our overall organic growth of 1.5% was attributable to our Garden segment which grew 4% organically despite unfavorable weather for the control category. Organic growth for the Pet segment was relatively flat, held back meaningfully by our animal health businesses which were impacted by very unfavorable weather for our fly control, cattle feed additives, and grain protection products. In addition, continuing weakness in our consumer behavior management products due to performance issues and increased competition was also a drag on Pet's results.

Our total company gross margin of 29.5% for the year declined 100 basis points. Half of that decline is attributable to acquisitions that were in this year's results, but not in last year's results. The largest impact was from the inclusion of two quarters of Bell Nursery this year that were not in last year's results. Those quarters for Bell had sizable losses, as the business earns all of its profit in one quarter, our third fiscal quarter. The lower results in our animal health businesses and an unfavorable mix of product sales also contributed to the gross margin decline. Our animal health businesses tend to have higher margins, and so when they underperform, they have a disproportionately large impact on the bottom line.

Operating income for the year declined 9.1% or $15.2 million and our operating margin declined 120 basis points, meaningfully impacted by the lower gross margin and higher logistics costs. Lower marketing expenses as a percent of sales offset some of the declines, as we chose to scale back spending in unfavorable weather environment.

EBITDA for the year, excluding the two last quarters for Bell in fiscal 2019 results that were not in the prior year's results declined 2% to $210.2 million. This year also contains certain non-operating factors that weighed on EPS, which came in at $1.61 for the year. A higher number of shares outstanding negatively impacted EPS by $0.13 and a higher tax rate reduced EPS by an additional $0.06 compared to last year. If we combine these factors with the dilutive effect of Bell in the first two quarters, the three factors together eroded EPS by the entire $0.30 shortfall compared to last year.

In summary, while certainly not the type of year we were hoping for when we began 2019, I continue to feel confident about the fundamentals of the underlying business. Our tax rate for the year of 22.3% was higher than the 19.5% rate a year ago, even after adjusting out the benefit received last year due to reevaluation of our net deferred tax liabilities. Changes in the accounting standards around non-cash equity compensation which benefited last year's tax rate had less of a positive effect on this year's tax rate. I'd also want to point out that our operating cash flow for the year of $205 million was an increase of $91 million from $114 million in the prior year.

Turning now to the quarter, fourth quarter consolidated sales increased 8% to $541 million, with organic sales rising 5%. Both Garden and Pet contributed to the organic increase. Consolidated gross profit for the quarter rose 1% and our gross margin decreased 180 basis points to 27.5%. Higher expenses relating to writing off inventory in our Pet segment and a mix shift in Garden were the primary drivers of the decline.

SG&A expense for the quarter increased 7% or $9 million versus a year ago and as a percent of sales decreased by 10 basis points to 25.5%. Operating income for the quarter declined to $11 million compared to $18 million a year ago. Our operating margin decreased 160 basis points to 2%, due to the receivables and inventory write-offs, as well as the CEO transition costs. Absent those expenses, operating income and margin were up versus the year ago.

Net interest expense decreased to $8.1 million from $8.9 million in the fourth quarter of last year. Other expense for the fourth quarter decreased $4.2 million compared to the prior year, due to our purchase of the remaining part of Arden, which is now reflected in the Garden operating results.

Our tax rate for the quarter of 22.8% was up over the prior-year quarter, which benefited from a gain from the revaluation of our deferred tax accounts and changes in the accounting standards around non-cash equity compensation expense. The latter had a smaller positive effect on this year's tax rate.

Our net income for the quarter was $2.4 million and our diluted earnings per share was $0.04 compared to $0.10 in the fourth quarter of 2018, after adjusting for the benefit of the revaluation of the deferred tax accounts. Shares outstanding increased to 56.6 million from 55.4 million in last year's fourth quarter.

Now I'll give some insights on the segments starting with Pet. Pet sales for the fourth quarter increased 5% or $17 million to $356 million, aided by our C&S acquisition. On an organic basis, sales increased 2% on strength in the dog and cat and wild bird businesses.

Our live fish business was down due to a large customer exiting the category and our aquatics business also declined due to temporary supply constraints which have been largely resolved. The Pet segment's operating income decreased $1 million or 4% compared to the prior-year quarter, with results in the animal health and pet bedding business with lower – excuse me, lower results in the animal health and pet bedding businesses, in large part due to receivables and inventory write-offs.

Pet operating margin declined 80 basis points to 8.7% due primarily to that lower profitability in our animal health and pet bedding businesses. I do want to point out that while we are projecting improvement in our animal health businesses in 2020, we are taking a more pragmatic approach to the rate of the improvement that we expect due to the normal weather. Also, this is one area where we will be likely to increase demand creation spend as we seek to reignite growth after a disappointing year.

Moving on to Garden, for the quarter, Garden segment's sales increased 13% or $22 million to $185 million, partly due to the inclusion of our Arden acquisition, but more so due to organic growth. Organic Garden sales increased 10% on higher sales of other manufacturer's products, as well as strength in our wild bird, live plant, and grass seed businesses. Unfavorable weather held back sales of control products offsetting a portion of the game.

Garden's operating income for the quarter decreased $1.2 million to $300,000 and operating margin decreased 80 basis points to 0.2%. Our Arden acquisition had a negative impact on operating income and margins, as the fourth quarter is its least profitable quarter of the year, and an unfavorable mix of sales in our organic businesses also was responsible for the margin decline.

Now to the balance sheet and cash flows. For the quarter, cash flow provided by operations was approximately $112 million compared to $96 million in the fourth quarter a year ago. The difference was primarily due to improvements in working capital accounts. CapEx for the quarter of $11 million was approximately flat versus the prior year. For the year, CapEx totaled $32 million compared to $38 million in fiscal 2018. We anticipate higher CapEx spend in fiscal 2020.

Depreciation and amortization for the quarter increased to $14 million, up from $12 million in last year's fourth quarter, due to the acquisitions in the past year. Cash and equivalents including short-term investments increased to $498 million from $482 million a year ago. We ended the quarter with a leverage ratio of 3.1 times, up from 3 times a year ago. We are comfortable with our current gross leverage levels, which is right around our targeted level of 3 times to 3.5 times.

During the fourth quarter, we repurchased 1.8 million shares. As of the end of the fiscal year, we still have $100 million remaining on our 2019 $100 million repurchase authorization, as well as an additional 1.2 million shares remaining under the board's equity dilution authorization.

In terms of EPS guidance for next year, we currently expect diluted EPS to be at or modestly above the $1.61 of diluted EPS we earned in fiscal 2019. This excludes any impact from potential M&A activities undertaken during the year. The reason for the lack of significant growth expected in fiscal 2020 EPS rests primarily with the sizable additional demand creation investment we expect to spend in fiscal 2020.

We also are being pragmatic about our expectations for the recovery in our animal health businesses and on the uncertainties regarding the impact of tariffs. As Tim mentioned earlier, he's still assessing the organization and will share his thoughts on the strategic direction of the company in more detail in the spring. I will also mention that we currently expect our first quarter results to be lower than the prior year, with us currently projecting a loss of

$0.10 or higher due to several factors, the timing of customer orders in the Garden segment, continuing challenges in our animal health businesses and higher corporate expenses.

Our EPS estimates for the quarter and year excluded the impact of a recent fire in a pet bedding facility. We believe our insurance coverage is sufficient to cover asset losses as well as the business interruption associated with this event. So while we believe the fire will not have a materially impact on the fiscal year's results, the timing aspect of when we recognize the losses versus when we receive insurance proceeds may impact our quarterly results, especially our first quarter.

In conclusion, despite fiscal year 2019 being a difficult year for animal health and pet bedding businesses and with next year expected to have its earnings impacted by investments for future growth, our company remains strong, well-capitalized and well-positioned to grow in the years ahead. We look forward to giving you an update on our first quarter call in early February.

Now let's open it for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, we will be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of Brad Thomas with KeyBanc. Please proceed with your question.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Hi. Good afternoon, everyone, and Tim, welcome.

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

A

Thank you.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

I guess, hope – first I was hoping to kick it off with a high-level question for Tim and then ask a couple of follow-ups on the financials to Niko, if I could.

Tim, I guess as you analyze the business and think about some of these investments that could position Central for accelerating growth, I guess how do you think about the level of investment that may be needed and the payoff with which you may be able to see some return on those investments?

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

A

Sure. I think it's important to say upfront it's only been a few weeks in the saddle, so there's still a lot to learn. But I've done the first round of business reviews and had a chance to meet our leadership on the ground and many of our business units around the country, I do think we find ourselves with a lot of opportunity, and that opportunity can be further unlocked I think with some investment. And the way I think about it is in a few buckets. I mean, one, clearly as I said in my comments, in the whole consumer space, really understanding the way that our consumer approaches these categories, knowing our categories better than our competition, enhancing our brand equity, building distinctive brands, driving some disruptive innovation, and winning in the highest growth channel in the United States today which is the e-commerce channel. Those are all big opportunities I think for us.

But it's not just in that space, I think the other areas are actually on the costs side. I think we've got some meaningful opportunities to advance our productivity agenda and that will provide two different benefits. One is obviously as fuel into that growth agenda and the other is obviously to enhance our margin structure from where it is. And I'm encouraged by what I see on that. That too may require some investment. That may require some CapEx et cetera.

Finally, to the second part of your question, clearly, I have a strong eye on returns and we will be assessing these opportunities as on a ROI basis. I think it's fair to say that some of these won't return in the first year, in the first fiscal year. And so, I'm looking at it obviously as a new CEO, to have a clear eye on returns, but make sure we're doing the right thing for the long term of this business and to really drive that long-term sustainable profitable growth.

Finally, as mentioned, I'd like to take a few more months to really do the deeper dive and I will come back in the spring with a more comprehensive and cogent view on your question.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

That's very helpful. Thank you, Tim. Niko, as we look at the quarter and try and get a sense for some of the margin puts and takes, can you help us think about quantifying sort of the one-time items in here, like when we think about some of the receivable and inventory write-downs, could you quantify those aspects for us in the quarter?

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

A

We're a little remiss to quantifying, because if we wanted to we would have non-GAAP-ed those. But what I will tell you is absent the receivables, the inventory, and the CEO costs, both our dollars and our margin would have been higher than the year before.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Perfect. That's very helpful. And then just lastly for me, I guess as we think about the first quarter, can you help us think a little bit more on puts and takes from a margin perspective and sales perspective that are driving that net earnings range that you guided us towards?

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

A

Yeah. So largely, the first quarter, keep in mind, it's the smallest quarter for Central. So, small puts and takes can have large impacts on the bottom line.

So, overall, we came into the quarter with a very soft grass seed planting season because of the excessive heat in October. So that was sort of an immediate headwind coming into the quarter. Then if you recall a year ago, we had one retailer on the Garden side that was very aggressive with respect to their load and they signaled that that's not going to repeat. So we have kind of those two headwinds going on.

And then on the Pet side, it's really timing of orders around the animal health and bedding businesses. So we're seeing some timing effects there as well. And then lastly, higher corporate costs around executive comp, as well as some investment in IT.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.
Q

That's very helpful. I'll turn it over to others and good luck to you all.

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

Thank you.

Operator: Our next question comes from the line of Chris Carey from Bank of America. Please proceed with your question.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch
Q

Hi. Good evening.

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

Hello.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch
Q

And Tim, welcome.

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

Thank you.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch
Q

So, few questions here. I guess, just first on the quarter and then have questions on some other dynamics over time. But I guess if you think about some of the pricing initiatives that have been part of the story over the course of the year and certainly heading into next year, doesn't really seem like any of that has provided much help. And I appreciate that mix has been a dynamic here, right. But this is kind of like the second year when gross margins are declining and mix gets called out. And it sounds like probably gross margins are going to decline again next year if investments are happening. And I suppose I don't know exactly where all those investments are occurring, but it seems to me like that's the case. And so, I guess because top line came in fine, certainly comps helped, but I think the full picture is still a little confusing. And I guess, Niko, am I off here, is this the case where we're not going to get a lot of visibility on the gross margin line for a while, and maybe if, Tim and Niko, if you could comment on where some of these investments are going to be happening?

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

A

So I'll kind of comment on some of your comments. So, as far as pricing goes, we did take fairly broad-based pricing across many of our businesses. I will tell you that there were some pockets where we took actually some price decreases because commodities did come down, and that's something that is very transparent to the retailers, so they know exactly what's going on in those commodity markets, and there's no hiding from that. So I would say that, that's one issue that's out there.

The other issue is obviously when you do take price, there are some elasticity implications as well. Third would be, as we mentioned in our earlier comments, we are lapping. If you look at the acquisitions we did, we did take on some negative quarters with respect to Bell and now with this most recent one with Arden. Those things all are going to have impacts on the gross margin line.

The other thing I would say is I can't overstate enough really, and I know you're obviously tired of hearing it, but the mix issue, and when our animal health businesses don't perform, you're going to see it, you're going to see it at the gross margin line and you're going to see it at the operating margin line, and that's just a fact around our business.

Now I'll address the other issue around gross margin in 2020. I can tell you that we are planning to expand margins in 2020. We're going to get more detail on that probably later in the year. But we have every intention of expanding margins at that gross margin line.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch

Q

Okay. Okay. And maybe just on the buyback program, right, so maybe let me know if my read here is wrong, but you still have the $100 million authorization and you basically had already bought back shares when you had announced the authorization, so maybe you haven't been as active recently, and perhaps you thought that there was a potential that the stock would be down tomorrow, which I suppose it could be. And so, is there a way to think about the cadence of this deployment going forward if your stock is down tomorrow as much as it was initially indicated? Is that the type of time when you would be opportunistic or is there another type of way that you're thinking about deploying that program over time?

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

A

Well, I mean, the way we're thinking of it is if the stock drops and we find ourselves at an implied multiple of 6 or 7 times, that's extremely attractive. As we look at M&A, we can't find businesses that are that attractive on the outside. So, when we see our stock drop to those levels, that's something we're going to act on, because it's the right thing to do. It's a tremendous value. We believe in our story. We believe in our people. And why wouldn't we support that?

I will tell you internally the way we think about it though is the $500 million that we've raised through both debt and equity, that's really earmarked for M&A. That's not something we're going to be really going after and buying our stock back. And the way we think of the stock buyback is we really want to do that with our cash flow. So, really you can see we've been buying back and we still have the same amount of cash on the balance sheet. So, we have in effect compartmentalized it, but if our stock drops to a certain level, we're going to support it because it's a tremendous value.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch

Q

Okay, that makes sense. And then just one final one. Just trying to understand this flat to slightly up guidance for earnings next fiscal year, and if you could kind of, I suppose, frame it between how much of that is getting impacted by the proactive investments that you're doing to just drive longer-term sustainability versus say some of the challenges that you're seeing in the business like an animal health or otherwise. So, how much of one versus the other? And then maybe how much of the impact we could see from the facility fire that you highlighted in the press release? So, that's it for me. Thank you.

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

A

We'll probably be able to dimensionalize the impact between the investments and the animal health business later in the year. We're going to give more detail going forward. But I'll give you a couple of comments. In the last few years, we have cut our spend, and for good read, if you go back to 2018, poor Garden season and we didn't want to lean into that. This year, it was animal health as well as our gen 1 Comfort Zone product that wasn't performing. So we didn't want to lean into that either.

So, in that respect, it was really the right thing to do given that we believe the returns will not going to be there for us. But what I would tell you is, when we went through our 2020 planning process, we began really challenging the plan and really asking some tough questions around, are we happy with our current growth rates? Are we happy with our share? Are we losing share? Are we being aggressive enough around digital and our consumer facing agenda? And if the answers are no, are we sufficiently investing in the steps to substantiate the higher growth as well as the market share gains. So those are really some tough questions we were asking ourselves and those are the things we're going to probably come back with in more detail later in the year.

Let me shift to animal health really quick and just talk a little bit about the challenges there, which include both the consumer as well as the pro business. And the challenges have been – will be to get our market share back in that consumer business around the Comfort Zone product. And that's on us. We have to go out there, spend wisely, have a high return on investment and take share back; simple as that.

On the pro side, there's a little more complexity. So, if you look at the challenges that are going on in the ag market around pro, some of which have been exacerbated by trade tensions. And if you look at that pro business, many of our end customers are the farmers and they've had a really rough go of it this year. So, weather aside, there's some real macro trends affecting the ag market like the overall health of the beef and the dairy industry.

I'll give you some examples. I think last quarter I mentioned 1 million calves dying in the winter spring flooding. In 2018, 2,700 dairies went out of business. And this year between January and May there were 300 shutdowns in Wisconsin, so 300 dairies shut down in that timeframe. And then just this month, Dean Foods, the largest producer of dairy products filed bankruptcy.

So, do I expect another year like 2019? No. But our view is that there's still a fair amount of uncertainty around that animal health business for us to be a lot more thoughtful in our guidance and not to expect a full rebound in 2020. If you take anything away from the comments here, I think we're taking a longer-term approach. We want to create a situation where we can create long-term sustainable growth going forward. And I think really that's the message.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch

Q

Thanks, Niko. Appreciate that.

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

Grant O'Brien
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Hi. This is actually Grant on for Bill. Thanks for taking my question and hi to Tim.

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

A

[ph] Hey, Grant (00:35:40).

Grant O'Brien
Analyst, SunTrust Robinson Humphrey, Inc.

Q

First one for us, just on the Pet segment. Just for the charge-off in the quarter on the pet bedding side, I'm assuming that's all related to the fire and not any lower demand, but just wanted to double check that.

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

A

No, so both the receivables and the inventory were on the Pet side. The receivables were due to – we had two customers go bankrupt in the fourth quarter, where we had to write-off those receivables. And then the inventory was largely due to the write-off of the Comfort Zone generation 1 product. So those are the two primary drivers.

So not related to the fire. The fire is a very recent thing. And we're still getting reports in terms of the investigation that's going on. So we're still pulling the facts together. We'll obviously have a lot more information come February, but it's fresh news even for us, so unfortunately we don't have a ton of detail there.

Grant O'Brien
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Got it. Okay. And then maybe just thinking longer term, your capital allocation strategy, it sounds like next year the CapEx spend is going to step up, but do you still feel like you have a number of potential M&A opportunities in the pipeline? And is that really the focus still going forward?

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

A

Absolutely. It's really the focus is going to be M&A and then also capital projects internally, meaning, growth, as well as cost savings. So those are really the top two. And then as I mentioned earlier, when we see our stock drop to the levels I've mentioned, we're going to be buyers at those levels just because we really believe in what we're doing here.

Grant O'Brien
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Got it. Thank you. [ph] I will pass it on (00:37:44).

Operator: Our next question comes from the line of William Reuter with Bank of America. Please proceed with your question.

Q

Hi, guys. This is [ph] Mike (00:37:54) on for Bill. Following up on the commentary about the M&A pipeline, is there a maximum size we should expect for a potential target?

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

A

No. I think we remain fairly open to size. It's kind of across the board. I don't see us doing something over $1 billion just to be fully transparent. The other way to think about it too is we're going to look at M&A from a product standpoint, but also from a capability standpoint. So, that's another thing we really look at in terms of if we see a business that has really strong digital capabilities and we want to up our game, that's something we might look at.

So, we're going to look at M&A across a number of factors. And I think $1 billion is going to be on the high end. But we do have about $1.1 billion of dry powder. So that gives you sort of an idea of what we could do. I suppose if we saw something bigger, you could always do some deal financing along with it.

Q

Great. And then just could you talk about the private label performance and if there's any change with the percentage of total sales? Thanks.

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

A

So, right now, I'll just talk overall company private label, and then I'll let our segment heads talk about their respective areas of business. Overall, we're north of 15% now as far as private label, and a lot of that has been due to the acquisitions we've made. So, some of the acquisitions we've done recently tended to have a big portion of their business being private label.

Overall, as everyone knows, this is very strong consumer trend. We like the business particularly when we're the low-cost producer. Typically, with retailers we're able to get our own products on the shelf as well as the private label. We know it's going to get bidded out to somebody, may as well be us is the way we look at it. And that way we have really a more meaningful relationship with the retailer, if you think about it.

The other thing it does for us internally, it fills up our manufacturing plants. So, we get a lot of operating leverage out of that and it really helps all the products [ph] run through the plant (00:40:16). So, that's sort of how we think about on a macro scale. I'll turn it over to our segment heads to talk about this.

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

A

Sure. This is J.D. I'll speak to the Garden segment. We're planning the private label brands across a number of our categories, fertilizers, controls, grass seed, wild bird feed, outdoor replacement cushions, even in live goods.

And it's an important business to us. And Niko touched on the key drivers behind that. It gives us larger share of the shelf. It gives us more critical mass with that retailer. It also helps with the factoring plant utilization, favorable variances as a result of that.

And then the last thing I'd touch on is just the strategic relationship with that retailer, because you are co-developing that brand with the retailer. And I think that we've been effectively able to leverage additional branded business as a result of our private label business.

John?

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

Yeah. This is John Hanson. I would echo in Pet as well, we continue to like the opportunity in private label, some categories more than others. But it does give us a partnership with our customers and it absorbs overheads. And it also gives us an ability to help the customer in the category and protect our brands and lead our brands and become a category leader and a business partner with our customer. So, we continue to like it very much and very much on consumer trend. Thank you.

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

James Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc. Q

Hi. Thanks for taking my questions.

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

Hi, Jim.

James Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc. Q

I know you talked about the impact of animal health and some other things on the full year, but just in terms of the fourth quarter sales performance versus what you expected back in August, how did things come in versus your plan?

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

We were a little bit short to plan on the sales side but again, we had nice organic growth on that top line in both Pet and Garden. So we felt pretty good about the top line in Q4.

James Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc. Q

Okay. And the pet bedding business last quarter, you guys I think called that out as a reason for the top line shortfall and you expect this – you had a good visibility into orders for fourth quarter. So, how did pet bedding play out in fourth quarter?

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

A

So, pet bedding really slowed down in the quarter towards the end. And it came up a tad short even though we – I know we've mentioned we had like 56% of the orders on the last call, but things had really, really slowed down in that bedding business in the quarter. So, it was a little under.

James Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Okay. And then I know you've talked about kind of the investments for next year and just understanding, this year for fourth quarter, it looks like some one-time-ish type items cost you guys like $0.11 in the fourth quarter. You've also talked about earlier this year an impact of some legal expenses last quarter. You wrote off the Arden inventory earlier this year which was a drag on earnings. You wrote down some home decor inventory last quarter. And so there's a lot of one-time expenses within that $1.60. So how do we think about that in terms of your expectations for next year?

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

A

Yeah. And again, really for next year, the two main drivers are going to be that investment spend and also our tempered outlook on animal health. In the animal health space there's more going on than just weather. There's trade. There's some real macro factors. We don't know how quickly or if at all we'll be able to gain market share back in the Comfort Zone product. So there's just enough uncertainty there for us to temper our outlook.

And then, again, we plan on being very aggressive on the spend side. So that's kind of where we are right now. That's very high level, I know. And I know everyone wants more. But we're going to give more detail later in the year. Keep in mind, Tim has only been here a matter of weeks and we need to get him properly on-boarded, and he's got to get his arms around the business and then think strategically going forward.

James Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

All right. And just finally, on the behavior modification of Comfort Zone, understanding kind of the sales challenges and market share challenge, but how has the reformulated product performed in testing and at the consumer level?

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

A

Yeah. So, this is John. We talked about Comfort Zone before. We did have a misstep and we worked really diligently on reformulating the product, and over the past quarter, in Q4, investing in digital and e-commerce as well as brick-and-mortar to get that product back to where we need it. I wouldn't say it's all the way back, but I think we feel very confident about the category and the brand and we're very excited about the future that we can get this turned around for growth in fiscal 2020.

James Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Great. Thanks, and best of luck this year.

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

Thank you.

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

Thank you.

Operator: Our next question comes from the line of Peter Graham with JPMorgan. Please proceed with your question.

Peter Graham Malone
Analyst, JPMorgan Asset Management (UK) Ltd.
Q

Hey. Good evening, everyone.

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

Good evening.

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

Hello, Peter.

Peter Graham Malone
Analyst, JPMorgan Asset Management (UK) Ltd.
Q

So, Tim, kind of given your background at Mondelēz and kind of the context of what we've seen in CPG, I guess over the past few years or this year with Pepsi, Colgate, I can't help but think that the increased investments you're talking to and then kind of the earnings growth you're looking to deliver this year kind of looks like a rebasing. I know it's been talked a lot about during this call, but clearly something in the first few weeks is pointing to investments being a driver of improved performance. So, just kind of, is there anything you can share that gives you comfort that higher spend is going to be enough to improve market share performance? And is there anything you can share in terms of where this spend is going to be directed?

And then I guess, lastly, do you feel your kind of current FY 2020 guidance reflects the appropriate level of spend or is this reinvesting commentary still in the early innings and kind of could be ratcheted up higher later in the year? Thanks.

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

Yeah, thank you. Look, again, I'll preface by saying it is early days and only a few weeks in the role. But I guess, one of the three sub-questions you asked, I am confident that we can get a good return on this spend certainly over time. Again, whether it all occurs in a fiscal year, I think my experience would suggest that it doesn't always work that way. And realize too, as everyone knows their fiscal calendar, we're already the better part of two months into this fiscal.

So, I'm not necessarily saying for fiscal 2020, but certainly over time that's going to be my orientation and our orientation. I think many of you have followed our company for some time. You know that our level of investment spend on the consumer side in the area of insights and marketing and innovation is actually a smaller part relative to some of the other firms you referenced in your question from a consumer standpoint. And therefore, that marginal impact of that investment I think can be quite meaningful.

As I've gone around to many of the business units and talked to our folks about return on investment in these areas, particularly in the digital space, I'm actually seeing some very encouraging numbers that gives me confidence that when we put a little more fuel into that system, that we can see a nice pop.

So, a lot more to come, a lot more diligence to follow. And I want to assure you and others that our orientation is going to be around investing where we feel like there's a good return in the years to come.

Then the last part of your question was do we think the amount of investment for 2020 is appropriate and consistent with that guidance that Niko provided. My short answer is yes. It does provide – while on this call we're not in a position to break out the exact detail of the numbers, I would say it gives us a good basis for reinvestment across a number of areas. And as Niko outlined, that's one of the reasons why we've guided where we've guided, is because we feel good about that level of investment. And I don't anticipate that will change as we progress through fiscal 2020.

Peter Graham Malone
Analyst, JPMorgan Asset Management (UK) Ltd.

Q

That was helpful. Thank you.

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

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Hi. Thanks for taking the call. I had two questions. Tim, as part of your evaluation of the portfolio, is it possible we might see divestitures too? It's been a long time since the company has kind of pruned some of the assets that it has.

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

A

Well, look, I would say, generally, my point of view on portfolio strategy is it's a very healthy discipline to consistently look at your portfolio and make sure that each of the pieces are contributing to the party. And to me, that's just kind of good housekeeping at this stage, nothing specific to share in terms of any sort of divestiture candidates. But to me, it's just part of good general management. I would say, overall, this company in the last many years have built a nice track record of growth through acquisition and brought in nice additions both in foreign and adjacent categories that have added to the overall portfolio.

The other thing in my first few weeks, we've done I think a good job of kind of doing postmortems on recent acquisitions to understand are they contributing as we had hoped, are they delivering on the investment thesis, and to the extent they are, great, how can we do more, to the extent they aren't, what do we need to do to get those back on track. So, that'll be a part of the continuing discipline we have as a leadership team.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Thank you. And then on the pet bedding facility fire, I was wondering if you could give us some insight into if you thought that was going to leave you short meaningful inventory to ship into the channels or if you're going to be able to source it from third-party manufacturers or elsewhere?

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

A

This is John. Yes, we stated we had a fire in our distribution center of our pet bedding business in November. No one was injured. We have the team on the ground that are in the process of really understanding the damage and going through all the details of the business and the damage. We're doing our absolute best to continue to service customers and we're working through each customer individually in terms of can we do that with existing inventory or how we get that done. We do, as we mentioned, have very good insurance. The timing of receiving that insurance and those benefits may impact quarters. But overall, we expect minimal financial impact in total.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

So, you wouldn't expect to lose any shelf space or have any issues with kind of your retail partners?

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

A

I think it's hard to call right now. We're going to have to see how the season plays out. But right now it's sort of hard to call.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you. And Tim, congrats on the new seat.

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

A

Thank you.

Operator: Since there are no further questions left in the queue, I would like to turn the call back over to Mr. Tim Cofer for any closing remarks.

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

Okay. Very good. I want to thank everyone for attending our earnings call and I wish everyone a wonderful Thanksgiving. Thank you.

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