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Central Garden & Pet Co. (CENT)

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Central Garden & Pet's Fourth Quarter Fiscal Year 2018 Financial Results Conference Call. My name is Hector, 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'd now like to turn the call over to Steven Zenker, Vice President of Investor Relations, FP&A and Communications. Please go ahead.

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

Thank you, Hector. Good afternoon, everyone. Thank you for joining us today. With me on the call today are George Roeth, Central's President and Chief Executive Officer; Niko Lahanas, Central's Chief Financial Officer; Howard Machek, Senior Vice President, Finance and Chief Accounting Officer; J.D. Walker, President, Garden Branded Business; and Rodolfo Spielmann, President, Pet Consumer Products.

A press release providing results for our fourth quarter ended September 29, 2018 is available on our website at www.central.com. Also on the website is the GAAP to non-GAAP reconciliations for the non-GAAP measures discussed on this call.

Before I 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 EPS and other guidance for 2019, expectations for new product introductions, future acquisitions and improved revenue and profitability 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 filing, 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, let me turn the call over to our CEO, George Roeth. George?

George C. Roeth

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

Thank you, Steve. Central ended the year on a solid note in the fourth quarter with fourth quarter GAAP revenues increasing 2%, and earnings per share up 138% versus a year ago despite one less week than fourth quarter of last year. On an organic non-GAAP basis, excluding the extra week, the gains were 3% and 25%, respectively.

Niko will talk more about the fourth quarter details later, but now I'd like to focus on how the year played out, and what we are doing to continue our growth momentum going forward. In fiscal 2018, Central experienced continued market share gains helping drive top line organic growth and higher earnings. The bottom line results benefited from a lower tax rate, the timing of our recent Bell Nursery acquisition, higher organic sales and continued cost savings from our cost reduction efforts.

Despite our gains, the year certainly was not without its challenges. For starters, the weather was not favorable for Garden business, nor was it favorable for some of our Pet segment categories including fly and flea and tick control products. And as I mentioned earlier, there was one less week in fiscal 2018 than there was in 2017.

Despite these factors, what's impacted fiscal 2018, we are able to grow overall revenue 8% for the year, and organic revenue by 1%. If we adjust for that extra week in last year, organic growth is up 2.6% right in the middle of our long-term target of 2% to 3%, despite the weather challenges.

The second half of fiscal 2018 saw accelerated cost inflation in many areas including freight, labor and raw materials. These increases, as well as the less favorable mix of sales, which we'll discuss later, were headwinds to margins. But aided by our cost savings initiatives and optimization of our demand creation activities, we still manage to keep our operating margin flat versus the year ago from removing the impact of our recent acquisitions. We believe this is significantly better than our peers, which we consider to be an accomplishment in this environment.

And now, I want to focus on the critical strategic initiatives where we made meaningful progress during the year. I'll start with digital. We all know that consumers are changing the way that they research products and make purchases. And increasingly, they are using the digital space to conduct those activities, enhancing our digital presence is the key priority.

And we not only redirected, but also added incremental resources to digital initiatives to reflect that changing retail landscape. We have four new teams internally called digital pod squad, expert employees who are arrayed around similar product groups, and are dedicated to driving demand in the digital space. We have increased our customer-facing digital resources to drive increased understanding, focus and ultimately results.

We have armed these marketing and sales teams with state-of-the-art technologies in order to improve their speed and effectiveness. Net-net, we have shifted more people on financial resources to the digital space, and had benefited from the change. We believe our digital capabilities can be a source of competitive advantage versus our much smaller scale of pet supply product competitors. Also, as with digital, we have increased the size of our consumer insights team to better understand who our consumer is, their past purchase of meat sticks.

As a leader in the garden and pet industries with our breadth of businesses and market understanding, driven by the reach for distribution business, we believe our understanding of the consumer marketplace gives us an edge, and we continue to invest to drive that advantage.

Improved consumer insight allows us to sharpen our focus and success in developing new products, and we continue to be encouraged by our innovation efforts. For example, during the year, we launched a number of new products including our first private label pet product in the e-commerce channel. We also introduced significant product improvements in our small animal bedding business, and a new Wee-Wee Pads product both centered around odor control. The latter utilizes Febreze on the product under license from P&G, which is proven to be a consistent formula for success across multiple categories.

We also introduced both new branded and private label products in our Garden segment, including a new line of branded mosquito control products that are doing well in the marketplace, and we'll have expanded distribution in 2019.

Another accomplishment during the year was our continued growth through acquisitions. We made two strategic purchases during the year that added even more breadth and depth to our portfolio. The purchase of Bell Nursery expanded us into the live flower and plant business. This is a fragmented category in a relatively concentrated garden industry that provides a significant growth opportunity. Bell is known for its quality product, and we are currently leveraging that reputation for incremental growth by starting to provide vegetable plants in some stores this coming garden season.

Our other acquisition in fiscal 2018 General Pet gives us a more complete national footprint for our pet distribution business. This has been an important strategic move by providing us a relationship with a major pet food manufacturer, which we hope to expand over time. In addition, General Pet's footprint helps our execution of the store-within-a-store concept and we are working to expand the successful model with other retailers.

Finally and importantly, we've also made progress driving growth and shareholder value in our businesses acquired in the last several years. Specifically, we are proud of the fact that our acquisitions over the last four years have grown sales at an average annual growth rate in excess of 4% since becoming part of our portfolio. And in fiscal 2018, that number was even higher.

Beyond organic top line growth, we are driving shareholder value from our newly-acquired businesses in number of other ways. For example, our two pet bedding acquisitions, DMC and K&H are now sharing manufacturing distribution space to drive lower costs in a new facility that we opened in Arizona. We're also sharing expertise around areas such as innovation and e-commerce capabilities.

In our SEGREST live aquatics and small animal business, we made several small acquisitions which have expanded our footprint beyond the areas in which SEGREST initially operated in. And finally, our IMS acquisition, which we acquired a few years ago is now fully integrated into our dog and cat business unit, and has subsequently improved operating effectiveness and efficiency as it utilizes our new facilities.

We have been saying for some time that growing both organically and through acquisition are both important priorities. We continue to grow organically in fiscal 2018, while also taking steps during the year to strengthen our balance sheet with two well-timed capital raising events that position us to finance an aggressive acquisition agenda going forward.

Simply said, we are the same great company successfully executing our strategy to cut costs to field sustained, profitable organic growth, but we now also have an approximate $500 million war chest to drive a more aggressive, value creating M&A agenda. This is a story of and/also. To drive our agenda, we've added resources this year in the M&A area, and are very actively evaluating a number of interesting opportunities.

We are continuing to look at larger acquisition targets and are expanding how we think about the Garden and Pet categories. We believe that with capital on hand, we are a very credible strategic buyer and are already having more opportunities presented to us. You can expect that we will continue to be very disciplined buyers, but we'll be appropriately aggressive when we see strong growth potential and tangible synergies.

You've seen our growth over the last three years averaging over 10% per annum in revenues, roughly a third of which was organic, and over 35% EPS net of one-time items. We are proud of these results and excited about our growth prospects ahead. So as we move forward, we are pleased with how the company performed this year delivering solid results in a challenging environment, while continuing to advance our strategic agenda.

With that, I'll turn it over to Niko to go more in-depth with the financials.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, George. Good afternoon, everyone. Our press release for the fourth quarter and fiscal year financial results was issued earlier today. It was a bit of a complicated quarter of the year from an accounting standpoint, particularly below the line. So, I'll be using certain non-GAAP numbers to make it easier to compare how we fared this year compared with the prior year.

Our 2018 fiscal fourth quarter and year non-GAAP numbers exclude the impact of the revaluation of Central's deferred tax accounts which added $5.2 million and $21.5 million to our results for the quarter and year, respectively. The 2017 non-GAAP numbers exclude one item, the sale of a Garden distribution facility that generated a gain of around $2 million in our first fiscal quarter.

I'll start with a brief summary of the year. As George mentioned earlier, we were pleased with our results in what was a challenging year in certain respects. Total company revenues rose 8% with organic revenue increasing nearly 3% when excluding the extra week of fiscal 2017. The Pet segment drove the organic growth. Pet revenues were up 8% or 5% on an organic basis, which excludes recent acquisitions and the extra week last year.

Sales gains in the dog and cat category, and sales of other manufacturers' products led the way. Sales gains in dog and cat were aided by good growth from our DMC and IMS businesses that were acquired in the last few years. The rollout of our store-within-a-store concept at Kroger drove our organic third-party pet distribution gains.

The Garden segment during the year faced headwinds from unfavorable weather and was comping against the high-8% growth rate from the prior year. Total Garden revenues were up 8% this year, which includes approximately six months of revenues from our Bell Nursery acquisition, which we acquired late in March of 2018.

On an organic basis, and excluding the extra week from last year, Garden sales declined less than 1%, which was ahead of our peers, and reflects continued market share gains. Total company gross margin for the year declined 30 basis points to 30.5% with the decrease attributable to the acquisitions made during the year. On an organic basis, gross margin was in line with the prior year despite an unfavorable mix of sales and inflationary pressures which led to higher than anticipated costs.

Operating income of $167 million was up 7% with operating margin remaining flat at 7.6%. The prior-year had a $2 million gain from the sale of a Garden asset. Excluding that sale, operating margin increased 10 basis points.

Now, there was significant move in our tax rate for the year due to the tax law changes. Our tax rate was impacted in three ways. First the federal statutory tax rate was lowered to 21% from 35% on January 1, 2018. So within effect for our last three quarters of fiscal 2018, and therefore our federal and state combined statutory tax rate for fiscal 2018 averaged 28%. Second, changes in the accounting standards around non-cash equity compensation resulted in our 2018 tax rate declining even further. Our reported 2018 non-GAAP tax rate of 19.5% reflects these two impacts.

Finally, due to the changes in tax rates, the revaluation of our net deferred tax liabilities resulted in a $21.5 million benefit which substantially reduced our GAAP tax rate even further, down to only 2.6% for fiscal 2018. Going into next year, we believe our tax rate will be more in line with the federal tax and statutory rates which together total 24.5%, well above the 19.5% non-GAAP rate we benefited from this year; as we do not currently expect any significant positive impact from the non-cash equity compensation component that benefited us in fiscal year 2018.

So with all that said, EPS for fiscal 2018 rose 53% to $2.32. Excluding the tax benefit of $21.5 million I just noted, as well as the sale of the Garden asset last year, non-GAAP operating income and EPS were up 9% and 27%, respectively to $167 million and $1.91.

Turning to the quarter, fourth quarter consolidated sales increased 2% to $502 million with organic sales excluding the extra week in the fourth quarter of last year rising 3%. The strength of the private label sales during the quarter offset weakness due to weather and lower sales of other manufacturers' products.

The impact of the extra week last year was approximately $35 million in total revenue, of which $33 million was related to organic revenue and $2 million to revenue from acquisitions. Consolidated gross profit for the quarter rose 1%, and our gross margin decreased 30 basis points to 29.3% due to the impact of the acquisitions we made during the past year.

Our Bell acquisition typically loses money in the fourth quarter, and that was the case this quarter, which pulled down the company's gross margin. Our organic gross margin was actually up meaningfully. SG&A expenses for the quarter decreased 2% or $2 million versus a year-ago, and as a percent of sales decreased by 110 basis points to 25.6%. The decreases were driven primarily by declining marketing and selling expenses to address the uncertainty around sales due to poor weather patterns.

Operating income for the quarter rose to $18 million compared to $14 million a year ago. Our operating margin increased 70 basis points to 3.6% due to the lower SG&A expenses. Our organic operating margin was up over double that amount.

Net interest expense increased to $8.9 million from $7.2 million in the fourth quarter of last year. The increase was due to the issuance of $300 million of senior notes in December of 2017. Other expenses for the quarter increased $3.1 million compared to the prior year due to timing differences in a seasonal business in which we had a stake. We do not expect the losses in the other expense line to continue at this rate in fiscal 2019.

Our tax rate for the quarter was negative and reflected a sizable benefit of the revaluation of Central's deferred tax accounts in a quarter that typically has lower earnings. We made reasonable estimates and recorded provisional amounts in our first quarter for the revaluation, and then finalized the number in the fourth quarter resulting in a favorable fourth quarter adjustment of $5.1 million. This caused the tax rate for the quarter to be negative.

Our GAAP net income for the quarter was $10.6 million, and our GAAP diluted earnings per share was $0.19 compared to $0.08 per share in the fourth quarter of 2017. Adjusting for the revaluation of the deferred tax accounts this year, EPS was $0.10 a share versus $0.08 a share last year.

Diving a little deeper into the Pet segment for the quarter. Pet sales for the quarter increased 3% or $9 million to $339 million aided by our General Pet acquisition. On an organic basis, and excluding the extra week last year, sales increased 5% due primarily to strength in dog and cat businesses, which more than offset weakness in our animal health business.

Pet segment operating income increased $5 million or 17% compared to the prior year, and operating margin rose 120 basis points to 9.5% as lower marketing expenses and cost savings more than offset higher freight, raw materials and labor costs.

Moving on to Garden; for the quarter, Garden segment sales increased 2% or $3 million to $163 million due to the inclusion of our Bell Nursery acquisition. On an organic basis, and excluding the extra week, Garden sales declined 1%. Weather wasn't favorable during that quarter due to Hurricane Florence which reduced consumer demand late in the quarter. The largest decline was the sale of other manufacturers' products in part due to a timing shift of sales which benefited our third quarter.

Garden's operating income for the quarter increased $1.3 million to $1.6 million, and operating margin increased 80 basis points to 1%, despite the meaningful negative impact of the Bell acquisition. Lower marketing expenses versus the prior year was the primary driver of the increased margin.

Moving to the balance sheet and cash flows. For the quarter, cash flow provided by operations was approximately $96 million compared to $72 million in the fourth quarter a year ago. The difference is primarily due to a higher level of receivables coming into the quarter versus a year ago, which were collected by the end of the quarter. CapEx for the quarter of $11 million was up $3 million versus prior year. For the year, CapEx totaled $37.8 million, compared to $44.7 million in fiscal 2017.

Depreciation and amortization for the quarter increased to $12 million, up from $11 million in last year's fourth quarter due to the acquisitions in the past year. Cash and equivalents including short-term investments increased to $482 million from $32 million a year ago. The increase reflects the proceeds from our raising $300 million through the sale of fixed income securities in December 2017 and $200 million from the sale of equity in August and September of 2018.

We intend to be more aggressive in the number and size of acquisitions we undertake, and have devoted additional resources to find attractive acquisitions. We believe as one of a limited number of strategic acquirers, we are an attractive buyer to the sellers in the Pet and Garden industries.

We ended the quarter with a leverage ratio of 3.3 times up from 1.9 times a year ago, due to the December note issuance. We are comfortable with our current leverage which is right around our targeted level.

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

George C. Roeth

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

Thank you, Niko. As we enter 2019, we are seeing consumption growth, and are comfortable with our inventory positions. We're also encouraged by meaningful distribution gains we expect to achieve in 2019. Cost inflation continue to be a factor, but we have raised pricing primarily starting in January of 2019 to offset the negative impact of rising costs. And we are executing plans to reduce our controllable costs by 1% to 2% again this year.

This should allow us assuming more normal mix of revenue and weather to continue to grow organic margin in the year ahead. Next year is a complicated one, as several non-operating items will significantly impact our EPS. So we thought it was important to give you additional guidance on some measures that give more transparency around what we expect from an operating perspective.

We currently expect revenue growth of mid-single-digits for fiscal 2019 with organic growth making up over half of the increase. To be clear, we are not factoring in any acquisitions that we might make in fiscal year 2019. We currently expect EBITDA which is defined as operating income plus depreciation and amortization to grow mid-single-digits.

However, it should be noted that our fiscal 2019 results will be significantly impacted by the inclusion of a full year of Bell Nursery. Central benefited in fiscal 2018 from the timing of the Bell acquisition, which effectively excluded two quarters of losses. On an organic basis, excluding the six months of Bell and General Pet that will be inorganic in fiscal 2019, the expected adjusted EBITDA growth rate is in the upper-single-digits.

As for our guidance. Our fiscal 2019 results are expected to include significant unfavorable impact from three critical factors, a higher tax rate, the timing of our mid-year acquisition of seasonal Bell Nursery business in fiscal 2018, and a higher number of shares outstanding due to our equity offering in August 2018. So, having said all that, we currently expect our EPS for 2019 to be $1.80 or higher. A decline from 2018 despite strong expected EBITDA growth.

To give you some specifics around the degree of impact of the items I just mentioned on 2019 results, we said on our last earnings call that we expected the timing of the Bell acquisition positively impacted fiscal 2018 year results by approximately $0.10 versus that we had Bell on our results for the entire year. In 2019, net impact reverses. Also, as Niko mentioned earlier, our tax rate is expected to be higher in fiscal 2019 than it was in fiscal 2018. These two factors are expected to negatively impact 2019 EPS by approximately $0.25.

On top of those factors, the net impact of the equity raise, share dilution and interest income is expected to total approximately another negative $0.15. So when you look at our expectations for EPS for fiscal 2019, adjusting for all these factors, expected growth would actually be 15% or higher. Now, to create a complete understanding, we also need to call out that the first half of the year will face more difficult comparison, due to the offseason impact of Bell and the results, and comparing with a strong second quarter relative to the third quarter for Garden a year ago.

On top of that, our first quarter will have additional challenges as their price increases are generally not expected to take effect until January 2019. Interest expenses in Q1 should also be higher than year ago due to the timing of our debt issuance in December of 2018.

Overall, we expect margin comparisons in our first quarter will be more challenging than what we experienced in fiscal 2018. For the rest of fiscal 2019, particularly in the back half we should fare much better. So all of these factors should result in a meaningfully lower EPS figure in the first quarter versus a year ago.

Keep in mind, our first quarter is typically the smallest of the year in terms of revenue and earnings for the company anyway, representing just 10% of our earnings in fiscal 2018. We would expect the second half of 2019 to show EPS growth over 2018.

At the beginning of the year, we talked about 2018 being bumpy in terms of sales and earnings growth, and we expect 2019 to be no different. In 2018 we delivered to our expectations and expect to do so again in 2019. We manage for the year not for quarters. Importantly, all the estimates we are giving you today do not reflect any benefit from putting the work to close to $500 million of cash, the equivalent of over $8 per share we have on our balance sheet save normal operating uses and anticipates a relative modest interest rate earned on those money. So making any accretive acquisitions in fiscal 2019 would be an upside to our estimates.

To conclude, we are optimistic about next year and our long-term future. We are cutting costs, fueling investment to drive profitable organic growth and have significant capital available for aggressive M&A agenda to drive additional shareholder value. We feel great about where we landed this year, and how we are set up for accelerated growth going forward.

And with that said, I would like to now open the line for your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time we'll be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of Bill Chappell with SunTrust Robinson Humphrey. Please proceed with your question.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thanks. Good afternoon.

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

A

Hi, Bill.

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

A

Hi, Bill.

Howard Machek
Chief Accounting Officer, Central Garden & Pet Co.

A

Hi, Bill.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

I guess, first, a couple things on the quarter. There had been some commentary about a weak flea and tick season, and there's also been some commentary from others about, I guess, Walmart shutting down the Garden season a little bit earlier this year. Didn't know if either or kind of, maybe give a little more color on both of those issues?

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

A

Sure, Bill. This is J.D. I'll speak to the lawn & garden, then I'll turn it over to Rodolfo to speak to flea and tick. Walmart, typically we don't talk about their – our individual customers and their strategies. I would say that in recent years, this has been widely known that they have exited the season in the middle of summer. And only kept certain stores as year-round Garden stores.

So we have seen a wind down of inventories in general on what I would call our traditional lawn & garden products. We have some categories that they continue to buy year-round like wild bird food and that's one of the benefits of having a more diverse portfolio. Rodolfo?

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

A

Perfect. So Bill, going into flea and tick, this is mainly related to having a very cold spring, and a late start of the summer. With that at the end of the day, we'll lose some of the season; one of the cycle for the flea and tick for the past. So we're not concerned about the strategies we have in place for the business or anything like that. It was honestly just a bad season as we said cold spring, late summer.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Got it. And then the comment on kind of the organic growth of 2% to 3% for next year in line with your normal route. How much of that, am I expecting to come from price? I realize price isn't happening until January 1, but I mean if you're taking 2% to 3% price, does that imply no volume growth next year as expected?

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

A

No, we didn't give – I think we said our organic would be about half of what we thought our overall growth would be. So I think, it'd be in the high side of the number you gave there, and there would be a portion of it that will be volume based, and all of our growth will be related to price.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. And then last one from me. Niko, I mean you said the company plans to be, I think, "more aggressive in terms of looking at acquisitions." Is that because you now have a bigger war chest or the market is becoming more fertile? I'm just trying to couple that with the fact that there haven't been any meaningful major acquisitions since Bell, and they have historically been pretty lumpy. So I didn't know if something had changed where you would see a pickup in the rate of deals.

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

A

Yeah, the way I would say it is, we have a strong operating rhythm, we really feel good about our core business growing organically and consistently organically. We've made, I think about eight acquisitions over the last several years. All have gone quite well. And at the end of the year one and year two, we do post audits on them to see how they're tracking versus our expectations. I will tell you they're all tracking well.

So, Bill, the way I would describe it is our confidence of our core business and our ability to integrate acquisitions successfully and grow them in excess of 4% as I pointed out. It has increased our appetite to do more. We put incremental resources in place to look for acquisitions and to integrate them, and we would expect and want to do more. I'll also add to that, that our pipeline is quite healthy and actually cash in-hand, the pipeline has gotten even stronger as folks are looking to us more positively for deal flow.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Great. I guess, have you seen the sellers be more open to sell?

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

A

I think more people call.

William B. Chappell
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Got it. Great. Well, I'll turn it over. Thank you.

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

Christopher M. Carey
Vice President - Equity Research - Consumer, Bank of America Merrill Lynch

Q

Good evening. Thank you for the question. So, I guess approaching the M&A question from a bit of a different angle, perhaps some investors have been a bit surprised not seeing deals since the last equity raise. So do you think the additional resources that you've added put you in a better position to capitalize on deals quicker?

And then, I guess secondly, you did note several times the deal sizes could be larger. So, I'm wondering if you can bracket that a bit and speak to potential size of deals as well as any flavor on margins, growth rates, those sorts of elements. Thanks.

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

A

Sure. So, I think we're pretty happy with our process and our speed with which we can do a deal. The added resources are going to be around – more around origination. So, continuing to fill that pipeline and create the funnel if you will with which we can look at more deals, and be even more discriminating.

As far as size, certainly having $500 million on the balance sheet allows us to play in a very different arena. I don't see us doing if that's a company kind of deal at this stage. So, I think, probably $500 million would be, if I were to put an upper limit is going to be kind of the ceiling there. But that said, there are some smaller deals that are extremely attractive that are out there. So it doesn't preclude us from doing anything smaller.

That said, I'll speak out of both sides of my mouth here. Small deals take as much work as the large ones. So I think at this stage, we'd prefer a larger deal, and one that's going to move the needle for us. So that's kind of where we're at. Margin-wise, yeah, we want to find deals that are going to be accretive. The last few deals we've done had been dilutive on a margin percent basis. So we are definitely looking at deals that have attractive margins, higher margins and growth is always going to be important. You want to buy businesses that are healthy, that are growing. And that's the type of business we want to buy. So kind of all the above.

Christopher M. Carey
Vice President - Equity Research - Consumer, Bank of America Merrill Lynch

Q

Yeah. Okay, that's helpful. So if I could, just a couple, just on sort of modeling and thinking about cadence for next year, obviously, more back-half weighted. But is it fair to assume that gross margins could be down in the first half of the year given the impact of mix, but also inflation and as pricing builds?

And also, on the comment that you made around the Q2 organic sales comping, tough in Garden, but it was also quite a late spring last year as well. So, the comps in my mind, from that standpoint it actually should be a bit easy there. Is there something that I'm missing or did you have early sell-in in certain regions of the country, like in the Southeast last year that, that gave you that disproportionate bump early on?

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

A

Chris, this is J.D. I'll take the latter part of that question, with regard to the load-in last year as they anticipated the upcoming season. Retailers brought in pretty aggressive inventories. There was favorable weather in certain pockets of the country in February of last year. We thought that was an early breaking spring. We soon found out in March and April that, that was misleading and it ended up being very cold spring. So, it was unfavorable weather conditions. And I think that this year we'll be comping against that. So, last year, Q2, a pretty aggressive numbers to comp against; in Q3 due to the poor consumption and poor takeaway during that period of time, I think it will be an easier comp.

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

And as far as the margin question, I think, mix is going to play a pretty big role in that; and with the addition of Bell as well as General Pet, we would expect there to be some margin pressure there. Bell, in particular loses money in Q1 and Q2, so there'll be some pressure there. Additionally, most of our pricing doesn't kick-in until the calendar year. So, there will be some challenges in those first two quarters as George had outlined earlier.

Christopher M. Carey
Vice President - Equity Research - Consumer, Bank of America Merrill Lynch
Q

Okay. Makes total sense. And then, just one last one , then I'll hand it over. What are you assuming for tariffs into fiscal 2019. I know China is only roughly 10% of COGS if I remember correctly.

Rodolfo Spielmann
President-Pet Consumer Products, Central Garden & Pet Co.
A

So, right now – and this is Rodolfo speaking. In terms of tariff, you're right, it's only 10% of our COGS. And what we are planning, we have taken a very clear approach and very transparent approach with the customers. So, first of all, we've approached our vendors to allow for concessions, then always we're looking for different places for the source of product and whatever is remaining, we are transferring that as a pricing to keep our margin to our vendors, to our customers.

And if the tariffs are at any point within that, we will resume that price from the customer. So making a very long story short, we have assumed that the tariffs that have been announced happened and they stay for the whole year, and we have taken price already to offset those tariff for the customers. I can tell you that the first wave of tariff is already – the pricing is already in place, not only presented, but accepted by our customers.

Christopher M. Carey
Vice President - Equity Research - Consumer, Bank of America Merrill Lynch
Q

Okay. Got it. Thank you very much.

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

Thank you.

Operator: Our next question comes from the line of Brad Thomas with KeyBanc Capital Markets. Please proceed with your question.

Bradley B. Thomas
Analyst, KeyBanc Capital Markets, Inc.
Q

Thanks. Good afternoon, everybody. Appreciate the question.

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

A

Hi, Brad.

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

A

Hey, Brad.

Bradley B. Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Let' see here. A question about the retail door opportunity. Clearly, some nice success over last year with Kroger. I guess, could you just talk about the potential to add incremental retail doors in the upcoming year?

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

A

Are you talking about the store-within-a-store concept that we've done at our Pet distribution?

Bradley B. Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

I think just more broadly, as you look at distribution, do you think there are any new potential partners for you out there?

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

A

Well, in terms of the Pet distribution, we do believe that there's other folks who would benefit from the store-within-a-store concept. I will tell you that's a long sell. So it takes a long time to sell that, and put it in place and test and roll out. But we do know that there's accounts that are open to the opportunity as well as we're working issues now. But it's not something you'll see in the next few months that's for sure.

If you're talking more broadly about distribution of our items, I'll tell you, we feel great about our new item introductions for next year. Our Garden line reviews went quite well, and you'll see a lot of new items both across branded and private label products.

Bradley B. Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. And with respect to Garden, where do we stand here today in terms of that sell-in process? How do you think your shelf space will look this upcoming spring versus last year? And how are those conversations going with respect to the price increases you're putting through?

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

A

So, Brad. This is J.D. I'll take that question. I think, we feel very good about the prospects for next year. So we're into our Q1, consumption has been strong in Q1. And replenishment has been robust as well. But in terms of the big volume yet to come, that would start in Q2 with new store sets, we feel good about, what I would call, the controllable causal factors. I talk about those frequently and that would be things like our listings which George just mentioned, our distribution for next year on new items.

We feel very good about our support from the customers, both the promotional support, display support. We feel great about all those controllable causal factors. So I think we're teed-up to take advantage of a strong season. What is uncontrollable is what we ran into this past year, weather and things like that, that would be out of our control. But we feel very good about the going in prospects for the upcoming year.

Bradley B. Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. And then, maybe just one last one from me. If we reflect on this year that we've just ended, and we try to think about what the weather impact was over the whole year, would you hazard a guess at quantifying what kind of a detrimental impact it had on sales and earnings?

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

A

That would be truly supposition on my part. I think that, it certainly had an impact. It was – you just can't make up for poor weather in March and April, it's very difficult to do. Most retailers report a strong takeaway from mid-May on through June. But you're not going to make up the peak season of Garden. So I think there was some callback during the course of this season, and we ran into some excessive heat and drought in August.

And then impacted by the hurricanes. So back-to-back hurricanes that have affected the Southeast and the mid-Atlantic; two areas that are one big grassy market for us, and secondly, that's where Bell resides. So it had a profound impact on the end of the year for us. So it had a – I know, you're asking for a number here. I'm hesitant to give you a number, but I would say that, we had plenty of headwinds from the weather.

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

A

I'll jump in and just add. I don't think you would expect our Garden business in an average to decline on an organic basis. And if you think about the category, Garden typically grows with Household. We have been growing, expect to grow share, so we would grow north of Household – Household growth.

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

A

And even if you look at our competitive set, their numbers, their metrics were far worse than ours.

Bradley B. Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Got you. That's very helpful. Thanks, guys.

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

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Hey. Good afternoon, guys, and thanks for taking the question. So I guess, first, if you could talk a little bit more about your private label offering in the market overall. I guess, housekeeping, just what percentage of sales was private label for the year, up from the 15% to 20% that you guys talked about previously?

And then, one of your competitors in the Garden side made comments recently that seemed to kind of indicate that they would be more aggressive on their private label contract pricing. Are you seeing in general more competitive stance on those contracts, and how often are they renewed?

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

A

So I'll start on a high-level, then I'll let J.D. get into the home centers. Private label, I think, you misquoted the number; where in private label, our company tends to be about 10% to 15% in both of our segments. It is growing, the interesting thing is, we have grown our private label consistently over the last five years as we've grown our profits and margins as well.

So we feel good about the private label business. And [indiscernible] (00:41:27) believe we're the low-cost producer and we have excess capacity. We've been very successful getting it. And believe it's a consumer tailwind. So private label is growing across all categories, we expect to continue to chase it, and we expect to continue to chase it, and be successful with it in Garden.

I'll let J.D. speak to some of the specifics.

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

A

Sure. Christina, I'll speak to a few of the Garden related private label offerings. We play in that space both in fertilizers, control, grass seed and wild bird feed. We've been at it for some time. These are well-developed businesses. And as George said, they're growing. I think that, I've heard the same sales pitch that you did from a competitor that they were coming after that space.

But I will say that, that's not new. They've been on the private label offerings in the areas where we compete with them. They've been on them consistently over the years, but – and I think they also referenced that their footprint, their supply chain footprint would be a strategic advantage. And I'd say that our supply chain footprint is extremely well-developed.

But I'd also comment about the private label in general. It's evolved over the years, it's no longer the inexpensive opening price point product. The retailers are expecting more. From a consumer standpoint, they want a value proposition for the consumer, that starts with efficacious products, and it also means having compelling consumer claims. They're equal to or better than in some cases the leading national brand.

But also, and I think that this is where we differentiate ourselves. We've taken a category management approach to private label, and that is partnering with the retailers. And a huge part of that is ensuring that we're delivering category margin enhancement, and I think that's where we separate ourselves from our competition.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Great. That's helpful. And then, Rodolfo, if you could also talk about the opportunities, maybe on the Pet side. I think, previously, you all have talked about maybe in the pet bed category or some additional space opportunity in Amazon. So any color there would be really helpful.

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

A

Okay. So, very similar to what George mentioned in terms of company strategy; we do pursue private label where we have capacity, we're the low-cost producer and we have ability to partner with customers. I can tell you that today, we have private label offerings in every relevant channels where we compete, and that includes private label or control brands in the e-commerce channel.

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

A

And Christina, it's J.D. again. I'll just add one comment to that, and that private label, we view that as similar to our distribution business, where we distribute other manufacturers' products through some retailers. Between the distribution business, our own products, the private label, it gives us a broader share of shelf, more critical mass with those retailers. As I mentioned earlier, that conversation between us and the retailer on private label becomes a very strategic partnership, and I think that, that allows us to leverage all of our business including our Branded business.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Yeah. That makes sense. Thanks. And I guess to take a step back away from the private label for a second. Just looking at the Nielsen data lately, it's been a really impressive acceleration in your sell-through rate. And so, I was a little surprised about the 2% to 3% organic sales growth guidance for year. How much of that is conservative, and – or is there something going on in the non-private channels or with your distribution business or private label that we're not seeing really in the data that would suggest things aren't as strong as the sell-through it suggests on Nielsen?

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

A

So I'm not sure exactly what Nielsen data you're looking at, because it can be kind of lot of different ways. You're talking about Nielsen data for any Central product sold in the Nielsen tracked channels, it's probably been positively affected at this point in time by wild bird food. It's a terrific start to the wild bird season given the cold weather particularly in the Northeast. So wild bird is doing quite well. The other thing I will tell you, there's a lot that we sell in those channels that doesn't show up as necessarily Central for this private label. So I'd be careful about drawing wide conclusions from the limited data.

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

A

And even some of our larger categories like grass seed is not tracked by Nielsen as well or some retailers don't participate in Nielsen. So it's an indicator, but it's just one of many.

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

A

So I suspect the answer is, I think, wild bird is driving that number.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Okay, yeah. That totally makes sense. And lastly, just to put a finer point on Chris' question I think earlier. Are you embedding in guidance for the tariff from Chinese imports increased to 25% in January or since that's not finalized yet, are you expecting in guidance at still 10%?

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

A

So we did expect that to happen. So that's already been presented to customers.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Perfect.

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

A

To be very clear, the tariffs don't go up 25%, they go up only 10%. Then, we will be seeing part of the price increase that we have talked about.

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

A

And to be clear, we're hoping not to pass along that much of a price increase if we can find alternate locations of supply or bring in-house or reduce our cost with the vendors through negotiation.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Okay. Great. Thank you.

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

A

Sure.

Operator: [Operator Instructions] Our next question comes from the line of William Reuter with Bank of America Merrill Lynch. Please proceed with your question.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Hi, you were talking a little bit earlier about Walmart in some of their stores reducing the time which they have lawn & garden on the shelves. In terms of aggregate shelf space, the lawn & garden category is either expected to get next year or got this year. Can you talk a little bit about what the trends are there in brick-and-mortar?

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

A

So, William, just to be clear, you're talking about the space within the store that's dedicated to lawn & garden?

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Yeah. So, I'm trying to exclude e-commerce and what's going on in that channel. Just trying to get a sense for how some of these kind of mass retailers are addressing the category in terms of what they're I guess allocating towards it coupled with store growth of some of the larger home and garden guys?

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

A

So what we're seeing is really similar to what we've seen in recent years. No reduction in the commitment of size, space within the store to lawn & garden. That particular retailer that we talked about earlier converts that space to a holiday late in the season. But they've been doing that for a number of years. In terms of what they will commit to in terms of space for the upcoming season, we anticipate it will be similar to what it has been the last few years. And the same goes really for the other big box retailers. I think that the space will expand, but it's certainly not contracting.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Okay. So generally there has – you're not seeing any meaningful reductions in shelf space from any, I guess, brick-and-mortar retailers?

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

A

No. I'm not saying that. From time-to-time we'll see short-term strategies that shift display space from one product category to another. But in terms of the lawn & garden department we don't see a contraction in the lawn & garden department from major retailers.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Okay. And then how about the way which they allocate their shelf space between branded and private label? Are you seeing any changes there?

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

A

Subtle changes. I think that – it varies by retailer, but some retailers are more committed to a private label strategy than others. But I'd go back to what I said earlier, I think they take a category management approach and those that are looking to add margin to the category oftentimes commit more strongly to a private label approach.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Okay. And then just lastly from me. I'm not sure if I missed it, but CapEx number for next year if it's there, I'm sorry, but what's your expectation?

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

A

Expectation is in the mid to high-40s for CapEx. We had some dribble over from this year into next year which could take it over the $45 million, call it $45 million mark. But yeah, so anywhere mid to high-40s.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Okay, that's all from me. Thank you.

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

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Hello, thanks for taking the call. I just had two questions. In the Pet segment you guys posted Q4, 22% increase in sales of other manufacturers' products, but it was down low-double-digits in Garden. It is one of the highest swings we've seen on a quarterly basis in those two line items. I was wondering if there's a driver there that was driving one to do better for the third party sales than the other?

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

A

So we've been doing very well on that area for the whole year, what you see that huge increase in Q4, remember, we have General Pet and that adds a ton of third-party vendor volume.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Got it. That was what I was missing.

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

A

And on the Garden side, if you look back over the last few years, that segment of the business has grown very rapidly for us in Q4, and really for F 2018. We had some headwinds there, but the two largest would be, well across the entire year, we've seen some softness in the hydro industry, which is some of the customers in that industry are customers of our independent business. So we've seen softness there. And then in Q4 specifically, we also saw just the timing of some orders from customers that shifted into Q3, and some that will shift out late Q4 into Q1, and that impacted Q4.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you. And then my second question was, I was wondering if you had seen any stabilization in your trends through pet specialty or if it was trending kind of the same way it had been trending all year?

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

A

Let me take a step back before answering the question. We clearly have a significant presence in pet specialty. Having said that, the exposure has been reduced in the last several quarters, as we keep gaining more and more volume in mass, club, e-commerce. So while we have been – while we say, we have been able to sustain 16 quarters of consecutive growth, because we're finding ways and putting the trust in front of where the consumers want it.

In terms of specialty, we have been having troubles that we have discussed in previous calls with only one large customer. In the rest of the pet specialty channel, we have been growing share. In fact, in most customers growing volume year-over-year and growing sales year-over-year.

With that customer, that has been a long-term issue. To be honest, it's becoming smaller and smaller. So the issue is also becoming smaller. I would love to tell you that we're growing with that customer. That's not the case. But the problem is significantly smaller now than what it was before. And so far, it has not affected our way of delivering the business.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Thank you very much. I appreciate it.

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

A

Thank you.

Operator: Ladies and gentlemen, we have reached the end of the question-and-answer session and I'd like to turn the call back to George Roeth for closing remarks.

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

I just like to thank everybody for attending today's call and have a great day.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.