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Central Garden & Pet Co. (CENT)

Q3 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Central Garden & Pet's Third Quarter Fiscal Year 2017 Financial Results Conference Call. My name is Manny 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 turn the call over to Steven Zenker, Vice President of Investor Relations and Communications. Please go ahead.

Steven Zenker

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

Thank you, Manny. Good afternoon, everyone. Thank you for joining us. With me on the call today are George Roeth, Central's President and Chief Executive Officer; Niko Lahanas, Chief Financial Officer; Howard Macheck, SVP Finance and Chief Accounting Officer; J.D. Walker, President, Garden Branded Business; Rodolfo Spielmann, President, Pet Consumer Products. Our press release providing results for our third quarter ended June 24, 2017 is available on our website at www.central.com and contains GAAP to non-GAAP reconciliation for any non-GAAP measures discussed on this call.

Before, I the turn the call over to George, I would like to remind you that statements made during this conference call, which are not historical facts including adjusted EPS guidance for 2017, expectations for new product introductions, future acquisitions and revenue and profitability expectations 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 December 2, 2016. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events or otherwise.

Now, I will turn the call over to our CEO George Roeth. George?

George C. Roeth

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

Thank you, Steve. Good afternoon, everybody. Central's third quarter was the most successful third quarter in company history from a revenue and net income perspective. The quarter's total revenue growth of 12% was driven by strong organic growth and also aided by our Segrest and K&H acquisitions.

Importantly, our organic sales growth was a robust 8% and reflected market share gains driven by strong consumer takeaways of our products. The favorable impact of the revenue growth and our realized cost savings more than offset an increase in demand creation spending and cost to upgrade and expand the capacity and capabilities of some of our facilities. The result was a record Q3 profitability and a gain to EPS of 22% over the prior year.

Our strong Garden season was a key driver of our success in the quarter. The season has exceeded our expectations. We have driven market share gains and benefited from weather that was favorable for our grass seed business.

The Garden segment strength 15% sales growth encompassed almost all areas, including our brands, private label and other manufacturer's products. Innovation, new listings and successful demand creation initiative drove significant revenue gains, while earnings benefited from the operating leverage of higher volumes, as well as from our ongoing cost savings initiatives.

The Pet side of the business posted its eight consecutive quarter of organic sales growth, driven by our consumer brands. The strength of our diversified portfolio [ph] was born out by (03:40) the fact that Pets delivered 2% overall organic sales growth despite lower sales of our animal health business and other manufacturers' products.

Our new acquisitions helped overall total Pet segment sales grow 9%, but those additions did negatively impact our operating margin. Niko will give some detail on that in just a bit.

We continue to make excellent progress on our strategic initiatives. Our cost savings and productivity efforts are moving along nicely. For example, during the quarter, we opened our new 550,000 square foot packaging and distribution facility in New Jersey. These services are Nylabone, Fore Paws and IMS businesses and will help this business operate more efficiently and support continued sales growth for the foreseeable future.

In addition, our Pet and Garden segments have a number of businesses [ph] that have (04:30) lower cost as we continue to optimize our insourcing, outsourcing mix. Moving beyond cost savings, our innovation activities are progressing as well and have played a significant part in this quarter's growth. This year, we rolled out several new products in our Garden segment, which has helped grow sales significantly.

For example, an array of new private label offerings spanning several product areas and customers have performed well. We also added SKUs and saw increased sales in some of our branded products like our AMDRO Quick Kill line.

And finally, we continue to work on building our strong customer focus and advancing our key retailer partnerships. Beyond the private label products which we have talked about, we are partnering in marketing, promotion and category management activities to help our retail partners expand their sales and profits.

For example, our Segrest acquisition, which has made Central Garden & Pet the only full line provider of aquatics products, has afforded us the opportunity as high level discussions with our customers about partnering to drive store traffic and [ph] helps with (05:29) penetration of aquatics.

On the acquisition front, Segrest continues to exceed expectations and the K&H integration is on track although it is early in the integration process. Importantly, we continue to evaluate a healthy pipeline of acquisitions and joint venture candidates and are adding resources to continue to strengthen our team in this area.

Overall for Q3, I think it's also important to mention that our earnings benefited from an increase below the line and other income, due to the seasonal nature of the JV we entered into this fiscal year. In the fourth quarter that benefit will be more than offset by loss from the same entity as they will be out of season. Next year, over a full year as a part of Central, we expect this investment to be accretive to earnings.

As we mentioned on last quarter's earnings call, certain non-operating factors were expected to impact net income in the remainder of the year. Those factors include the seasonal JV I just mentioned, along with the second JV and higher corporate expenses versus the prior-year quarter which has benefited from lower insurance and payroll related expenses.

We expect this impact to be felt in our fourth quarter which we will believe will cause our fourth quarter earnings to be below the prior year. We spoke of this last quarter and it's playing out as expected. Also keep in mind that the fourth quarter is relatively small for us from an earnings perspective. So, money spending for future growth has a disproportionate impact on the EPS number.

Net, net, in light of our strong third quarter performance and the factors I just detailed that impact our fourth quarter, we are raising our adjusted EPS projection to a \$1.44 or higher. This includes any impact from our K&H acquisition.

Now, before I turn it over to Niko, I do want to acknowledge his recent and well-deserved promotion to Chief Financial Officer. Niko has tremendous operating knowledge of our businesses, and the financial acumen that the role demands. We are fortunate to have him in the seat and driving the business.

And with said, I will now turn over to Niko to go over the financial and give some more color on the quarter's results.

Nicholas Lahanas

Senior Vice President & Chief Financial Officer-Pet Segment, Central Garden & Pet Co.

Thank you, George, and thank you for those kind words. Good afternoon, everyone. We issued our third quarter press release with our financial results earlier today. I'd like to give you some more detail on the results and then we'll open it up for questions.

Earnings for the quarter of \$0.62 per diluted share were up 22% from \$0.51 over the same period a year ago. Let me give you some color on how that played out. Consolidated company third quarter sales rose 12% versus the prior year to \$575 million, driven by organic growth in both our Garden and Pet businesses and enhanced by two acquisitions in the Pet segment; Segrest and K&H.

Quarterly organic growth was 8%, with Garden the larger contributor on the heels of a very successful season. Consolidated gross profit rose \$20 million and our gross margin increased 10 basis points to 31.9%, due in part to cost savings which helped offset less favorable mix compared to prior year.

SG&A expenses for the quarter increased 8% or \$10 million versus the year ago and as a percent of sales, decreased 70 basis points to 21.8%. Operating leverage from higher revenues and realized cost savings drove the improvement. We've been making good inroads into our efforts to bring controllable cost down to 1% to 2% per year.

Operating income for the quarter increased to \$58 million compared to \$48 million a year ago, in large part due to the strong Garden results. Also keep in mind that in the third quarter of last year, we benefited by \$2.4 million gain from the sale of a manufacturing plant. Operating margin of 10.1% was up 70 basis points on the lower SG&A expenses as a percent of sales and to a lesser extent, our improved gross margin.

Turning now to the Pet segment. Pet segment sales for the quarter increased 9% or \$26 million to \$313 million. The company's latest acquisition Segrest and K&H made up a good part of the gain. Organic sales increased 2%

with the dog & cat, small animal, and health and wellness categories offsetting weaker results in our animal health business, as well as lower sales of our other manufacturer's products.

Year-to-date, our Pet organic growth of 3% is pretty much in line with our Nielsen POS numbers, which in most cases are exceeding their respective category averages. Pet segment operating income decreased \$3 million or 7% compared to the prior year. Almost all of the decrease is due to the comparison against a manufacturing plant sale I mentioned earlier that occurred in the third quarter of 2016.

Pet operating margin decreased 200 basis points to 11.5% with the manufacturing plant sale accounting for 90 basis points of the decline. Other factors which contributed to the decline included unfavorable expenses to expand, move and consolidate facilities, sales mix and the company's recent acquisitions.

Now, turning to Garden. For the quarter, Garden segment sales increased 15% or \$34 million to \$261 million. [ph] The strength (10:54) was widespread with grass seed and private label products doing particularly well. Initiatives around successfully launching new products, upgrading packaging and increasing promotions contributed to the strong performance.

Garden's operating income improved to \$38 million from \$26 million in the third quarter of last year and operating margin was 14.7%, up 310 basis points from the prior-year quarter. Higher volumes which enables favorable operating leverage and benefits from cost savings initiatives were significant factors in the margin expansion.

Moving back to our consolidated results, in the third quarter, other income rose to \$1.6 million from \$300,000. The difference reflects the contribution from the JV we entered this year. As George mentioned earlier, since the business is seasonal, the benefit we drive this quarter will be offset next quarter. 2018 will be the first full year we've been in this JV and we expect it to be accretive for the year.

Net interest expense was flat at \$7 million, our net income for the quarter was \$32 million and diluted earnings per share was \$0.62 compared to \$26 million or \$0.51 in the third quarter of 2016. Adjusting for the manufacturing plant sale in the prior year, third quarter 2016 EPS was \$0.48. So on a GAAP basis, EPS was up 22% and on a non-GAAP basis up 29%.

Now looking at our balance sheet and cash flow statements. For the quarter, cash flow provided by operations was \$139 million, relatively unchanged from \$140 million in the third quarter a year ago. CapEx was \$10 million versus \$7 million in the third quarter of 2016. The increase was predominately driven by investments and expanding and consolidating our facilities.

Depreciation and amortization for the quarter was \$11 million, flat with a year ago. Our total debt increased to \$435 million from \$395 million a year earlier. The increase reflects higher borrowings on our revolving line of credit, resuscitated by recent investments in JVs and the K&H acquisitions, as well as our higher level of sales which have increased our accounts receivable balance.

Our leverage ratio at the end of the quarter was 2.1 times compared to 2.5 times a year ago. We also had \$360 million of availability on our credit line at the end of the quarter. During this quarter, we did not repurchase any of our outstanding stock and approximately \$35 million remains available under the board approved stock repurchase program.

Now, I'll turn it over back to George.

George C. Roeth

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

Thanks, Niko. So to summarize, we are very pleased with our results and the strong momentum the company is demonstrating. We will continue to execute on our strategic plans and the initiatives to increase sales and lower costs in an effort to drive sustainable profit growth in the years ahead.

So, with that said, operator, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] Our first question is from Bill Chappell of SunTrust. Please go ahead.

George C. Roeth

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

Hi, Bill.

A

William B. Chappell

Analyst, SunTrust RobinsonHumphrey, Inc.

Thanks. Good afternoon. Hey, how are you?

Q

George C. Roeth

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

Very good.

A

William B. Chappell

Analyst, SunTrust RobinsonHumphrey, Inc.

I guess first question on the Garden section, how much – as we look at the gains and market share gains, is there a way to say that was largely due to like one mass player focusing on private label and you being well-positioned there or did you see it kind of across the board in terms of market share gains?

Q

J.D. Walker

President, Garden Branded Business, Central Garden & Pet Co.

Hi, Bill, this is J.D. I'll take that question. Bill, we really saw strength across not just all of our segments of business, all of our businesses I should say in the Garden segment, but also across customers. So, I can't point to one channel and say that one channel performed much stronger than others. Our strength was really across the entire business.

A

William B. Chappell

Analyst, SunTrust RobinsonHumphrey, Inc.

Okay. Great. And then, in terms of the Pet side, can you maybe talk about how much the channel pulled you back then we certainly heard plenty about the PetSmart and Petco in the pet specialty remaining weak throughout the quarter. Is that an increasing drag on your business? Was it increasing drag on the quarter? How do you that going forward as we go into next quarter as well?

Q

Rodolfo Spielmann

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

A

Hi, Bill. This is Rodolfo. We do have significant presence in the pet specialty channel and we're committed to drive growth with our partners there in the channel. As you mentioned, there have been some challenges, but we're gaining share in the channel. We're partnering with our customers really well and that has allowed us to continue growing.

We're working in a number of ways through the channel, including the independents, to provide value and help us both drive category growth and food traffic. Just to name a few, we're leveraging Segrest to have different conversations in terms of how to drive against the traffic. We are increasing [ph] product (16:35) and innovation and we established [ph] high (16:38) methodologies to safeguard the value proposition across channels. So in general, we continue seeing growth in our channel products.

George C. Roeth

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

A

Yeah. I would just add that Petco and PetSmart indeed have slowed down. We've been able to compensate for that by driving our business with our other retail partners, as well as trying to get the business online with them in the [ph] ways that we'd also described (16:58).

I don't see that trend reversing in the quarter. I know they're both very committed to getting store traffic up and improving the results. So, I have every expectation they'll make efforts to do that, but that takes more than a month.

William B. Chappell

Analyst, SunTrustRobinsonHumphrey, Inc.

Q

Yeah. I imagine. And then, last one from me. Just in terms of the margins, are we done largely with the New Jersey plant kind of facility consolidation? Are there any other projects that are in the works at this point?

George C. Roeth

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

A

The bulk of it is done. There is still a little bit of expense going on there, but I would say that the bulk of it is done as far as New Jersey consolidation goes, yes.

But, I would add that our cost savings initiatives and capital spending will continue. So, while that project may wrap up towards the end of Q4, there will be up – there are others and will be others in the pipeline [ph] that continue (17:53) to drive the savings.

William B. Chappell

Analyst, SunTrustRobinsonHumphrey, Inc.

Q

Okay. Great. Thanks so much.

Operator: Thank you. The next question is from Jason Gere of KeyBanc Capital Markets. Please go ahead.

Jason M. Gere

Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, great. Congratulations, guys. I guess two questions. One, just following up on Bill's question about the projects. I guess, I'm wondering as you think about projects going forward, how much relates to acquisitions – future acquisitions that you're doing? And I know a lot of the acquisitions you do are kind of smaller tuck-in, but I was just wondering; A, your thought about maybe some larger bolt-on acquisitions or transformative acquisitions and how that would play into kind of rightsizing I guess I would say the footprint from a cost perspective? That's the first question.

George C. Roeth

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

A

So, from a cost perspective, I would argue what we're doing is not acquisition dependent. So, we're looking at optimizing our current footprint. We've done that to some extent with our Garden distribution network with movement of some facilities. As you know, we've done it in New Jersey.

But there is also projects around automation, there is projects around in-housing of certain products, driving best practices. I'll say there is a lot of initiatives on cost savings that are completely independent of any M&A activity.

I'll tell you our M&A pipeline is quite healthy. We're looking at a range of sizes. I wouldn't argue that something transformative is our highest priority. There are plenty of tuck-in opportunities to leverage our capabilities in Garden & Pet. Just the sheer fact that there is 1,400 pet manufacturers out there globally gives us a rich target field to go after and frankly we can be patient and not overpay.

So, we're feeling good about our M&A pipeline. That will continue and I would say that our cost savings initiatives are independent of that.

Jason M. Gere

Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Great. Thank you for that. And then, I guess I know you guys talked about the market share gains that you saw in lawn and garden. I guess I was just wondering how much you could talk about doing the private label side versus your own branded product in terms of some of that share gain and how much of that was incremental distribution at new points of retail as opposed to just expanding kind of shelf space.

So, I was just wondering if you could talk about that. And then, do you see opportunities on the private label side out there with obviously the world is hearing about the invasion of all the and everything else out there private label. Just what's the penetration opportunity for you for doing more private label with other retailers that are in the lawn and garden industry?

J.D. Walker

President, Garden Branded Business, Central Garden & Pet Co.

A

Sure. Jason, it's J.D. I'll take that. So, private label is an important part of our business and it has been very successful this year as some retailers seek to differentiate their offering from other retailers. It's always been important to us and that it gives us more critical mass with the retailer, it gives us a bigger share of shelf. It also allows us to run those products through our manufacturing facilities and those favorable variance that flow off of that, so favorably impact our branded products as well.

And having said all that, this year, our private label business and we had two major private label re-launches with two major customers. So, those have been successful, but our branded business has grown nice as well.

So, we believe that by partnering with the retailers on the private label brands, it creates a strategic partnership with that retailer and then you jointly driving that brand together. So, it's been a beneficial relationship for us. As far as the future and what that looks like potential opportunities we'll continue to pursue private label opportunities if it makes sense for us.

George C. Roeth

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

A

And the only thing I would add to that as well is, our approach to private label I would argue is fairly unique and that we drive our retail partners private label [ph] is hard or every bid is hard is our own (21:43) business. So, we treated it as it's our own brand, we wanted to be every bit as successful and you couldn't tell a difference in how we approach it relative to our own brands and I think that's unique in the marketplace.

Jason M. Gere

Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. And then, just a last follow-up. Some of your competitors talked about the weather and some of the pushback on – and again, everyone does something different within lawn and garden, you guys are primarily grass seed, fertilizer. Just wondering if there was any delayed sales that you saw that came in from last quarter to the quarter just reported or anything that you think that could be pushed off from the quarter you just reported as strong as it was into next quarter, anything that went into July, any late season, so I was just wondering if any context around there?

George C. Roeth

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

A

Sure. So, I know that some of our competitors have talked a quite bit about weather. I would say that [ph] weather for, (22:35) what I would call our traditional lawn and garden categories, you mentioned [ph] grass seed, grass seed (22:40) some of our controls business, the fertilizer business.

The mild temperatures in the spring that carried into summer, it became a bit of an extended season. So, we benefited from that. That's been the tailwind for those businesses. I had failed to mention earlier when Bill Chappell asked this question, but it's been a headwind for our wild bird business.

So, that business typically benefits from harsher weather conditions. Weather in general though, if I had to summarize, I would say that it did not negatively impact our business as what's reported by others. I think that it was a benefit to us, particularly grass seed. It's been an exceptional grass seed year.

As far as shipping between quarters, I would say that our POS, our consumption has been pretty strong throughout the year. It was strong in Q2, into Q3 and we're seeing that extend into July as well.

Jason M. Gere

Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Great. Thanks for answering the questions.

Operator: Thank you. The next question is from Jim Barrett of C.L. King. Please go ahead.

Jim Barrett

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

Q

Good afternoon, everyone. George, you touched upon POS. Could you tell us what the POS growth was for Central in the quarter and year-to-date? And if you have it, what the POS growth was for pet specifically in the quarter?

Rodolfo Spielmann

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

A

Hey, Jim. This is Rodolfo. What I – I won't quote the numbers specifically. What I can tell you is our growth is at least 300 basis larger than the categories where we compete in. It depends again on what channels are being measured, et cetera, so it gets a bit complicated. But on the channels, we can measure via Nielsen, we're growing at least 300 basis points higher than the category.

George C. Roeth

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

A

Yeah. To give you some directional sense, I would say, low-single digits is, we're typically seeing.

Jim Barrett

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

Q

I see. And you touched upon it already, George. Could talk about the demand creation programs? Were they and how effective were they and how much more opportunity is there in that area?

J.D. Walker

President, Garden Branded Business, Central Garden & Pet Co.

A

Jim, this is J.D. I'll take that question. So, we've talked a lot about on previous calls about our conversion model and that model relies on us to take costs out, operating costs, where we're taking some of those savings and reinvesting them back into main creation activities. That can take on a number of forms. It could be increasing our advertising on our products, and we've seen a big focus on digital this year, and enhancing our digital presence.

It also is working with the retailers and reinvesting some of those funds back with the retailers to drive promotion of our products, get our products off shelf. We believe that if we can drive trial of our products, and our products are excellent, second to none, that if the consumer tries our products, typically they have a favorable experience in terms of efficacy, that they'll return and we've converted that consumer for the long haul.

So, we've invested in demand creation activities both at the store level with the retailers as well as through media spend, et cetera.

Jim Barrett

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

Q

Thank you, all, very much.

J.D. Walker

President, Garden Branded Business, Central Garden & Pet Co.

A

Thank you.

Operator: Thank you. The next question is from William Reuter of Bank of America Merrill Lynch. Please go ahead.

William Michael Reuter

Analyst, Bank of America Merrill Lynch

Q

Good afternoon, guys.

George C. Roeth

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

A

Hello.

William Michael Reuter

Analyst, Bank of America Merrill Lynch

Q

You talked a little bit about how private label was certainly a driver of the Garden segment. Can you talk about maybe how much of the growth that we saw in this quarter would've been due to private label versus brand, meaning just break it down and kind of broad brush strokes?

George C. Roeth

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

A

We don't break it out by certain segment. So, we're not going to reveal that. What I can tell you pretty definitively is we saw strong growth in branded, saw strong growth in private label, and we saw strong growth in other manufacturer's products across Garden. So, it's been all elements working to our advantage.

J.D. Walker

President, Garden Branded Business, Central Garden & Pet Co.

A

Across our entire portfolio, both Garden and Pet, private label is a little over 10% of our total portfolio.

William Michael Reuter

Analyst, Bank of America Merrill Lynch

Q

Okay. Earlier on in the call, one of your questions asked about acquisition, and you said that they weren't necessarily going to be transformative. Was this speaking to how large the size they were going to be, or was it speaking to the fact that they were not going to be outside of your existing categories?

George C. Roeth

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

A

I would tell you, when we say transformative, you're typically talking about the size of the acquisition, but it also could be whether you added a major third leg. I would tell you that that is not our strategic focus. Our strategic focus is on Garden and Pet leveraging our current capabilities, tuck-in acquisitions that we can drive value pretty quickly on, and that we can fund through our cash flows and line of credit.

William Michael Reuter

Analyst, Bank of America Merrill Lynch

Q

Okay. And then, just lastly from me, the New Jersey facility that's going to be completed soon, is there any way you can quantify how much of an impact you might see on your P&L from this coming online?

George C. Roeth

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

A

No, we wouldn't give away those specifics. I will tell you any capital endeavor that we would drive would obviously earn well above the weighted average cost of capital, and we look at each project with [ph] that in mind (28:14).

William Michael Reuter

Analyst, Bank of America Merrill Lynch

Q

Okay. I'll pass it to others. Thank you.

George C. Roeth

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

A

Thank you.

Operator: Thank you. The next question is from Karru Martinson of Jefferies. Please go ahead.

Karru Martinson

Analyst, Jefferies & Company, Inc.

Q

Good afternoon. Just a follow-up on the facilities question. Once you're complete with this project, where do you see yourself kind of on a facility utilization rate? I mean, how long do you feel you need before you need to make more investments in your facilities?

George C. Roeth

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

A

Well, that's a very situation dependent question. It varies across the company. I would tell you, we have comparable demand to capacity ratio, and most of our businesses are – dog & cat business have been growing quite rapidly and became capacity constraint. That's not the norm in the company. And most parts of the company, we have the capacity we needed. And frankly, one of the reasons we like private label is we're lowest cost producer and we often are. We have excess capacity. We're going to aggressively pursue private label, and that's what we've been doing.

Karru Martinson

Analyst, Jefferies & Company, Inc.

Q

Okay. And with the strong POS data that you're seeing, I mean, how do you feel about inventories at retail kind of especially on the Garden side, in particular?

J.D. Walker

President, Garden Branded Business, Central Garden & Pet Co.

A

It's J.D. again, I'll take that, the Garden portion of that question. In terms of retail inventories, I would say in aggregate, we feel very good about the position. Now, there's put and takes. We did have a couple of major launches this year. So, there might be a couple of spots where we have some heavier inventories and others. But in aggregate, our inventories are below prior-year and in good shape going into the next quarter.

Karru Martinson

Analyst, Jefferies & Company, Inc.

Q

Okay. And then, when we look at that leverage right now in 2.1 times, you guys seem to be signaling more of a patient wait for tuck-ins. How do you see that leverage trending over time? And kind of longer term, where would you like leverage to kind of settle out?

Nicholas Lahanas

Senior Vice President & Chief Financial Officer-Pet Segment, Central Garden & Pet Co.

A

This is Niko. Yeah. So, our target leverage ratio is 3.3 times, so really in that 3 times to 3.5 times range. As we look at acquisitions and the acquisition universe, for the right deal, we would stretch and go over 4 times, and hope that we'll get that back down to that 3 times to 3.5 times in short order.

Karru Martinson

Analyst, Jefferies & Company, Inc.

Q

Great. Thank you very much, guys. Appreciate it.

Operator: Thank you. [Operator Instructions] The next question is from Grant Jordan of Wells Fargo. Please go ahead.

Grant Jordan

Analyst, Wells Fargo Securities LLC

Q

Good afternoon. Most of mine have been asked already. I guess just one kind of following up on the capital allocation. As you continue to do well and generate earnings, is there a thought given to ramping up the share repo activity as you weight on M&A?

George C. Roeth

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

A

I would simply answer that question is, the primary use of our capital is, again, current operations to drive the growth and the cost savings that we've been talking about. And the next highest priority is around mergers and acquisitions where we believe that we have a rich target field to go after.

Grant Jordan

Analyst, Wells Fargo Securities LLC

Q

Yeah, okay.

J.D. Walker

President, Garden Branded Business, Central Garden & Pet Co.

A

Yeah. I mean, the way we look at, just to expand on George's answer is, we look across the entire spectrum as far as investments go, and we're looking for the highest IRR. Right now, we're still seeing very attractive IRRs internally as well as acquisitions that we can make that really pay out that are still a little bit ahead of doing a stock repurchase. So, we're actually quite methodical when we look at that.

Grant Jordan

Analyst, Wells Fargo Securities LLC

Q

Great. That's helpful. Thank you very much.

Operator: Thank you. [Operator Instruction] Our next question is from Hale Holden of Barclays. Please go ahead.

Hale Holden

Analyst, Barclays Capital, Inc.

Q

Thank you very much for taking the call. I just had two quick ones. On acquisitions and your rich pipeline, I was wondering how you thought about rational multiples. You're seeing sellers still with multiple expectations that you thought were reasonable, or if there have been inflation over the last six or nine months.

George C. Roeth

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

A

Yeah. I mean, I think absolutely, there's been inflation. We see it every day. Money is still relatively cheap. So, that manifests itself in higher multiples.

That said, we are very prudent buyers. We typically do not get lulled into purchasing businesses for higher multiples. That said, if we saw value somewhere and had to pay a premium for it, certainly we're happy to explore that.

Hale Holden

Analyst, Barclays Capital, Inc.

Q

Got it. And then, my second question is, [ph] actually sort of (33:15) the question that Bill Chappell had on superstores. Part of your answer was going to independent and helping get the product out online, whether it's with online specialty or retail brick and mortars online.

I was wondering when you think about how you assist your retail partners either with private label or the branded products, if you thought you thought you have the right muscle skill set to really accelerate the online growth and help them with their online sales? Or is that somewhere that for the development?

Rodolfo Spielmann

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

A

Okay. This is Rodolfo. Let me take the question on two different sides. So, can we help them drive in store traffic and can we help them get people to the store? The answer is yes. We feel we're more capable than most companies. We have the ability to drive into theatre. We have – the figures allows us to do that. Our presence across the whole store, not only in one category enables to do that.

So, when customers are looking for partners to say, okay, help me here, we're normally among the first calls. So, that's the first part of the question.

The second one in terms of e-commerce and online, we will follow the consumers whatever they want to follow or they want to buy. And e-commerce is growing really fast. For that, we've put more resources in the past, and we're committed to put more resources in the future.

Now, if you see our acquisitions, see what we've done, we're committed to work with our partners in all channels, which means, we are working with e-commerce field players, and we're working with our brick-and-mortars to also drive their online [ph] kind of business (35:04). We have thankfully enough capacity to do both.

George C. Roeth

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

A

Well, I'll also think about it as, it's our job to have the right policies, products, and promotions and programs to allow each channel whether it's brick-and-mortar or omni-channel, which is brick-and-mortar plus e-commerce. E-commerce pure play to compete effectively, consumer will ultimately go [ph] where they're going to go (35:27).

And I'll tell you we have committed significant resources to making sure we're getting clarity around those fall season and also are doing things like product differentiation, SKU differentiation to allow our channels to compete with different products, and we're making investments on that front as well as our digital communications.

Hale Holden

Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much for the time. I appreciate it.

George C. Roeth

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

A

Thanks.

Operator: Thank you. [Operator Instructions] And the next question is from Carla Casella of JPMorgan. Please go ahead.

Carla Casella

Analyst, JPMorgan Securities LLC

Q

Hi. I just have some – a question on the pet specialty and the Pet business. How much of your business in the Pet is now sold through the specialty channel versus online versus mass? And how do you see that changing over time?

Rodolfo Spielmann

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

A

Hi, this is Rodolfo. We're not disclosing the split by channel. What I can tell you is, thanks to the quality and the amount of brands we have and the categories we have. We do have strong presence on every channel that you mentioned.

We mentioned [ph] before we follow (36:53) consumers. And that has allowed us that while pet specialties having right now a tough time, we have been able to more than gain in the other channels that long. If or once that specialty comes back, we will be ready to be there. But all in all, we're growing honestly in all channels.

George C. Roeth

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

A

What I can add to give you some perspective where J.D. eluded to it earlier, in the Pet channel, about 10% of the sales were e-commerce, and we're a little bit south of that, because it tends to be more food and we're higher in supplies. So, that gives you some perspective. It's still largely a brick-and-mortar business. It just allows the growth that's happening in ecommerce.

Carla Casella
Analyst, JPMorgan Securities LLC



Okay. Great. It's really helpful. Thank you.

Operator: Thank you. I would now like to turn the conference back over to Mr. Roeth for closing comments.

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

I just want to say, thank you everybody for attending today's call. I appreciate the questions and have a great day.

Operator: Thank you. Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. And thank you for your participation.

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