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Joe Altobello: Well, good afternoon, everyone. Thank you for joining us. I'm Joe Altobello, equity research analyst here at Raymond James, covering the household personal care and leisure sectors. Our next presentation of the day and the final one will be Central Garden & Pet. As the name would indicate, Central plays in two healthy and growing categories, mainly lawn and garden and pet supplies. The company actually started out a few decades ago, largely as a distributor, but has evolved over time into primarily a branded manufacturer in a number of areas, including fertilizer, grass seed, aquatics, and dog and cat, just to name a few.

We are very pleased to have with us today, Central CFO, Niko Lahanas, as well as the Vice President of Investor Relations, Friederike Edelmann. We should have some time at the end of our chat for audience questions as well, which you can submit electronically via Open-Xchange through the chat icon in the upper left of your screen. So, to begin, for the benefit of those in the audience that don't know the story very well, Niko, if you wouldn't mind, could you give us an overview of the industries that you play in, their size, their growth rates, for example, as well as your areas of focus and some of your key brands?

Niko Lahanas: Sure. I'd be happy to, Joe. Thanks for having us here today. Very, very exciting. Yeah. So, as Joe mentioned, as the name implies, we're in the pet and garden categories. They're very different. So if you look at pet, I'll start off with pet, it's a rather fragmented category. It's valued at about over a hundred billion when you look at pet. We play in $28 billion of that hundred billion, and we play in what's called the supplies area of pet. So, non-food, non-services, and we're not in kitty litter either. So, really, just $28 billion of that hundred billion. When you think of our company, our leading brands are Nylabone, which is in the dog treat and chew category, Kaytee, which plays in the avian and small animal category, Four Paws, which is also dog and cat, Zilla, Comfort Zone, and Aqueon, which as the name suggests is a leading fish tank and aquatics brand. Really two great categories. We're very excited to be in them. Great consumer tailwinds.

As you think of pet, the tailwind is a little stronger, so in that 4% annual growth rate, which is inclusive of all the categories that I mentioned. So that includes services, as well as that vet and food and just a great tailwind in terms of the humanization of animals, we see that going on, as well as just incredible household penetration recently. I'll get into that a little bit later when we talk in terms of COVID and what's happening recently with the company. So very fragmented when you look at that pet category. I would also say strong e-commerce presence there too. So, a few years ago, very much disrupted by e-comm. The overall sales of pet are north of 20% in e-comm. So very, very different than garden.

I'll switch over to garden. As we think about garden, it is much more consolidated. So you've got a really large customer base in Depot, Lowe's, Walmart. They're anywhere from 65 to 75% of the category. You also have a concentrated set of vendors or competitors for us in Scotts and Spectrum. So very different there. The category is roughly 33 billion. We play in 30 billion of the 33 billion, largely in the consumables. Just like pet, we like consumables as opposed to durables. The growth rate is a little more muted. So think of the growth rate as growing with households, so in that one to 2%. Although, recently, it's grown a little more dramatically and we can get into that a little bit later.

As you think of our business, we're in grass seed, fertilizer, controls. When you think of our brands, Pennington is what we call our growing brand. So that's a fertilizer, as well as grass seed. And then we have Sevin and the Amdro which are killing brands, which kill, pesticides and such. So, again, we've also seen a nice tailwind there as well in terms of garden with a lot more participants entering the category in the last year.

Joe Altobello: That's very helpful. Now, Niko, you're in an interesting situation because you've been at Central for a fairly long time, about 15 years, I believe. So it gives you a really good perspective, I think, on how the company has really evolved over time. How would you compare the Central of today versus let's call it five or 10 years ago? In particular, what changes has current CEO, Tim Cofer, brought with the organization since he joined, I guess, about a year and a half ago now?

Niko Lahanas: Yeah, it's been an interesting ride, for sure, over 15 years. I would say Tim coming into the CEO seat, it's been, I would say, an evolution as opposed to a revolution. George Roeth did a great job of really setting the company up with a strategy, which we really hadn't had that discipline before. But I would say Tim differentiates himself with a very strong consumer orientation. He came to us from Mondelez. He was the chief growth officer there. So, consumer orientation, he has a very strong brand building agenda. He wants to innovate and then he really wants to drive e-comm and digital as well. And those are all the things he was in charge of as chief growth officer over in Mondelez.

The other thing too, and George and I shared this perspective as well is as it pertains to M&A, we've historically been hardcore value type buyers. I think we want to evolve that a little bit and really go after businesses that have maybe a stronger brand awareness, a better growth margin profile, a higher growth rate. We do expect to pay higher multiples for those, but something that's going to be more accretive to the portfolio than we've done, say, in the last eight years, and I think you've seen that with the last three deals we've done, all being fairly accretive there.

Joe Altobello: So if you look at your portfolio, lawn and garden on one hand, pet supplies on the other, what is it about those businesses that benefit from being under one roof? I guess, what synergies do you derive from that corporate structure?

Niko Lahanas: Great question. We get asked that a lot.

Joe Altobello: Sure.

Niko Lahanas: Just a matter of background, the company really started in garden distribution. As everybody knows, garden is a highly seasonal business. You do the bulk of your revenue in six months. So, being a distributor, we got into pet distribution to smoothen that seasonality out. So, really, that was one of the key drivers. But as far as synergies, we're really just scratching the surface there. On the pet side, we've got a life science business that has a lot of active ingredients. Taking those active ingredients and now putting those into garden pesticide products is an area that we're working on, which has yielded some nice results. Additionally, we do have some businesses that straddle both segments. An example would be wild bird. So we've got Kaytee on the pet side as a wild bird business, and then our Pennington brand on the garden side. We're able to really align for scale deal in terms of how we buy grains, packaging, corrugated, things of that nature. So, really early stages, Joe, as far as finding those synergies, but we really think that the harder we look, we're finding more and more there as we move forward.

Joe Altobello: Because the customer base, the retail base is fairly different, right? I mean, between lawn and garden and pet supplies.

Niko Lahanas: It is. We've got one big customer where we ship both products, and that's Walmart. But yeah, you're right. The garden business is largely in the home centers. And then you've got pet, which is pet specialty, e-comm, and food, drug, mass.

Joe Altobello: Mm-hmm (affirmative). So on the garden side, you mentioned that it's pretty concentrated from a distribution standpoint. Obviously, last year, very strong year, somewhat COVID-related. How were your retailers thinking about the category this year going into the spring?

Niko Lahanas: They're bullish, and they signaled that to us very early on. They were going to buy bigger and sooner than before. I think our Q1 reflects that. Some of our competitors numbers reflect that as well. So they're gearing up for a big, big garden season. So, very bullish. We've got to make sure that we're able to fulfill that demand and be a great partner there.

Joe Altobello: I get this question a lot, but obviously you've had a number of new customers come into the garden category last year, simply because they were at home during April and May. The Depot, Lowe's and Walmart were open. They have a $1,200 check in their hand, right? You're looking out their window at the door. So, it was the perfect storm. So I'm curious how you think about those additional customers that you gained last year? Do you feel like you're going to keep most of them, or do we go back to a pre-COVID level at some point?

Niko Lahanas: Joe, I don't think we're going to go back to 2019 levels. What we saw in garden, which was really interesting, the existing consumer was buying more. So that was lifting up consumption. And then to your point, we had a number of new entrance into the category and they were younger, which was really encouraging. While feeding wild birds is a hobby enjoyed by an older population, what we saw for the first time in 2020 was millennials getting into it, younger folks entering the hobby, which was really encouraging, and we haven't seen a drop-off this year. So, we're fairly optimistic. I think there will be some give back, but I don't think we're going to go back to '19 for a number of reasons. I think there are some real trends that are happening that go above and beyond pets that are real tailwinds for those two categories.

One of which is you're seeing a lot of folks leaving the urban centers, going to more suburban areas. The housing market is red hot. You're seeing millennials buying houses that invariably have yards. And so, they're going to want to beautify those homes, the outdoors as well, and stay in the hobby. And then, of course, we've seen 4% penetration with live animals. And so, that's encouraging, and that's also a big commitment when you have that live creature now that you have to take care of. So, we're very encouraged. Also, just work from home, right? So, we feel a lot of companies are going to allow their employees to work from home a number of days a week. When you work from home, you're going to do more work outdoors. You're going to feed your pet more treats. There's more going on in the home, and we feel like that that's a really big macro trend that favors our categories.

Joe Altobello: Mm-hmm (affirmative). So just switching over for a second to the pet side, the retail landscape is quite different and it's changed a lot over time, particularly among independents and specialty retailers. So maybe talk about what's going on in that segment from a retail standpoint, how things have evolved and where it stands today.

Niko Lahanas: Sure. So, as I mentioned earlier, pet was really disrupted a few years ago by e-comm. So if you go back five, six years, it was Petco, PetSmart. Really, they had dominant positions in the pet industry, and then you had that independent channel. And then you had food, drug, mass, where you could buy pet products, but they typically were lower end type of pet products. Chewy and Amazon have come in and really disrupted the pet channel, and we've seen that migration to e-comm in a very dramatic way. What these brick and mortar folks have had to do is really try to differentiate themselves from e-comm. The way they do that is really live animals and creating that theater type atmosphere in the stores, where consumers can go in. They can view animals. They can even handle the animal before they buy it, and really creating a deeper experience for the consumer.

But largely we think e-comm is here to stay. You're even seeing a lot of the independent type of retailers embrace e-comm now via Shopify or Amazon marketplace. During the pandemic, we saw some very interesting things happen where the big e-comm players were not able to fulfill the orders because simply too much demand. Folks got frustrated. They went to their neighborhood pet store, and those stores began delivering directly to people's homes. So, where there's a will, there's a way, and we think there's still a place though for that independent channel, particularly the ones that really specialize in either reptile, aquatics for the real intense hobbyist that want that consultative selling experience, where you go in there and you're just getting great service and great intelligence around that hobby. We think there'll always be a place for that. And you're always going to buy those live animals in brick and mortar. So, we think that that will continue to exist going forward.

Joe Altobello: So do you feel like there'll be more stability on the pet retail side than there has been at least in recent years going forward?

Niko Lahanas: Yeah, I think so, Joe. I think it's going to reach a point of equilibrium. I do believe e-comm will continue to grow. What you see in e-comm is a lot of food being bought in that channel, just because food is bulky and hard to handle. A lot of times, it's the woman of the house that's buying the food. No one wants to carry a 30-pound bag of dog food to the car. So, the convenience factor is massive with e-comm. And you're seeing the subscription model really take off as well. I think when you look at Chewy, they're approaching around 70% that's on subscription. So the convenience factor is there, but I think, again, if you want that extra service level, you're going to go into the store.

Joe Altobello: Mm-hmm (affirmative). So shifting gears a little bit on the competitive landscape, we actually have a couple of your competitors here at the conference. Scotts presented yesterday. Spectrum Brands is tomorrow. So maybe give us a thought, a little bit of, I guess, a thumbnail sketch of who you compete against and what categories, what brands primarily.

Niko Lahanas: Sure. Yeah. We were always compared to Scotts and Spectrum. In many cases, we have to reiterate that we really don't compete in that many categories head to head with, say, Scotts. If you look at their portfolio and ours, they're very different. We're highly indexed in wild bird food. They no longer have a wild bird food business. They're really big in growing media with Miracle-Gro and Mulch. We're very, very under index there as well. So there are a lot of puts and takes there. I think where we go head to head most with them would be in grass seed and in the premium. In that premium segment of the grass seed, a market is where we really go head to head. But they're a great competitor and a great company. They make the garden segment that much better by being in it, because they make us be better. As far as Spec, they're very focused. I give them a lot of credit. They've decided they want to be in controls, in liquid controls and that's sort of their core focus area. So that's where we primarily compete with Spectrum, is in that controls category.

Joe Altobello: Now, in terms of the pet side, is the competitive landscape as fragmented as the retail landscape is?

Niko Lahanas: It is. It is. Spectrum being the other big player in pet, we compete against them in dog treats, also in aquatics. I think our portfolio might be a little bit broader as far as breadth, but then we have different competitors depending on the category. So, we'll have a different competitor in reptile as opposed to small animal. And so, you have a very fragmented situation there in pet as well.

Joe Altobello: Right. Gotcha. From an advertising perspective, I know Scotts obviously has always spent a lot of money on advertising. Can you talk about your advertising strategy? I don't think you guys invest as much on the advertising side. I'm curious how you think about that going forward. Do you see your advertising budget going higher or is it still more of a push strategy versus a pull strategy?

Niko Lahanas: No, I think that's one of the things Tim brought to the table, is we want to have more of a branded approach. And so, we do want to invest in our brands. I think you'll see that increase. We're going to be very selective of where we do that, very strategic. And that's going to be a slow transition, where you're going to see that marketing expense increase. In the past, we've largely been promotional, as you know, really working at the point of sale, trying to intercept that consumer at the store level, and really having that challenger brand. We're going to continue to do that, but I think look for us to ramp up that investment on the marketing and brand building side. I think areas where we want to lean in are going to be in the digital marketing side as well. And then, of course, you want to invest in innovation to bring new and fresh ideas to the category.

Joe Altobello: Is that Tim's background in CPG showing in terms of the increase in advertising?

Niko Lahanas: Absolutely. Absolutely. I mean, chief growth officer coming in from Mondelez, so those were big levers for them. He's very much into creating the virtuous cycle flywheel where you take that cost out and then reinvest it in demand creation, and that includes brand-building, e-comm, things like that.

Joe Altobello: So roughly, how much of your advertising today is digital?

Niko Lahanas: Oh, it's over half, I would say. Yeah.

Joe Altobello: Okay. So I want to ask about your fiscal '21 guidance, in particular, the adjusted EPS outlook, at least $2.09. You did $2.26 last year. Now, it sounds like you've got some investments that are weighing on that number, which we could talk about in terms of things like capacity, expansion, brand building and e-commerce, obviously, as well as some pressures from headwinds, supply chain, freight, materials costs, things like that. So, help us better understand those margin dynamics and why you're expecting to see that big drop off in earnings.

Niko Lahanas: Well, a lot of it is really uncertainty, in the second half of the year, lapping a really big comp. We've never seen that growth in the second half of the year. The other part was we're lapping also really favorable weather in '20. So we still have yet to see how the garden season plays out in '21. But I can tell you, '20 was an absolutely fabulous weather year for our garden business. So, those are all sort of risks. The other piece of it was COVID, the consumer, the availability of the vaccine and how that consumer going to react once they're vaccinated. Are they going to go to Disneyland or are they going to go to Hawaii? We just don't have answers to those questions.

And then as you look at '20, there wasn't a ton of promotional spend going on because we couldn't meet the orders that were being placed anyway, so we weren't going to promote. I would tell you, a lot of the retailers weren't promoting either because they didn't want to be driving traffic into their stores. It was a safety issue. So, promotion, I believe in '20 overall was fairly muted and we think that that's going to come into play again as the vaccine becomes a little more distributed and we get a little bit more back to normal. So, all those things played into us thinking, "Geez, let's be smart about this."
That said, we've really gotten off to a great start in Q1, but it's a small quarter and it's really hard to really prognosticate what the year is going to do based off our Q1. I think we're going to know more when we report Q2. We'll have a little more line of sight into that quarter. We'll give a little more of an update on the acquisitions we did. So, I think there's more to come there, Joe, but I think initially we wanted to stay a little conservative.

Joe Altobello: Gotcha. Okay. So we talked about the increase in advertising that you expect to happen. Putting that aside, what are the big margin drivers for you guys over the next few years?

Niko Lahanas: Well, our dog and cat business is growing, one of our fastest growing businesses and one of our highest margin businesses. I think some of the acquisitions we just did are going to be driving quite a bit of margin. Our grass seed business continues to drive more margin as we take cost out of that business. And then I think overall, just as a company, we want to take costs out every year. Half of that will get dropped to the bottom line to expand margin, and then the other half of those cost savings are going to be reinvested in the demand creation to continue to drive that growth and take market share. And so, I think once we get that virtuous cycle going, where you've got cost savings programs that go out three years, you can feel pretty confident that you can year after year take that cost out and continue to expand margin.

Joe Altobello: Right. Right. I just want to go back to e-commerce for a second. I should have asked this earlier. It sounds like what you said earlier, Niko, that your penetration on the garden side is fairly small just because of the category, but it's fairly big in pet. Could you remind us again how big that penetration is for your pet business online?

Niko Lahanas: Sure. Our pet business is running at right around 20% in e-comm. Just to be clear, that's not direct to consumer. We don't really have a large direct to consumer. That's us selling into a Chewy and Amazon and other e-comm players.

Joe Altobello: Walmart.com, for example, is countering that number.

Niko Lahanas: Yeah.

Joe Altobello: Okay.

Niko Lahanas: Exactly. Exactly.

Joe Altobello: Got it. And as we think about your margins online versus brick and mortar, are they fairly similar or do you have a preference?

Niko Lahanas: Well, they're actually a little better, but I have to caveat that. We're very thoughtful about what we sell online. So it tends to be the higher margin product. We want to sell products that are lower in cube, higher value so that we make money and the retailers making money. So, it's quite intentional. It's sort of a self-fulfilling prophecy. We planned it that way so that the higher margin products are going through there. So it's not like we're getting favorable pricing in that channel or any other benefit. It's really more a driver of a result of mix, if you will.

Joe Altobello: Okay. That's helpful.

Niko Lahanas: Yeah.

Joe Altobello: So the last topic I wanted to discuss in the time we had had left here is capital allocation. As long as I can remember, M&A has been a big part of the Central story. In fact, if I'm not mistaken, I think you've completed 50 or so acquisitions over the past 25 years, which with math, about two a year, with the most recent being, obviously, the addition of Green Garden Products, just a couple of weeks ago, in fact. So first off, where does your leverage stand pro forma post that deal?

Niko Lahanas: Our leverage pro forma post that deal is right around three, two nine, three-ish. We're comfortable with that range. It's in the three to three and a half and we feel very good about that. In the future, if we see other deals and we've said this many times, we'd be willing to lean in to as high as four and then quickly deliver back to that three, three and a half range.

Joe Altobello: Okay. And so, with that in mind, how would you rank your priorities in terms of cash deployment? Is it debt reduction? Is it share repurchases? Is it more M&A? In terms of that next dollar, where is the best place to put it?

Niko Lahanas: I think right now we're very focused on internal investments and M&A. Our service levels still aren't where they need to be. We've got to expand capacity. We've got some businesses that are really growing and we have to address those needs. We can't think of a better way to invest than in those businesses. And then the other part is M&A, we want to continue to be aggressive and do deals and maybe look over on the pet side for some deals, since we just did three garden deals. So, I would say stock buybacks, we still have shelf with our board authorized buyback program there, but I would put that below the two I'd mentioned earlier. So, not the highest nail right now.

Joe Altobello: Okay. Gotcha. So in terms of potential acquisitions, what do you typically look for in a target? Do you have a preference? You mentioned you've done three garden acquisitions in a row. Do you have a preference between garden and pet or that's just how things shook out?

Niko Lahanas: No, we love both the categories. A lot of folks have been asking us, "Are you going to become a garden company now?" because we did three garden deals. The answer is no. It just happened that those were the ones that we liked and the timing was right. They were just great deals. But as far as what we look for, we look for value, first of all. Like everybody, we're value buyers of growth companies. So, that's going to be the first thing. Strong management teams, we typically like the management team to come with the acquisition. So, we're looking for that. Cultural fit, so we want to make sure that management team's going to fit our culture here. We're very entrepreneurial at heart so we look for fit. And then all the other things that you look for in a business. You want to see a good barrier to entry or a barrier of entry, a nice moat, some IP. So, all of those things we would look for.

And then also, if we're in that category that we like, we like that category, we want to grow the category. We'll look for adjacencies as well. Green Garden is a perfect example of that. It's in the seed business. We weren't in the veggie or flower seed business, but we're in garden. And that business sits in the garden segment of the store right across the aisle from our other products, and now we can reap synergies around merchandising and sales. Our merchandisers are already in that store and they can merchandise those shelves as well. And then if you look at DMO, which was a direct-to-consumer play, that's the capability. And so, we'll look for that as well. We look for capabilities with acquisitions, and we want to accelerate our e-comm agenda, our digital capabilities. We think DoMyOwn brings a lot of great stuff to the table that we can distribute across Central some of those capabilities. So, really, those are the things we look for when we're doing M&A.

Joe Altobello: That's helpful. So, it sounds like your balance sheet's in good shape. You still have an acquisition or an appetite for more deals. What does the acquisition market look like at this point in terms of the number of assets that are available, the quality of assets that are available, and maybe their valuation?

Niko Lahanas: Yeah. We still have a very active pipeline. What we're seeing is both pet and garden. We're not seeing great pet assets out there right now, just because I think business is so good that there's a real value capture going on in a lot of these businesses and we'll probably see more come to market in '22, I would imagine. But the valuations are still high because the market is high and everything follows the public market. So, you're seeing higher multiples, particularly for good assets. If you want an asset that has a great brand, a great margin profile, a good growth, you're going to have to pay for that. And then I would say size, size really makes a difference. So once you get over 150 million in sales, you're going to pay for that scale with a higher multiple. So, that's sort of what we're seeing.

Joe Altobello: So the last one for me, it's a two-part question. Where do you typically source your acquisitions? Is it usually family-owned businesses? Is it private equity-owned businesses? And who do you typically compete against when you bid for those assets?

Niko Lahanas: Great question. We source from everywhere. So, we're pretty resourceful. Believe it or not, we use our distribution businesses. We look at some of the third-party products that we distribute and that can be a nice fertile ground to find acquisitions. Investment banks bring us deals. We also have our own scouts that are out in the field and can many times bring in deals. And then really we rely on a lot of our operators. So, we'll go to our operators and say, "Hey, who would you like to buy?" A lot of times, it's a competitor or an up and coming business. So, we have a number of channels where we're collecting a really good deal flow and pretty eclectic as well.

Joe Altobello: Okay. Is it mostly family-owned or is it private equity-owned or parts of larger corporation?

Niko Lahanas: No, I would say, Joe, historically, more entrepreneurial owner-led deals, but of recent, we've done a few private equity deals. So Bell Nursery, which we did back in 2018, was private equity-owned. The one you had just mentioned, Green Garden, was also private equity-owned. So we're starting to do more and more of those, but I think that's a smaller number. But as you know, a lot of these companies have sponsors. So, it's almost the rule numbers. You're going to have to buy them from private equity because there are so many private equity firms out there that have ownership in these companies, so it's been variable.

Joe Altobello: Who do you guys typically compete against when you're bidding for these assets? Is it other strategics? Is it private equity?

Niko Lahanas: Yeah, it's a little bit of both. In the Green Garden auction, we were the only strategic. I can tell you that we've been in auctions where we've been up against strategics, as well as private equity. So, it's a bit of a mixed bag and always competitive though.

Joe Altobello: No, absolutely. Well, that's all the questions I had. Let me check to see if the audience has any. It looks like there are none. So with that, Niko, Friederike, great to see both of you. Thank you for joining us today. Thanks to the audience for listening. Appreciate it. Enjoy the rest of the conference.

Niko Lahanas: Thank you, Joe. Our pleasure.