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Central Garden & Pet Co. (CENT)

Q4 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.

OTHER PARTICIPANTS

William B. Chappell
Analyst, Truist Securities, Inc.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

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

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Oliver Grossman
Analyst, Jefferies

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Central Garden & Pet's Fourth Quarter and Fiscal 2021 Earnings Call. My name is Diego, and I will be your conference operator for today. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to turn the call over to 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. 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 provide an update of our business and industry; and Niko will discuss our fourth quarter and fiscal year 2021 results and share our outlook for fiscal 2022. J.D. and John will join us after the prepared remarks for Q&A.

Our press release providing results for our fourth quarter and fiscal year ended September 25, 2021, and related materials are available on our website at ir.central.com and contain the GAAP to non-GAAP reconciliation for the non-GAAP measures discussed on this call. Lastly, unless otherwise stated, all growth comparisons made during this call are against the same period in the prior year.

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 fiscal 2022, expectations for new capital investments, product launches, and future acquisitions are forward-looking statements subject to risk 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 filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K, expected to be filed tomorrow. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events, or otherwise.

Now, I will turn the call over to our CEO, Tim Cofer. Tim?

Timothy P. Cofer

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

Thanks, Friederike, and good afternoon, everyone. Thank you for joining our Q4 and fiscal year 2021 earnings call today. I'd like to begin with some reflections on the company's performance for the fiscal year and the current state of our industries. Then, I'll turn it over to Niko, who will walk you through our financial results and our outlook for fiscal 2022 in more detail.

Before talking about our results, I want to recognize and think the more than 7,000 employees who make up Central Garden & Pet, fueled by our mission to lead the future of the Pet and Garden industries they have navigated the many challenges of the pandemic with perseverance. And thanks to their strong execution, Central delivered another record year. Thank you, team Central.

Fiscal 2021 net sales increased 23%, driven by organic growth in both segments and the contribution from four recent acquisitions. In addition to strong top line growth, we're pleased that our gross margin held largely in line with the prior year despite supply chain pressures and inflationary headwinds in commodities, freight, and labor. We were able to offset much of these pressures. Thanks to our pricing and productivity agendas.

Operating income increased 29% and despite rising costs and heightened investment spending, we improved our operating margin by 40 basis points. These results culminated in diluted earnings per share on a GAAP basis of $2.75, an increase of 25% versus the prior year. We're proud of the strong double-digit top line, bottom line, and EPS growth on top of our record 2020 performance.

This was the first full year of our teams focusing their efforts towards the Central to Home strategy. And while there is more work to be done to unlock our full potential, I'm encouraged by our early progress across all five of our strategic pillars. In support of our quest to build and grow brands consumers love, we've recently added new talent to our Pet and Garden consumer insights, e-commerce, brand marketing, and innovation teams. In addition to making significant investments to bolster our long-term organic growth agenda, we recently held the company's first ever innovation summit. Leaders from across the organization came together to align on our innovation ambition, share best practices, and review multiyear innovation pipelines. These investments in people and capabilities will continue into 2022 to set us up for stronger organic growth.

We remain focused on strengthening our brand foundations and developing new content and creative campaigns across our key brands. Let me share two recent examples. On our Comfort Zone, Health and Wellness brand, we adjusted our digital consumer acquisition strategy, resulting in our highest sales to new consumers growing 270% versus Q3, as well as a 50% increase in our return on ad spend or ROAS. On our Kaytee, bird and small animal brand, we successfully launched the MyKaytee consumer rewards program to engage bird enthusiasts with the brand and offer access to exclusive rewards. In the first few weeks of the campaign, we experienced incredible consumer response and our digital engagement metrics well exceeded benchmarks.

Next, as we march toward our goal to win with winning customers and channels, as outlined in our customer pillar, we're proud to share that the Home Depot recently named Bell Nursery, the outdoor garden supplier of the year. For over 25 years, Bell has been supplying live plants and goods to the Home Depot. Today, Bell supplies more than 2,000 SKUs across 18 states. Bell currently maintains the second-largest greenhouse footprint in the United States with over 16 million square feet. We look forward to continuing to grow our relationship with the Home Depot for years to come.

Moving to the Central pillar of our strategy, in fiscal 2021, we proudly welcomed four businesses into the Central portfolio: Hopewell, Green Garden, DoMyOwn and D&D. Each of these acquisitions presents a unique opportunity and has positioned us for continued growth in core and adjacent Garden categories, while also adding new capabilities to our business. Importantly, all four acquisitions are delivering on our expectations. A noteworthy example of adding new capabilities via M&A comes from DoMyOwn, the online professional-grade pest control retailer we acquired last December.

In addition to acquiring DoMyOwn's profitable and growing direct-to-consumer e-commerce business, we envisioned bolstering Central's direct-to-consumer fulfillment capabilities with their proprietary backend system.

We recently completed the enhancement of our Garden distribution center at our Greenfield, Missouri campus with the automated pick, pack, and ship process utilized by DoMyOwn. We believe that this enhancement will increase our DTC shipment capacity by 300% at our Greenfield facility, and we're excited about the potential of leveraging DoMyOwn system in other Central facilities.

Our Central Ventures platform, which was launched to discover and nurture emerging businesses that are innovating and shaping the future of the Garden and Pet industries recently invested in three pet companies: Project Blu, an emerging leader in sustainable pet supplies, which utilizes recycled ocean plastic to manufacture a full range of premium pet accessories, including beds, collars, and leashes; Companion Labs, a company that uses machine learning, robotics, computer vision, and artificial intelligence to train dogs; and Finn Wellness, a provider of premium supplements for dogs that combine trusted research and modern wellness to support issues such as Calming, Hip & Joint, and Skin & Coat. We look forward to partnering with these promising companies on their growth journeys.

On to the fourth pillar, cost. In our efforts to reduce cost to improve margins and fuel growth, we continue to invest in automation to increase productivity and pursued opportunities to insource additional production to better leverage our fixed assets. Recent examples include automating the fiber cutting process in our Arden outdoor cushion business. In Aquatics, we further automated the assembly of our Aqueon fish tanks. And we brought the manufacturing of our Pennington Hummingbird Nectar in-house.

Additionally, to further our productivity agenda, we are investing in our supply chain capabilities. And earlier this year, we hired Aron Kolosik as our new Chief Supply Chain Officer. Prior to joining Central, Aron spent almost 25 years at Procter & Gamble, where he worked across multiple business units and categories, bringing a track record of delivering net productivity savings, fill rate improvements, innovation practices, and a safety-first mindset.

We're at the forefront of outlining long-term supply chain strategy that can leverage the scale of our leading Garden and Pet platforms, optimize our network and drive cost, quality, service, and safety excellence. We'll keep you updated on our plans going forward.

And finally, our culture pillar, which is dedicated to the passionate and resilient employees here at Central. In Q4, we refreshed our company values. Our values are the cornerstone of our culture. They're at the root of every decision we make. We call them the Central way. Created by leaders across the company, they comprise six simple values. We do the right thing. We strive to be the best. We are entrepreneurial. We win together. We grow every day and we are passionate. We believe having a strong set of values provides a foundation for employee engagement and strengthens how we all work together.

In addition to bringing many talented new hires into our management teams, we've also made some great additions to our board of directors. Over the last 12 months, we've added Brendan Dougher, Daniel Myers, and Courtnee Chun to our board of directors. And most recently, we were thrilled to welcome our third female board member, Lisa Coleman. Lisa brings deep expertise in human resources and leadership development to the role and we look forward to her active participation.

Now, to provide some color on our segment performance. As I mentioned at the beginning of the call, our industries have experienced two years of extraordinary growth. Consumers are more engaged in our categories than ever and this builds our confidence in our long-term growth potential. In Pet, net sales improved 13% in fiscal 2021, on top of the 13% growth we saw in the prior year, as we continue to see traction in long-term consumer trends such as humanization, premiumization, and health and wellness.

Since the beginning of COVID, about 35% of consumers have adopted a new pet, and almost half of these adoptions were driven by millennials and Gen Z. These younger generations are major influencers of the pet humanization trend, often spending more on their beloved pets than older demographics. In total, more than 4 million new households added pets to their family, an unprecedented pet boom that can be a category growth tailwind for years to come.

We launched several innovations across our Pet portfolio. For example, Zilla Micro Habitats, perfect for small reptiles and amphibians, they can be easily assembled when needed, then broken down and stored when not in use. Field+Forest by Kaytee, premium small animal food made with wholesome ingredients, each ingredient carefully curated from nature's fields and forests.

Nylabone Broth Bones, highly digestible, limited-ingredient dog treats crafted with real beef bone broth that is rich in amino acids. And Nylabone Easy-Hold chew toys, specifically designed with four paw grips that fit dogs' paws and allow for comfortable chewing from any angle. Also, a quick call-out to our equine business. I want to congratulate our Farnam brand on their 75th anniversary. Farnam is a leader in quality horse care products from grooming and supplements to wound care. We're proud that Farnam products gained share and I look forward to seeing how we take this brand into its next chapter.

As digital has penetrated all aspects of our lives and the pandemic has deepened consumer engagement online, we're excited about the progress we've made to enhance our digital capabilities. In fiscal 2021, our e-commerce business, including buy online, pick up in store, saw another year of strong growth of almost 20% and now represents 22% of our branded Pet business.

Now, shifting to Garden, Garden net sales rose 38% in fiscal 2021, largely driven by our strategic acquisitions. And on an organic basis, Garden sales grew 10%, comping strong 14% growth in the prior year. This year, our Garden e-commerce business grew in the mid-teens on top of triple-digit growth last year.

Looking at consumer dynamics in Garden, in 2020, about 18 million new gardeners entered the category, according to the National Gardening Survey. And today, about one third of all gardeners are millennials, the largest current generation, and they're hitting their prime spending years, which suggest future growth for our industry. While we saw softness across our Garden portfolio in the fourth quarter, which is our smallest quarter in Garden, our wild bird feed business continued to grow and we're certainly pleased with our share gains in this category.

In grass, our marketing efforts for the new Pennington Smart Seed reached over 13 million consumers on Facebook and Instagram. Ads on Pinterest, YouTube, and our influencer campaign drove over 23 million impressions. We mainly focused on straight grass seed and saw a healthy share gains in that segment last season. However, we lost market share in overall grass seed, driven by weakness in patch and repair. Expect to see renovation, innovation and marketing targeting this segment in fiscal 2022.

Finally, I want to provide some context for fiscal 2022 in advance of Niko sharing our guidance in a few minutes. While our growth rates have been overwhelmingly positive during the last two years, the increased demand for pet and gardening products continues to outpace our capacity and has negatively impacted our service levels in many areas. We have tackled this challenge head on with meaningful investments in capacity expansion and automation across our business. Our expectation is to bring our service levels up to historic performance by the back half of 2022.

Additionally, we will continue to face increasing inflationary costs in key commodities, labor and freight. And in response, we have developed a significant pricing and productivity agenda. Much of the pricing has already taken effect, while some is still to come as we progress further into fiscal 2022. We plan to increase strategic investments in growth levers, including consumer insights, digital marketing, brand building and innovation to set up long-term organic growth. And, as always, we continue to pursue M&A opportunities to build our scale in core categories, enter adjacent categories, and add capabilities. Net, while fiscal 2022 will be another challenging year, I'm confident in our team's ability to perform in this environment.

And with that, let me turn it over to Niko.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, Tim. Good afternoon, everyone. Building on Tim's remarks on our continued strong business momentum, I'm pleased to share with you how this has translated into record results for fiscal 2021 and feeds into our outlook for fiscal 2022.

First, let me start with fiscal 2021. I'm excited to report that fiscal year net sales broke the $3 billion mark, increasing 23% to $3.3 billion. This strong growth was driven by our recent acquisitions, namely Hopewell, Green Garden, DoMyOwn and D&D, which together added $292 million of net sales to the year, as well as a 13% organic growth, driven by strength in both segments. Significant growth contributors include dog and cat, our pet and garden distribution businesses, Wild Bird Feed, Aqueon aquatics and Kaytee small animal supplies, as well as Arden outdoor cushions.

Gross profit for the year increased 22% to $971 million. As Tim mentioned, gross margin was largely in line with prior year, declining only 20 basis points to 29.4% as the combination of pricing across our portfolio, gross productivity initiatives, and favorable product mix largely offset significant inflationary headwinds and the impact of inventory-related purchase accounting we faced in 2021.

SG&A increased 20% to $716 million, but declined 50 basis points to 21.7% as a percentage of net sales. Much of the decline as a percentage of net sales was driven by operating efficiencies and pandemic-driven reduced travel and entertainment and office expenses.

Operating income for the year increased 29% to $254 million and our operating margin grew 40 basis points, thanks to improved overhead leverage despite higher logistics costs and meaningful increase in our investment spend.

Other expense was $2 million compared to $4 million in the prior year. The improvement was due primarily to a $3.6 million impairment in fiscal 2020 on two investments in private companies impacted by the COVID-19 pandemic.

Net interest expense landed at $58 million, up from $40 million, mainly driven by the incremental interest expense related to recognizing the impacts of the call premium, unamortized senior notes issuance cost, double interest on the senior notes retired during the first quarter of fiscal 2021, and decrease in interest income as well as higher debt outstanding.

Our net income increased 26% to $152 million and diluted EPS came in at $2.75, an increase of 25% over the prior year. Shares outstanding decreased to 53.9 million from 54 million in the prior year. We bought back a total of approximately 521,000 shares for roughly $22 million.

Adjusted EBITDA for the year increased 30% to $329 million. Our tax rate for the year increased 60 basis points to 21.6%. Operating cash flow for the year was $251 million compared to $264 million in the prior year, primarily driven by higher working capital, mostly offset by higher operating profits.

Now, turning to the consolidated financials for the quarter, fourth quarter net sales grew 9% to $739 million, which was largely driven by recent acquisitions, while organic sales declined 1% versus prior year. Keep in mind that this compares to organic net sales growth of 25% in the fourth quarter of fiscal 2020. Looking at it over a period of two years, organic sales increased at a healthy CAGR of 11% in the fourth quarter.

Gross profit for the quarter rose 8% to $213 million. And similar to the fiscal year, our gross margin was largely in line with the prior year, decreasing 20 basis points to 28.8%. This decline was minimal, thanks to our pricing actions, favorable product mix and gross productivity efforts.

SG&A expense for the quarter increased 19% to $203 million and 220 basis points as a percentage of net sales to 27.5%, primarily driven by acquisitions as well as heightened commercial investment and higher logistics costs. Operating income for the quarter was $10 million compared to $25 million a year ago, and operating margin decreased 240 basis points to 1.3%. As increasing costs for key commodities, freight and labor, as well as on increased investment spending were only partially offset by our pricing actions, favorable product mix, and improved overhead leverage.

Net interest expense increased $4 million to $14 million, primarily due to higher debt outstanding. Net loss for the quarter was $3 million and loss per share was $0.06 compared to earnings per diluted share of $0.25 in the fourth quarter last year.

Now, I'll provide some insights into the segments starting with Pet. Pet net sales for the fourth quarter increased 3% to $459 million, thanks to strength in dog and cat, distribution, as well as small animal supplies and outdoor cushions. The growth comes on top of exceptional 22% net sales growth in the prior year quarter.

Operating income for the Pet segment was $32 million, a decrease of 11% and operating margin as a percentage of net sales decreased 110 basis points to 6.9%. Much of the decrease was driven by significant cost inflation across key commodities, freight and labor, as well as our increased levels of investment to build capacity and drive our growth agenda, partially offset by pricing increases and favorable product mix. Pet adjusted EBITDA decreased 10% to $41.6 million.

Moving on to Garden. For the quarter, Garden net sales increased 21% to $280 million. $78 million of the growth came from our four recent acquisitions. Weather in Q4 was less favorable than in the prior year quarter. Organic sales declined 13% due to softness across the Garden portfolio, except for continued strength in wild bird. It's important to note that this compares to organic growth of 31% in the fourth quarter of 2020. And looking at the growth over a two-year period, organic sales increased at a 6% CAGR in the fourth quarter.

Garden segment's operating income for the quarter was $1 million, down from $14 million in the prior year quarter and operating margin as a percentage of net sales decreased 570 basis points to 0.4%. This margin decline was driven by the impact of significant cost inflation and investment, which was not fully offset by our pricing increases and productivity initiatives. Garden adjusted EBITDA decreased to $12 million compared to $17 million in the prior year quarter.

Now to the balance sheet and cash flows. On the cash flow side, we generated $251 million in cash from operations in fiscal 2021. In the fourth quarter, we invested $23 million. For the year, CapEx totaled $80 million, an increase of 87% over the prior year, reflecting our heightened focus on capacity expansion and automation, as well as IT infrastructure to support our long-term organic growth.

Depreciation and amortization for the quarter increased to $22 million, up from $16 million in the prior year quarter, primarily driven by acquisitions. Cash and equivalents, including short-term investments, were $426 million compared to $653 million a year ago, reflecting cash payments for acquisitions and capital expenditures.

Total debt was $1.2 billion, up from $700 million a year ago. During the last year, we took action to strengthen our balance sheet. In October 2020, we issued $500 million 4.125% senior notes due in 2030, which we used to redeem all of our outstanding $400 million, 6.125% senior notes due in 2023.

And in April 2021, we issued $400 million 4.125% senior notes due in 2031, which we used to repay outstanding balances under our revolving credit facility. Our refinancing enabled us to take advantage of low borrowing cost, enhancing our ability to invest to drive organic growth, while maintaining financial flexibility for future acquisitions. We ended the quarter with a leverage ratio of 3 times compared to 2.2 times a year ago. We had no borrowings under our $400 million ABL line at the end of the year.

Now, turning to our 2022 outlook, we remain committed to our long-term goal of growing net sales in line or above our industries, growing EBIT faster than net sales and growing EPS faster than EBIT as we continue to invest in our business going forward.

For fiscal 2022, we anticipate continued pressure on our supply chain related to increased demand levels, which in 2021 manifested in outstripped capacity, sourcing challenges for various raw materials, and heightened cost for freight and labor. In response, we plan for further investments to expand our capacities, increase automation, and continue to pursue creative sourcing solutions and efficiencies. We currently expect CapEx spend to be at or slightly higher than last year.

Additionally, we expect international ocean freight to remain constrained into 2022, and inflationary pressures on key commodities and labor to continue throughout next year. And while we are working with our retail partners to counter these increases with pricing in addition to improving productivity across Central, we do not expect to be able to fully offset the impact. As prices increase in fiscal 2022, we anticipate that some shoppers will switch to private label, buy fewer units, or otherwise reduce expenditures.

Beyond capital investments, we are planning for sizable spend to drive profitable long-term organic growth and further build out our consumer insights, digital marketing, brand building, and innovation. Fiscal 2022 is looking to be another investment year on many fronts. Further, we expect more normalized travel and entertainment and admin spending level, which will be headwinds as we enter the new fiscal year. We are assuming a higher, more normalized tax rate of 23% to 24% as compared to the 21.6% we saw in 2021.

All said, we currently expect GAAP EPS for fiscal year 2022 to be $3.10 or better. As always, our outlook excludes any impact from potential acquisitions undertaken during the year. It's important to note that we are currently expecting stronger headwinds overall in the first half of fiscal 2022 as compared to the second half.

Accordingly, as we look toward the first quarter of fiscal 2021, we expect Q1 GAAP EPS to be well below the prior-year quarter, largely driven by outsized Q1 in 2020 where retailers loaded in inventory early on the Garden side. As a reminder, Q1 is one of our smaller quarters. To summarize, while 2021 was another challenging year for all of us, it was also another record year for Central. Our company remains strong, well-capitalized and well-positioned to grow both organically and through acquisitions in years ahead, and we are excited for the challenges ahead.

Now, operator, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, at this time, we will be conducting our question-and-answer session. [Operator Instructions] Our first 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

Hi, Bill.

[indiscernible] (32:52)

William B. Chappell
Analyst, Truist Securities, Inc. Q

I guess first just with the thought that your guidance is you'll grow faster than the categories, what is your outlook for the category growth both Pet and Garden in calendar 2022. I mean we've heard from Scott kind of a low-single digit decline or low to mid-single digit decline for US Garden. Pet seems like it's on stable, if not great footing as pet ownership continues to rise and you have a bigger base per se. So kind of what's your outlook there and kind of what you're basing your growth off of?

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

Sure. Thanks, Bill. Well, the crystal ball is continuing to be polished. I think it's difficult to forecast after these two extraordinary years. And I think to repeat the context you're familiar with, I mean, we've seen in both fiscal 2020 and fiscal 2021 unprecedented growth rates in both Garden and Pet, and you see that strong double digits that really for us on both businesses certainly through the first seven, eight months of this last fiscal year continue to be on a tear.

Now, as we got into late in the fiscal year and into Q4, we saw things start to moderate and maybe a little bit of an indication of what we're going to see into fiscal 2022. I think it's broadly in the territory that you suggested, Bill, in your question and that is on the Garden side, if we start there, after two explosive years of growth, it's probably more at the waterline or maybe a little below. We've seen POS kind of in that very low single-digits to flat type performance in the last quarter and probably through certainly the front half of next year, that's what we should expect, weather, of course, being the big wildcard.

We saw inventory levels on Garden at the retailer, pretty high out of Q3 and we've seen a burn-off on that of late as POS continues to be in that low single-digit to flat range. I think on Pets – on the Pet side, we're seeing POS in low single-digits right now, and we would expect that to be right for the category in fiscal 2022.

William B. Chappell
Analyst, Truist Securities, Inc.
Q

That's great. Thanks for the color. And then the commentary on pricing not fully offsetting input costs, labor issues in 2022, trying to understand is that for the fiscal year or do – meaning your costs have popped up, we're now into November, December and you're still kind of passing off pricing to offset it. So you won't really catch up, say, till the second or third quarter or are you just saying you don't – you're not comfortable raising prices enough to fully offset the costs, and so margins will be – and profit dollars will be lower on an absolute basis?

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

Bill, I'd start by saying if we look at 2021, which was also an inflationary year for us across commodities, labor and freight, we feel good about our ability to offset those higher costs, both through a pricing agenda and through our net productivity or cost out agenda. You saw our gross margin was down only 20 bps, which in this inflationary environment feels pretty good to us. For next year, we actually expect the inflationary pressures in fiscal 2022 to be even higher than fiscal 2021 on the order of magnitude of a couple hundred million dollars all in across commodities, domestic and international transportation, and labor costs.

We do not believe on the fiscal year, our pricing agenda will fully offset that big number, but we do have a substantial pricing plan, some of which has been realized and some is yet to come, and we have a cost out plan, again. So I would think overall kind of similar to last year, we probably won't be able to cover all of it, but we'll cover the majority of it.

William B. Chappell
Analyst, Truist Securities, Inc.
Q

Okay. Great. And then last one from me, any kind of input commodity costs that are specific to you that we should be watching and thinking more like grass seed or I mean there is some that are very specific that have maybe been spiking that we're looking into or is it more just the general freight, ocean freight and resin that are really the headwinds?

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

A

Yeah. Bill, it's kind of across the board, but I would say it's particularly acute on the Garden side in the form of the grains for wild bird and then also on the fertilizer side, so NPK also spiking and then all the things you mentioned, you've got the ocean freight, which has come down a little bit, but it's still at historically very high levels. We're still battling labor among other things. So it's across the board, but we have seen some spikes on the Garden side. And then on the Pet side, we also have foam and then glycerin as well for our dog treat and toy category.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Great. Thanks so much.

Operator: Our next question comes from Brad Thomas with KeyBanc Capital Markets. Please go ahead.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, thanks for taking my question. First on Garden, I was hoping we could talk a little bit more about how you all are thinking about the organic sales growth. Obviously, in the quarter you just reported, down 13% organic, up against a really, really tough comparison. Those will get easier as we go through the year. But I'm just kind of curious, are you expecting things get slower before they start to get better because of lapping things like some of the build-ins that occurred last year? How are you thinking generally about the cadence of the organic Garden?

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

A

Sure. Hi, Brad. This is J.D. I'll take that question. Yes. We had a challenging quarter Q4 from an organic standpoint, down 13%. If you look on our – at it on a two-year stack, as Niko said, it's a 6% CAGR growth. So we felt good about that.

I think some of the headwinds that we saw over the fourth quarter will continue into Q1, and really we'll see some of the headwinds, we're comping against an incredibly strong period from a year ago. So I think the first six or seven months of the fiscal year, we'll see those headwinds. And then once we get past that COVID bump from a year ago, I think then we'll start to see positive comps, significant positive comps again.

But from an organic standpoint, we do anticipate some of those challenges. And then as Niko just said, we have – we're getting – working through some service issues, some of the service metrics getting back in – supply chain back in order. We also have headwinds from a – from an inflationary environment. So as we navigate all of that over the first seven months and navigating up the first six months of last year, our POS was up 30%, so we're up against that. From an organic standpoint, I think we'll have some headwinds. But for the long term, for the year, we're still cautiously optimistic.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.
Q

Great. And then, Niko, in terms of the of the guidance, as we sort of bridge the year you've just completed with the year ahead, obviously, you have some tough comparisons at the start of the year and some supply chain headwinds at the start of the year. How should we think about major elements of bridging earnings one year to the next, one of which in particular is I believe you're getting still some tailwind from some of the acquisitions that you've done and any color on being able to quantify that would be wonderful.

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

Yeah. So, we are getting some tailwinds with the acquisitions, so they are going to definitely help margin. What I would say, too, is be cautious about how much you bake in on the acquisition front because we still have some purchase accounting that we're lapping. And then there's also quite a bit of purchase accounting sitting in the D&A side.

So, if you look at for instance our EBIT in Q4 is a simple example, it was down 62%, but EBITDA was down only 23%. So you're starting to see us throwing off a lot more D&A, but we will get a tailwind from the acquisitions. And then, of course, offset with all the commodity increases and then the pricing we're going to take. And then keep in mind, too, what I would say, one of the wild cards is obviously weather every year, but the other one is going to be elasticity, because we are taking pricing and we still have to see how the consumer reacts to that higher pricing and what that elasticity is going to be. So, I think that's another wild card out there.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.
Q

Great. Very helpful. Thank you so much.

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

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

Hi. Thanks for taking my questions. Could you quantify [indiscernible] (42:52)?

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

Hey, Jim, can you get closer to the microphone?

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

Yeah. Sorry about that. So, yeah, could you just quantify kind of EPS contribution from acquisitions this year as well as the EBITDA contribution?

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

Yeah. We're not going to quantify that. What I will tell you is the range we gave earlier, we did manage to exceed that. I think we gave a range of $0.11 to $0.16 and we managed to exceed that. And then I think next year, you can plan on the contribution being higher than that, obviously, because we have those acquisitions for a full year as opposed to stub period.

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

Q

Great. And then it sounds like you're seeing really good returns on investments in marketing and brand building as well as some of these capacity expansion projects. Where are you in terms of kind of realizing all the opportunities you see from both a margin and top line perspective?

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

A

Sure. Yeah. I'll take that. You know what, break it into the two components, as you mentioned, Jim. I think on the CapEx standpoint, you saw fiscal 2021 was another big year of investment, overwhelmingly driven by our need to build capacities across our manufacturing network, also put in quite a bit of automation. We are seeing the benefits of that as we speak, as more capacity comes online. And in many of our facilities, these automated robotics palletizers, case packing, automatic fill lines, et cetera, are also helping quite a bit with our cost agenda in terms of efficiency. We expect, as Niko said, another year of significant investment on CapEx both to ensure we've got great fill rates and to lower our cost profile over time through automation.

The second major investment area is around the kind of the consumer agenda, consumer insights, brand building and innovation, digital marketing, and e-commerce. This past year fiscal 2021 was our first meaningful year where we really accelerated those investments. A lot of that, Jim, think is foundational investment. A number of new hires in the area of e-commerce, marketing, and innovation, that now will begin to lay out plans to impact 2022, 2023, and beyond. Saw a mild increase in working media in 2021, expect that to accelerate in 2022. And it's really when we convert those investments from kind of foundational infrastructure, people, and capabilities into working media, that's where I think we then have good expectations for return on that investment. In the way that will manifest, most notably is accelerated organic growth over the mid to long term and a more competitive profile with regard to market share performance. And that's certainly something we're baking into our long-term algorithm.

For fiscal 2022, I hope as the quarters unroll, I'll be in a position to come back and give more specific details about where we're making investments, new brand campaigns, new innovation launches, et cetera.

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

Q

Right. Thank you.

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

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

Thank you, and good afternoon. And well, congrats on your results. I'm hoping, if you can elaborate a little bit more on the cost impact you had in fiscal 2021, and I appreciate the color you said $100 million impact in fiscal 2022. And related to that, how much pricing you were able to realize in fiscal 2021 already, and how much do you think that will carry over into the first nine months of the year that can partially offset the tough comparisons? So I mean, I was just trying to do the math of the $100 million you quoted for fiscal 2022 would require an additional

300 basis points of price increase, all else equal. It doesn't seem to me too difficult to fully offset, or am I missing any additional pressure that would prevent you to expand margins into 2022? Appreciate any color. Thank you.

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

A

Andrea, thank you. First, just to clarify the comment I made earlier, I said a couple hundred million, not $100 million. Okay.

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

Yeah. Okay.

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

A

In terms of overall inflationary pressures that we're anticipating at this stage for fiscal 2022, that number in fiscal 2021 was call it half that or less. So, it's a significant step up in fiscal 2022 in terms of that inflationary envelope. And I mean, inflation in the broadest sense, the key commodities, the domestic and international freight, and the labor costs.

On the pricing agenda, it is our goal to price away much of that, but we don't anticipate we'll do it all, call it 75% or so or more if we can. I appreciate your comment that it sounds potentially easy, but it's challenging. We need to work very constructively with our retail partners on pricing in a way that still delivers value to our consumers and in a way that works with them and their overall pricing strategy. Some of that pricing agenda is indeed carry over, Andrea, that was part of your question. I would say it's the minority element. Quite a bit of it was pricing that we put in place at the beginning of the fiscal year. So, think about that in October, but there is still a tranche required that is not yet in market.

And so, those are still under negotiation with our retail partners on both the Garden and Pet side. And that's obviously a part of the risk that needs Niko referenced in his guidance commentary, both in terms of our ability to successfully get that pricing through, and number two, the impact that that has on consumer elasticities.

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

That is very helpful. If I can squeeze a little one related to that, you said the inventory in the third quarter was a little high in the gardening side. And then I think you said it kind of normalized as you went through. Is that like the way – obviously, the first quarter, as you said is super light for the gardening. But how do you feel about the new [indiscernible] (49:56) and how we're entering this new gardening season for spring and potentially the second quarter?

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

A

Hi, Andrea. It's J.D. Yes, Garden. So, the – our larger customers took a very aggressive approach into loading inventory for the season in anticipation of continued strong trends in the category. So, when we ended Q3, as Tim mentioned earlier, we had relatively high year-over-year inventories in the stores. We anticipated that there would be some destocking of inventories during Q4, and we certainly saw that. That carried into Q1. And I would say that by the end of the first month of our quarter, we are back in good shape in terms of inventory year-over-year, up low-single digits. But again, a year ago at this time, we had [ph] ramped it (50:51) out of stocks, the retailers did. So, I'd say we're in good shape for inventory going into the season next year.

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

Perfect. Thank you very much. I'll pass it on.

Operator: Thank you. Our next question comes from Oliver Grossman with Jefferies. Please state your question.

Oliver Grossman
Analyst, Jefferies

Q

Hi, thanks for taking the questions. Just to jump back into the automation, I was wondering what portion of your production process is currently automated at this point, and how much capital do you plan on putting behind this initiative?

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

A

All right. On a percentage, Oliver, I think it's difficult to answer that question in terms of what's automated. Obviously, there are various levels of automation across the manufacturing process. Everything from the packaging to product fill, and we've got all sorts of different products. Liquid filled bag, manufactured products, et cetera, and then kind of towards the end. I'd say the end of the line tends to be more automated than the others when you get into packaging and when you get into palletizing. But in general, I would say it is an opportunity for Central Garden & Pet to be more automated across our manufacturing lines. And so, I would say it's less than half. We're still a – have a number of our manufacturing lines that are still more labor-intensive and that really presents the opportunity, particularly with rising labor costs to look at automation. And that's why it's been a meaningful part of our investment.

I think second part of your question was around what percent of the CapEx? What would you say? Less than half certainly is automation.

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

A

Yeah.

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

A

And what would you say?

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

A

Yeah, I would say, yeah, that's probably pretty accurate. And to your point, Tim, I think we're in the early stages of this.

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

A

Yeah.

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

A

We have a long runway ahead of us. And we're investing in the business. You look at the $80 million we invested in 2021, and we're going to do at least that much, if not more in 2022. So, we feel like we have some real opportunity ahead of us.

Oliver Grossman
Analyst, Jefferies

Q

Great. Thanks. And then how are the activity levels of the customers that you acquired over the pandemic? Are there data points that you guys keep track of that suggest that they have become core customers?

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

A

Yeah. You're talking about the end user, the consumer of our products, yes?

Oliver Grossman
Analyst, Jefferies

Q

Yes, exactly.

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

A

Yeah. Yeah, we're seeing, I'd say a promising level of stickiness, Oliver, on post-pandemic. I mean certainly starting on the Pet side, it's really driven by that pet adoption. One out of three households adopted a new pet. And over 4 million households are first time pet owners, many of them, over half of them millennials and Gen Z. We're seeing a real stickiness there, as you might imagine, because their pet is at home and continues to need to be fed and cared for, treated, pampered, spoiled, and our products fit very nicely there. So, we're seeing good stickiness there.

You know, on the Garden side, an incredible boom in outdoor lawn and garden activities as people are beautifying their homes. And we're seeing good stickiness there, as evidenced by even in this most recent quarter where we did see a decline on sales. We saw POS still near the waterline around 1%, 2% in that two-year stack in the mid-single digits. So, I think that does bode well. I think the other thing is because so many of the consumers in the last couple of years especially the new ones are younger consumers, millennials now represent the biggest part of our target market. This is digital generation and one that is very much one that likes to build relationships with brands that they love online. And that affords us with good digital marketing skills and e-commerce skills to create a stickier platform where we can retarget, pursue the subscription ideas and really generate enhanced loyalty to our franchises.

Oliver Grossman
Analyst, Jefferies

Q

Great. Thanks.

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

A

With that...

Oliver Grossman
Analyst, Jefferies

Q

Oh, sorry.

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

A

Yes, Oliver.

Oliver Grossman
Analyst, Jefferies

Q

Just so you guys are sitting kind of at the lower end of your leverage target range or do you have any idea of how far up you'd be willing to take that leverage ratio as you pursue these strategic acquisitions?

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

A

Yeah. We'd be willing to go over 4 times and then quickly delever back down to the 3, 3.5 level.

Oliver Grossman
Analyst, Jefferies

Q

Okay. Thank you so much.

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

A

Yeah.

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

Yes. Thank you. And, operator, with that, I'd like to wrap up today's call. I want to thank everyone for joining us. I wish everyone a happy, safe, healthy Thanksgiving holiday. Thanks for your interest in Central Garden & Pet, and our Investor Relations team is ready for any further questions. Thanks, everyone.

Operator: Thank you. This concludes today's conference. All parties may disconnect. Have a good evening.