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Central Garden & Pet Co. (CENT)

Q1 2021 Earnings Call

CORPORATE PARTICIPANTS

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

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

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

J.D. Walker
President-Garden Consumer Products, Central Garden & Pet Co.

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

OTHER PARTICIPANTS

Karru Martinson
Analyst, Jefferies

William B. Chappell
Analyst, Truist Securities, Inc.

William Michael Reuter
Analyst, BofA Securities, Inc.

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

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Sarah Clarke
Analyst, JPMorgan Chase & Co.

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Central Garden & Pet's First Quarter Fiscal 2021 Earnings Call. My name is Diego and I would be your operator – 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 Friederike Edelmann, Vice President, Investor Relations. Please go ahead.

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

Thank you, Diego. Good afternoon everyone and thank you for joining us. With me on the call today are Tim Cofer, Chief Executive Officer; Niko Lahanas, Chief Financial Officer; J.D. Walker, President, Garden Consumer Products; and John Hanson, President, Pet Consumer Products. Tim will begin with the business update and Niko will discuss our Q1 results and our outlook for fiscal 2021 in more detail. After the prepared remarks, J.D. and John will join us for the management Q&A. Our press release providing the results for our first quarter ended December 26, 2020, is available on our website at ir.central.com and contains the GAAP to non-GAAP reconciliation for the non-GAAP measures discussed on this call. We've also made available a supplemental investor presentation.

Before I turn the call over to Tim, I would like to remind you that statements made during this call, which are not historical facts, including the potential impact of COVID-19 on our business, earnings per share and other guidance for 2021, expectations for new capital investments, product introductions and future acquisitions are forward-looking statements subject to risks and uncertainties that could cause actual results to differ materially from those implied by forward-looking statements. These risks and others are described in Central's Securities and Exchange Commission filings, including our Annual Report on Form 10-K filed on November 24, 2020. 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 CEO, Tim Cofer. Tim?

Timothy P. Cofer

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

Thank you, Friederike. Good afternoon, everyone, and thank you for joining our Q1 earnings call. We hope you and your families are staying healthy and safe. We're pleased to report that Central has delivered another quarter of strong financial performance. Today, I'd like to start by providing a recap of the Central to Home strategy we shared with you in early December, walk you through our recent acquisitions and how they map back to our strategy and discuss the key factors that drove our Q1 results.

Before we dive in, I want to begin with an update on how Central continues to navigate the COVID-19 pandemic. The company remains vigilant in our efforts to operate and conduct business safely, which is even more important now as we've seen cases rise across the country and Central is certainly not immune to this trend. Our facilities have diligently maintained strict health and safety standards and we remain committed to all measures needed to keep our employees safe. Thanks to the hard work of our teams, all of our manufacturing facilities and distribution centers remain open and fully operational. A big thanks to Team Central for their continued dedication and strong execution.

As you know, just a couple of months ago, we held an Investor Day, where we shared our Central to Home strategy, our strategic roadmap for how we will take our business, our brands and our people into the future. The foundation of our strategy starts with an inspiring company purpose: to nurture happy and healthy homes. Our employees are equally excited by our new, bold mission: to lead the future of the garden and pet industries. And this all culminates with our five strategic pillars. These pillars provide our organization with clear direction and a roadmap for the next few years. It starts with our focus to connect with and understand our consumers better than ever. Building and growing brands consumers love, investing in demand creation and creating disruptive innovation platforms. The second pillar is about the customer. Our retail partners. Here, our goal is to win with winning customers and channels. We will accomplish this by building a leading e-commerce platform, strengthening our relationships with our winning retail partners, responding to channel shifts and improving our sales capabilities.

The third pillar is focused on strengthening Central's portfolio, from optimizing our brands and business units to our evolved M&A strategy and our social responsibility agenda. The fourth strategy centers on cost. Our goal is to reduce costs, to improve margins and fuel growth across the enterprise. Our priorities include operating with excellence, stepping up our net productivity efforts, improving our cash position and better leveraging our scale.

And finally culture. This pillar is dedicated to our most important asset, our people. We want to recruit and retain the best talent, strengthen our entrepreneurial business unit-led growth culture and make Central a great place to work that embraces diversity and inclusion. Our long-term strategy will be measured through our success in three critical areas: delivering top tier financial performance, building a strong portfolio with leading brands and becoming the destination for top talent in our industries. A great example of early progress against our Central to Home strategy is our recent acquisition news. We've evolved our M&A priorities toward an ambition to acquire growth and margin accretive, brand focused companies with talented management teams. As you've seen in our recent press releases, we announced three additions to our Central portfolio. Based on the timing of these, only DoMyOwn had a minor impact on our Q1 results. We are confident these acquisitions offer attractive returns, will position us for continued growth, add new capabilities and enable us to achieve our long-term targets.

Let me briefly share some information about each of our new businesses. Hopewell Nursery, which closed in early January, is a leading commercial grower serving garden centers, retail nurseries and wholesalers across the Northeast. Following the successful acquisition of Bell Nursery in 2018, adding Hopewell to our portfolio will further bolster our position as a leading live goods provider and better serve consumers with more high-quality live plants. With the collective industry knowledge from both Hopewell and Bell, we are confident both businesses have an opportunity to evolve and realize their next phases of growth and profitability.

Green Garden Products, which is expected to close in February, is a leading provider of vegetable, herb and flower seed packets, seed starters and plant nutrients in North America. The addition of Green Garden will expand our portfolio into an attractive, adjacent, garden category and strengthen our footprint with key retail customers. We're also looking forward to providing Green Garden access to Central's resources such as digital marketing and in-store merchandising to take this business to the next level.

And lastly, DoMyOwn, which closed in December, it's a leading and fast-growing online retailer of professional-grade control products. This acquisition strengthens our position in the controls category. In addition, it provides access to their expansive digital and logistics platform. DoMyOwn has invested in industry-leading technologies that are fast, unique and focused on providing a seamless and personalized direct-to-consumer experience. A key element of our new strategy is to become a digital-first business that's focused on the digital consumer and customer, data and analytics, adopting digital ways of working and enabling a digital supply chain.

The acquisition of DoMyOwn further advances our digital capabilities to deliver strong omni-channel performance. We're already sharing best practices across DoMyOwn and Central to further our digital roadmap. Across all three of these companies, we are impressed with the management teams. We are pleased that the management teams of Hopewell and DoMyOwn are staying onboard and expect the Green Garden management team to join upon the completion of the transaction. We're excited and confident in our new Central to Home strategy and our recently acquired businesses. We won't be sharing a lot of financial details on today's call related to these acquisitions nor the impact of these on our fiscal 2021 results. However, we look forward to providing more details on our Q2 call in a few months.

Now to our quarterly results, we delivered another very strong top and bottom line performance in our first quarter of fiscal 2021. While we're pleased with the start to our fiscal year, it's important to remind everyone that Q1 is one of our smaller quarters and we still have most of the year ahead of us. Net sales increased nearly 23% versus the prior year quarter to $592 million. Our growth was broad based with 34% growth in our Garden segment and 19% growth in Pet. Let me give us some color on both segments, especially as it relates to our sales growth and trends across our consumers and customers.

In Pet, we enjoyed continued consumer demand strength across all our categories, with contributions from dog and cat, our distribution business and small animal supplies. Q1 was a record quarter, both for online and in-store. E-commerce represented 20% of our branded pet consumer business, with the fastest growth coming from the combined online and buy online, pickup in store sales at our large brick-and-mortar customers. Our point of sales trends were exceptional in e-commerce and strong in brick-and-mortar, where we took further share in wild bird feed, small animal, rawhide and waste management.

In 2020, a third of pet owning households added another pet to their family and about 2.7 million households became pet owners for the first time. Looking forward, there's still unmet demand for pets, with many future pet owners waitlisted for a pet due to a tight supply of adoptable pets. While it's difficult to predict what longer term demand might look like, growing pet ownership is a good indicator of a sustained increase in pet supplies consumption compared to pre-COVID. Similarly, in garden, strong demand accelerated across all our garden business units. Mainly in our distribution business, wild bird feed, grass seed, controls and fertilizers as well as live plants. This robust growth was driven by strong consumer engagement related to stay-at-home activities and over 8 million incremental households that participated in lawn and garden consumables categories in 2020.

From a point of sales view, we see strong double-digit gains and we've gained share in many of our categories, especially in wild bird feed and fertilizers. Retailers are taking inventory earlier this year in anticipation of the strong consumer demand in the spring. Overall, retailers are seeing an increase in buy rates as shoppers are spending more and are buying more frequently and the trend to online shopping sustains. Our garden e-commerce business, whilst still on a small footing, grew triple digits as consumers are shifting their buying patterns. As I've indicated in the last two calls, this strong consumer demand certainly puts pressure on our supply chain. Accordingly, we've been working closely with our suppliers and customers to address the needs for our products and we are investing in incremental capacity to improve our service levels. For example, in the first quarter, we invested in incremental capacity for our dog treat, wild bird and small animal businesses, our controls and grass seed businesses, as well as in automation and our lives plants and aquatics businesses. We expect to see the benefits of these investments manifesting in incremental capacity later this year and into fiscal 2022.

Our supply chain remains stressed and we are navigating through a higher cost input environment, including key commodities such as milo and millet as well as higher freight and labor costs. Despite these challenges, EBIT increased significantly to $27 million, well above prior year performance of $2 million and we delivered EPS of $0.10 per share on a GAAP basis as compared to a loss of $0.08 per share in the prior year quarter. This represents an improvement of $0.18, while at the same time, we absorbed an incremental $0.15 of interest expense related to our earlier debt refinancing, a testament to our strong operating results.

In closing, I want to once again express my great appreciation for our employees. They continue to successfully manage through the challenges of the pandemic, execute against our Central to Home strategic priorities and deliver strong financial results.

With that, let me turn it over to Niko, who will share more details of our Q1 financial results. Niko?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, Tim. Good afternoon, everyone. I'm very pleased to start the fiscal year on such strong footing. We had the strongest first quarter net sales and operating income in the company's history. Net sales reached $592 million, an increase of 23% or $109 million compared to the first quarter a year ago, driven by organic growth in both segments.

Consolidated gross profit increased $34 million to $165 million and gross margin increased 70 basis points to 27.9%, driven by favorable product mix and volume-related efficiencies in both Pet and Garden. SG&A expense increased 7% versus a year ago to $138 million, but as a percent of net sales, SG&A decreased 340 basis points to 23.4%. This increase was driven by higher payroll-related and logistics costs, resulting from our increased volumes, partially offset by lower travel and entertainment expense. Operating income increased $25 million to $27 million, driven by higher sales volumes and improved gross margins, partially offset by higher SG&A expenses. Operating margin increased 420 basis points to 4.6%, thanks to improved gross margin and operating leverage, offset by continued pressure on our supply chain and inflation. EBITDA increased 163% to $40 million.

Turning now to our Garden segment. Garden segment sales increased 34% or $40 million to $156 million. The growth was driven by garden distribution, wild bird feed, grass seed, controls and fertilizers as well as our live plants business. Garden segment operating income was $5 million, an increase of approximately $12 million or 168% compared to prior year. Garden segment operating margin increased by 890 basis points to 3%, a record operating margin for the Garden segment in the first quarter. The improvement was driven by the organic strength mentioned previously, improved gross margins as well as lower SG&A. Garden segment EBITDA increased 275% to $7 million.

Turning now to Pet. Pet segment sales increased 19% or $70 million to $436 million. Sales increased broadly across all categories with notable strength in dog and cat consumables, distribution and small animal supplies. Also worth mentioning that due to synergies to be gained in sourcing, manufacturing and innovation with our pet bedding business, we have moved our Ardern Outdoor Pillow and Cushion business from Garden into the Pet segment as of the first quarter of fiscal 2021

Pet segment operating income increased by approximately $15 million or 51% compared to the prior year to a total of $44 million. Pet segment operating margin increased by 220 basis points to 10%, driven by strong sales contribution as well as improved operating leverage. Pet segment EBITDA increased 39% to $53 million.

Now getting back to our consolidated results. Other income was $800,000 compared to other income of $300,000 a year ago. The increase was primarily due to increased earnings from minority investments during the quarter. Net interest expense increased $12 million to $21 million, $10 million of which was incremental interest expense related to our recent debt refinancing.

Our tax rate was 19.7% as compared to 27.6% in the first quarter a year ago. While the first quarter of 2021 had pre-tax income and the benefit from stock compensation decreased the tax rate, the prior year had a pre-tax loss and the benefit from stock compensation increased the tax rate in that quarter. Cash and cash equivalents at the end of the first quarter increased to $608 million, up from $446 million at the end of the first quarter a year ago. We paid approximately $83 million in cash for the acquisition of DoMyOwn during the quarter. Net cash used by operations was $36 million for the quarter versus $18 million in the first quarter a year ago, as higher EBITDA was more than offset by changes in working capital, largely related to the strong demand for our products, whereas you would expect receivables, payables and liabilities were up while inventory increased only slightly.

As we've pointed out, we've heightened our focus on capacity expansion and increased our CapEx 48% over the prior year quarter to $15 million. Total debt was $789 million, up $96 million from the same time last year. As you'll recall, we successfully refinanced our 2023 senior notes and raised an additional $100 million. Our gross leverage ratio at the end of the quarter was 2.3 times, within our target range. At the end of the first quarter, we had no borrowings under our $400 million credit line.

Depreciation and amortization for the quarter was $13 million, in line with the prior year period. During the quarter, we did not repurchase any of our stock. There remains $100 million under the board's previously authorized share repurchase program and an additional 1 million shares under the board's equity dilution authorization.

And finally, turning to our fiscal 2021 outlook, although we're pleased with our Q1 results, the quarter remains one of our smallest, with the vast majority of the garden season still ahead of us. We anticipate our strong business momentum to carry on and as mentioned previously, we are stepping up our strategic investment spending to expand our capacity to meet the increased demand and to drive future profitability and growth.

That said, we also expect continued pressure on our supply chain, including outstripped capacity and labor shortages as well as increased costs for freight and raw materials. While we are taking pricing, we do not expect to be able to offset all of the impact this fiscal year and finally, there still remains uncertainty around the weather for the upcoming garden season and the impact of lapping COVID in the second half of fiscal 2021. This leaves us to continue to anticipate full-year 2021 GAAP EPS of $1.90 or higher. This translates to 2021 adjusted diluted EPS of $2.09 or higher, excluding Q1 non-GAAP items. Please note, this outlook does not include the impact of our recent acquisitions or additional acquisitions that may close during fiscal 2021.

Now operator, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, at this time, we will conduct our question and answer session. [Operator Instructions] We'll pause for a few moments while we poll for questions. Thank you. Our first question comes from Andrea Teixeira with JPMorgan. Please state your question.

Andrea Teixeira, your line is open. We'll move on to the next question. [Operator Instructions] Our next question comes from Karru Martinson with Jefferies. Please state your question.

Karru Martinson
Analyst, Jefferies

Q

Good afternoon. A wonderful quarter here. I was curious how much of the point of sales and the retailers taking inventory earlier would represent kind of a pull forward from your quarters into the traditionally smaller quarter and how should we kind of balance that out for the year and any thoughts on retail, inventory at retail.

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

A

Sure. Thanks for the question; this is Tim. I'll start and I can kick it over to JD and John as I think the dynamics could be a little different across the businesses. I mean in general, I would tell you starting on POS, we feel very good about our POS trends. You're seeing these on the Garden and the Pet side in very strong double-digit territory. And when you see the alignment between the POS and our revenue, that is encouraging to us that they're not out of line. There's no question particularly on the Garden side that retailers, having experienced the strength of last year's consumer demand garden season and with the ongoing COVID-19 pandemic and kind of consumer behavior, our retail partners are very much counting on another strong season and they are planning for that accordingly and I would say pulling inventory sooner.

But again what's most encouraging for me is the fact that our inventory and our, sorry, our point of sales and our sales shipment or net revenue are quite in alignment and that's I think encouraging for future quarters. On the pet side, there's less obviously of a seasonal dynamic than Garden and in general there, I'd say good alignment between POS and sales. So I don't know JD or John, if there's any builds on that.

J.D. Walker
President-Garden Consumer Products, Central Garden & Pet Co.

A

I think you said it well, Tim, I'll just add a couple of comments. We said earlier in the script that the sales were up for Garden 34% for the quarter. Our POS metric is almost that exact same number. So it's tracking very closely. We're not significantly building inventory, not in Q1, that is. And I think part of the reason for that was the timing of our Q1, our – that quarter ended on December 26, the day after Christmas, our facilities were closed that day. So retailers if they were going to really aggressively build inventory would have had to ship well before Christmas in order for it to hit their stores. And that just wasn't the case, so we saw a lot of replenishment in Q1, but not aggressive inventory building until after the holiday and that extended – that really accelerated during the month of January.

Karru Martinson
Analyst, Jefferies

Q

Okay. Thank you.

J.D. Walker
President-Garden Consumer Products, Central Garden & Pet Co.

A

I will turn it over to John.

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

A

Yeah. On the Pet side, as Tim stated, our POS and shipment trends were very consistent. So we feel very good about how we ended the quarter and coming into Q2, relatively clean. So very good about it.

Karru Martinson
Analyst, Jefferies

Q

Now when you guys talked about investing in the business, expanding the line and adding incremental capacity, what magnitude are we looking at in terms of CapEx for this year? How much of it is kind of growing into this growth capacity and how should we kind of flow that through the year for our models?

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

A

This is Niko, yeah, we guided in our last call that we will be doing about $70 million to $80 million of CapEx on the year. And then the way to think about it, our maintenance CapEx tends to be kind of mid-20s all the way up to $30 million a year, so the rest of it would be very much growth and capacity-driven.

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

A

And that that incremental number that Niko references, up to that $70 million, $80 million, that's very important for us, I think you've heard us talk over the last couple of quarters, I said it earlier on the call that our service levels are challenged and so the disproportionate amount of that incremental CapEx is to build incremental capacity. That incremental capacity is both on the Garden and the Pet side across multiple business units and we expect that incremental capacity to begin to come online in the back half of this year and into 2022.

Karru Martinson
Analyst, Jefferies

Q

Just a point of clarification on that, while your capacity may have been challenged here and your service levels weren't quite optimal, it does sound like you're still gaining share in the industry and this may be a wider issue, is that the case?

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

A

Yes on both counts. So we are gaining market share in a number of key categories on the garden side, a wild bird and fertilizer would be a couple to reference. We're also gaining share in a number of pet categories, both brick-and-mortar and online. So and then I would affirm the second part of your comment, which is – it is quite common to industry right now. I think all of us in the garden and pet industry have been pleasantly surprised with the extent of the strength of the consumer demand and so that – the fact that our service levels are still somewhat challenged is not unique to Central Garden & Pet.

Karru Martinson
Analyst, Jefferies

Q

Thank you very much guys, appreciate it.

Operator: Our next question comes from Bill Chappell with Truist. Please state your question.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Thanks. Good afternoon.

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

A

Hey, Bill.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Hey, I guess, first – I know or I'm accustomed to your level of guidance, but maybe you could talk about on the top line, do you expect both businesses to post organic growth in fiscal 2021? It's – it doesn't. If I remember correctly, the comparison for the March quarter isn't as difficult just because I think things have kind of started off a little bit slower, retailers were somewhat closed in the early lockdowns and so the tougher comps are obviously the June and the September quarter, but just any color on do you expect organic growth from the two businesses in 2021.

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

A

Yeah, Bill, you're spot on. This Q2, we hadn't seen the real lift take off. So the tougher quarters are going to be June and September. As far as organic growth, yeah, the answer is yes. And I would refer back to our algorithm, where we intend to grow our organic business in that low single digit – at that low single digit rate. So that's our intent every year.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Okay. Great. Yeah, it's obviously an abnormal year or period, but that's good to hear. And staying on the acquisitions, can you at least give us a little more color just in terms of – I believe you've indicated that all three acquisitions are in kind of your target valuation range. But maybe were all three growing – in the past 12 months, were all three margin-accretive? And then any idea or help, if you could give us just on what D&A is expected to be from these three deals would be helpful. Thanks.

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

A

So, yes, on the first two. They were growing and they are going to be accretive in the long run. As far as D&A, we've got work to do on the purchase accounting side. So we're going to give a lot more information on that on the next call, given really we've only closed one of them in Q1 as well. So more to come.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

I guess an easy one, would the seed business – I'm sorry, I just escaped me. Would that be – because of the timing? Would that actually be less accretive this year in fiscal 2021? I mean, are you missing some of the normal seasonal profitability because it won't close until, let's say, March?

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

A

I think that's fair. Yeah, but – but again more to come we still need to look at all the ins and outs of the purchase accounting so there'll be you know a substantial inventory mark-up. And we know that this is their peak season. So yeah, there's a good chance of that happening.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Okay. And then last one for me just in terms of just general commodity outlook right now. There have been certainly some spikes in key commodities. I know your forebuy hedge a fair amount, but didn't – and price accordingly. Just didn't know if there's anything that's popped up in the past three months that's meaningfully changed your outlook.

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

A

Nothing major, Bill. I mean, it's labor, it's freight. It's particularly ocean freight. We saw some spikes in commodities and grain. So for the wild bird food business and that's where we've taken some price. And then on the Pet side, I would say foam – in our bedding business, we've seen a spike there as well. So that's kind of what we're dealing with. And then again we've got pricing set up to be taken throughout the year. But again we don't – we flew this first quarter with no pricing air cover, so to speak. So we've got some catching up to do.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Great. Thanks so much.

Operator: Thank you. Our next question comes from William Reuter with Bank of America. Please state your question.

William Michael Reuter
Analyst, BofA Securities, Inc.

Q

Good afternoon. Following up on the previous question, is it possible to provide a total aggregate inflation number that you're seeing across your portfolio? And then you mentioned that you have pricing coming in across Pet. I guess it sounds like there's going to be a little margin pressure, how much of – how much increase in your own prices do you expect across the portfolio.

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

A

It's hard to call because we see acute pricing pressure in certain areas. And so in Wild Bird for instance, it's going to be a little more aggressive whereas in some of the other businesses, it'll be muted. But we will be taking prices. So we haven't pulled together the business at large. But what I would tell you, it's very kind of business-specific in terms of the timing as well as the magnitude of the pricing.

William Michael Reuter
Analyst, BofA Securities, Inc.

Q

Okay. And then Karru's first question, where you guys helpfully shared that POS was aligned with your sell-in. Is there any way to think about what dollar amount of sales you think may have shifted from 2Q into 1Q, I guess, really on the Garden side?

J.D. Walker
President-Garden Consumer Products, Central Garden & Pet Co.

A

I think that's a difficult – it's difficult for us to assess that. I will – as I said, sell-in was tracking very closely to consumption. So a lot of that was replenishment in Q1. There may have been a little pull forward, but it's relatively low number. Most of the inventory build that we saw for the season started after the holidays and as I mentioned earlier, really accelerated during the month of January. But I think our pull forward into Q1 was minimal.

William Michael Reuter
Analyst, BofA Securities, Inc.

Q

Okay. And then lastly for me, you just completed or I guess you completed one acquisition you have two more that are going to get done here shortly, you're still well below your leverage targets of 3 to 3.5 times. I guess will you continue to evaluate additional M&A this year or do you think that you want to focus on integration of these before you add other businesses?

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

A

Yeah, certainly priority one now is the successful integration and the continued delivery of our three new family members, two of which are closed, as you said, only one impacted Q1, one in Q2 and then the other is pending closing and that one is Green Garden. So that's clearly priority one. Having said that, no, we are not putting our pencils down on the M&A or corporate development desk as you referenced. We continue to have firepower on the balance sheet for other deals and we continue to have an acquisitive appetite in both garden and pet. You would also know that in the in the world of acquisitions, you can never time things perfectly. So we're going to continue to be out there, looking at options and if there's an opportunistic move later this year that meets our criteria and meets the thresholds, we won't be opposed to pursuing it.

William Michael Reuter
Analyst, BofA Securities, Inc.

Q

Great, I'll pass to others. Thank you.

Operator: Our next question comes from Jim Chartier with Monness Crespi & Hardt. Please state your question.

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

Q

Good evening. Thanks for taking my questions. First, I think last quarter, you expected first quarter EPS on a GAAP basis to be below last year and you guys came in meaningfully better than that. So just curious what drove the upside in first quarter versus your expectation.

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

A

Well, it's largely volume-driven. We had tremendous volumes. If you look at the growth rates in both Pet and Garden, we didn't anticipate having that strong a volume. And then the other bits and pieces would be fairly favorable mix. And then if you look at the SG&A, it was, as a percent of sales, was down once again, largely driven to the volume that we got. And we just were able to gain these operating leverage as the quarter progressed. So I would just say we're continuously surprised by the high engagement of the consumer and it just continues on. As JD and John have mentioned, it's well into January as well; so very, very pleased with the results.

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

Q

Okay. So it sounds like...

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

A

You think about it, I mean Pet grew 19%. Those are incredible numbers. You would know from spending a lot of time in this industry. And then you look at Garden at 34% growth. That one in particular I think, to Niko's point, was even more robust than we had anticipated.

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

Q

Okay. So it just sounds like there wasn't a ton of pull forward in terms of sales and sales were much better than expected. But you guys are kind of maintaining your guidance for the year just to be more on the conservative side. Is that kind of the right way to characterize it then?

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

A

Yeah. And remember Jim, this is a small quarter for us, it's about Q2 and Q3 in this business, particularly on the Garden side, of course uncertainty as it relates to COVID and how that dynamic plays out in balance of year. So since it's a small quarter, we think that's most prudent and obviously after Q2, we'll be back and share any new outlook if appropriate.

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

Q

Okay. And then another question, you talked about the investments to expand capacity. Can you give us a sense of how much sales you might have lost last year due to these capacity constraints that you plan to expand this year?

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

A

Yeah I mean, always hard to exactly pin it down, right, because when you think about customer service level and case fill rate, often kind of reorders are exaggerated when you fall short of delivery. But I would say certainly it's in the probably low tens of millions type of number across the entire enterprise in the back half of last year.

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

Q

Great, thanks and best of luck for the rest of the year.

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

A

Thank you.

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

A

Thanks Jim.

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

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Hi, good afternoon. Congratulations on a great start to the year. My first question was around some of these acquisitions, particularly with Green Garden being I think the biggest deal the company has ever done. And the question we get asked is really for more color around the synergies and how you're going to leverage bringing in these three businesses in the Garden category at the same time and then for two, as you think about the strength that you have been seeing in the industry and the business in 4Q and 1Q, how you make sure you're not sort of overpaying at a time that the industry is seeing so much strength? Thanks so much.

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

A

Yeah, well, look, obviously we're bullish and we're confident on all three of the acquisitions. They fit such a nice complementary role to our overall garden footprint. One, obviously building significant digital capabilities in direct to consumer, pick pack-and-ship fulfillment capability and a key controls category, one, extending our live goods and live plants leadership from mid-Atlantic to Northeast and adding a few other classes and then the big one, as you say, the biggest of the three is Green Garden which has yet to formally close, but adds a really important adjacency in seed packets and seed starters to the garden portfolio.

We feel great about the management teams in all three cases. You reference synergies. There are definitely opportunities for synergies, but first and foremost, we buy businesses with a business proposition and a return expectation that can largely be achieved without those and then on top, synergies allow us to generate an even higher return. We feel good about the outlook on these businesses. To your point, I think you raised a fair question, which obviously is one we ask ourselves, Niko, myself, J.D. and the boardroom around ensuring we don't overpay. I think we're a very disciplined buyer. We certainly took into account as much as possible what we think may or may not have been the COVID bump. And of course running $1 billion plus garden business, we have a good sense of what COVID did and did not do to our business and what the sustainable growth potential is. So we were able to extrapolate that as well, for example, onto the Green Garden business. But we're bullish on that one, a strong leadership position, talented management team, very strong fit to J.D. Walker's business down there in garden and we're confident we'll generate a strong return.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Really helpful. Thank you, Tim. And Niko, if I could ask one of you and Tim may want to chime in here as well. How to think about spending plans and flow through for this year because it does seem you're off to a fantastic start. Depending on how long these COVID dynamics last or what recovery looks like, there really seems to be a pretty wide range of outcomes of how sales could unfold here this year. So if there's any more color you can share about how to think of how much you might decide to flow to the bottom line if the sales continue to be strong versus perhaps where you might be able to reduce expenses if they do so to a greater degree, anymore color on [indiscernible] (00:46:47) flow through would be helpful. Thanks.

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

A

Yeah. We think about that all the time. And the way to – the way we're thinking about it at least is we've got to meet the customers' needs first of all. And we're not happy with those service levels. So we've got to get those up into the high 90s, which is what we're accustomed to. Once we're able to do that, then we can talk about investing and driving even additional growth. As we outlined in our Vision 2025 strategy, which is the virtuous cycle of re-investing for even more growth and expanding those margins. I think we're pretty firm on the CapEx as far as that investment goes across the year. You can see Q1 got started off very, very strong, doubling up what we did a year ago. I would look for more on that. And we just feel very bullish and good about the company, where we're headed, market share. And that's why you're seeing that strong commitment on the CapEx side. I think the variable side, the marketing piece, we're going to wait and see. We need to get our baseline fill rates up and then make some moves there on investing.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Very helpful. Thank you so much.

Operator: Thank you. Our next question comes from Andrea Teixeira with JPMorgan. Please state your question.

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

Thank you. I hope all is well, so congrats on the numbers. My question is, if there is a lot of uncertainty that you mentioned in guidance, so in order to understand a bit of your reinvestment in capabilities and capacity, perhaps if you can elaborate more on what are you investing outside of capacity that would bridge us to a very conservative margin guidance, if I understand it correctly. And as you talk about raw material price increases and freight costs, can you let us know the cadence of that increase that you're seeing? Is it going to be fully when you're going to be lapping part of this freight cost and if you can comment on what you've had in terms of freight cost increases in this quarter? Thank you.

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

A

Maybe, I'll start and Niko, you jump in. First in terms of – the first part of your question was around investing in both capacity and capability. And indeed, I think earlier on the call, we've highlighted the capacity investment that again is on both the Garden and the Pet side and it's critical to ensure we service our customers, as Niko just mentioned. On the capability side, we are making further investments in kind of the growth consumer-oriented space. So this would be continued investment in e-commerce whereas we shared earlier in the call, we had another very strong quarter of e-commerce on the Pet side, where that is now 20% of branded consumer pet sales and we're seeing very strong kind of 40-plus percent, 40%, 50% type growth on the pet side. And then on the garden side, while underdeveloped, we're seeing continued triple-digit growth on garden e-commerce.

Continued investment in e-commerce in people, in the team, in content development, in servicing and in fulfillment, as well investing in areas like brand building, which you will see more of this year and a couple of our flagship brands on the garden side as well as on the pet side. There'll be more investment in marketing against our power brands. We're dialing up our innovation agenda here in this company and we've got some good innovation for this year. We expect even better going into 2022 and 2023 and as you would know, you need to invest early in that innovation funnel for it to bear fruit in future years and we're doing that both on John and J.D.'s business, both Pet and Garden. Digital marketing is another area. So we are taking the opportunity consistent with that strategy to invest proactively in the growth agenda in more of those consumer-facing capabilities as well as capacity.

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

Yeah. That's helpful. Sorry, go ahead.

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

A

I was just going to add in terms of increases in cost, freight, particularly ocean freight continues to go up. We're not quite sure what we're going to lap it. I think as you look at the world and the supply chain of the world coming out of Asia and China, that's where the ocean freight is particularly acute. And we just don't have a sense yet of when that's going to slow down. So we're still trying to figure that out in terms of when we would lap that.

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

And one last question if I may on the household penetration. You said like you obviously have a good sense of how much your household penetration is and you gave that information on the Analyst Day. But like how sustainable and you mentioned a moment ago that you have a good sense of the impact of COVID in Pet and Gardening. And I think that obviously hopefully that's going to be sustainable as you adopt a new pet. And there is a line of new pet – pet owners to adopt more. But in terms of the gardening, you have a sense of the new household, how you're going to keep those and retain those consumers? Like how sustainable that can be as you lap COVID?

J.D. Walker
President-Garden Consumer Products, Central Garden & Pet Co.

A

Yes, Andrea. This is JD, I'll take the question. It is in terms of how sustainable it is, I think that that's yet to be determined really. And what we saw was a 5.5% increase in household penetration, roughly 8 million new households participating in our categories, which is fantastic and we've seen them continue to remain engaged beyond last year into Q1 of this year and the signs are that they are going to continue to be engaged. So we feel good about that. I think one of the reasons why we have had some – a conservative outlook on the latter half of the year is we just don't know how sticky that will be. So as the vaccine starts to spread across the country, as people start to get more comfortable with maybe doing other things away from the home, we'll see how many people remain engaged in our categories. But I don't think that's going to go back to zero. That number will still be something most likely above the normal run rate that we saw historically.

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

That makes sense. Thank you. I'll pass it on.

Operator: Thank you. And our final question...

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

A

Maybe time for one more question please.

Operator: Certainly, our final question comes from Sarah Clarke with JPMorgan. Please state your question.

Sarah Clarke
Analyst, JPMorgan Chase & Co.

Q

Hi, thanks for taking my question. How much of your business today is the distribution business and where do you see that going?

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

A

It's roughly about 20% of the business in total across the two segments. It's an important part of both Garden and Pet. It is obviously a lower margin business than our branded business. But it does afford us a number of advantages in terms of strengthening the partnership with key customers who benefit from us, not only as a branded manufacturer, but also a distributor. It gives us quite a bit of intelligence on the broader industry because we're not only working with our own products, but many of our competitive products. And that allows us to keep a pulse on the industry, what's growing, what's not, what are customers looking for, et cetera. So, a good business, above 20%, but obviously a lower margin business than our branded business and good growth I would say, finally, it's growing very nicely on both the Garden and the Pet side.

Sarah Clarke
Analyst, JPMorgan Chase & Co.

Q

Got it. That's really helpful, thank you.

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

Thank you. Thank you very much for joining this Q1 earnings call. We appreciate your time and your interest in Central Garden and Pet. We encourage everyone to stay safe. We look forward to talking to you again next quarter and if you have any questions, feel free to follow up with our Investor Relations team, thank you.

Operator: Thank you, all parties may disconnect. Have a good day.