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Central Garden & Pet Co. (CENT)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

I would now like to turn the call over to Friederike Edelmann, Vice President, Investor Relations. Please go ahead.

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

Thank you, David. Good afternoon, everyone. Thank you for joining us. With me on the call today are Tim Cofer, Chief Executive Officer; Niko Lahanas, Chief Financial Officer; J.D. Walker, President, Garden Consumer Products; and John Hanson, President, Pet Consumer Products. Tim will begin with a business update and Niko will discuss our Q2 results and our outlook for fiscal 2021 in more detail. After the prepared remarks, J.D. and John will join us for the management Q&A.

Our press release providing the results for our second quarter ended March 27, 2021 and related materials are available on our website at ir.central.com and contain the GAAP to non-GAAP reconciliations for the non-GAAP measures discussed on this call. Lastly, unless otherwise stated, all growth comparisons made during this call are against the same period in the prior year.

Before I turn the call over to Tim, I would like to remind you that statements made during this call which are not historical facts, including the potential impact of COVID-19 on our business, EPS and other guidance for fiscal 2021, expectations for new capital investments, product launches and future acquisitions, are forward-looking statements subject to risk and uncertainties that could cause actual results to differ materially from those implied by forward-looking statements. These risks and others are described in Central's filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K filed on November 24, 2020. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events or otherwise.

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

Timothy P. Cofer

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

Thanks, Friederike, and good afternoon, everyone. Thank you for joining our Q2 earnings call. Today, Niko and I will discuss our second quarter results, our perspective on how Central is performing in the current environment and how we are approaching the back half of fiscal 2021 to drive future growth.

Before we get started, I want to take a moment to recognize that it's been a little over a year since the onset of COVID-19. This time last year, we were about a month into the pandemic and most concerned about how to protect the health and safety of our employees, while serving our customers and consumers. As we look at where we are today, I'm hopeful that we're seeing a light at the end of the tunnel. As vaccine rollouts accelerate across the country, I'm optimistic they will play an important role continuing to keep our frontline colleagues safe, assisting in the return to our offices and helping all of us get back to doing the things we love.

The company remains vigilant in our efforts to operate and conduct business safely, and our facilities have diligently maintained health and safety standards. We have hosted mobile vaccination clinics at our larger manufacturing and distribution sites, providing vaccines to hundreds of our frontline employees. We will continue to bring these vaccination clinics to our facilities for as long as they are necessary and useful. My entire executive team and I are or soon will be fully vaccinated. And importantly, thanks to the hard work of our teams, all of our manufacturing facilities and distribution centers remain open and fully operational.

Now to our results. I'm pleased to share that Central has delivered the fifth consecutive quarter of record results, both on the top and the bottom line. Our consistent delivery during the pandemic is not only a testament to our team's ability to execute and adapt to a rapidly changing environment, but also a reflection of the progress we have made on our Central to Home strategy.

Let me share with you some highlights from the quarter to illustrate recent progress made across all five of our strategic pillars, supporting our mission to lead the future of the pet and garden industries. First, our Consumer pillar, which is dedicated to understanding our consumers and growing brands consumers love. Our Pennington brand just relaunched its Smart Seed portfolio. The brand's drought resistant, environmentally conscious lawn seeds are even more reliable, effective and easy to use, and can help consumers conserve up to 30% more water year-after-year. The portfolio has been simplified, package designs have improved, so it's easier for consumers to find the exact grass seed varietal they need and recognize the trusted Pennington brand. Each bag features new digital integration and links to relevant content and social media platforms, including helpful videos on YouTube.

The relaunch was also supported by new advertising, Pennington's Smart That Never Fails campaign, which came to life across digital, television, radio and in-store channels. While still early in the garden season, customer listings are above our expectations and we're seeing strong double-digit increases in POS year-to-date. We're confident the Smart Seed relaunch will play an important role in regaining share in grass seed.

Now on our Customer pillar, where our goal is to win with winning customers and channels. We're investing heavily in the eCommerce channel and building capabilities in digital marketing. In addition, we've added new partners to strengthen our e-commerce analytics. We had encouraging Q2 performance across both Pet and Garden in the eCommerce channel, including pure play omni-channel and direct-to-consumer. Our pet business grew more than 50% versus prior year and, in garden, our eCommerce business grew triple digits.

In support of our Central pillar, which is focused on strengthening the company's portfolio, we have now closed all three of our recently announced acquisitions in the garden space, DoMyOwn, Hopewell and Green Garden. DoMyOwn brings key digital capabilities that we're already beginning to leverage in two of our business units, one in each segment. Hopewell adds scale to our live plants business, one of the fastest growing segments in the industry, and we expect many synergies to come from the partnership of Bell and Hopewell Nurseries. And finally, Green Garden adds the adjacent vegetable, herb and flower seed business and extends our seed capabilities.

All three acquisitions delivered strong Q2 results in line with our expectations and we expect them to be accretive to earnings in fiscal year 2021. We have initiated the integration work across all three companies, but of course, there's a lot of work ahead to integrate and capture the capabilities, synergies and full potential benefits. And while we're pleased with these new additions to our Central family, our thirst for acquisitions is not yet quenched. We continue to actively scan the market for great assets to add to both our Pet and Garden portfolios.

The fourth pillar in our strategy Cost is focused on reducing cost to improve margins and fuel growth across the enterprise. Some current examples of this work are our procurement pilots aimed at taking advantage of our purchasing scale in corrugate and flexible packaging, as well as freight optimization across multiple business units. Additionally, we are investing in automation in several of our businesses to not only lower costs but also help to improve service levels. We anticipate seeing the benefits of these projects unfold beginning in the back half of fiscal 2021 and over the next several years.

And finally, our Culture pillar is focused on our greatest asset, our 7,000 employees. Let me briefly highlight two areas. We've recently introduced our diversity and inclusion strategy, where we're dedicated to making meaningful progress in the areas where we can have the most impact including mentorship, leadership development, recruiting and employee education. We've also heightened our focus on digital capability development, rolling out a cross-functional eCommerce flywheel training program across our organization.

Now, to provide some more color on our Q2 performance. Net sales increased 33% to $935 million, aided by 23% organic growth as well as inorganic contributions from our recent acquisitions. Gross margin decreased 40 basis points to 29.1%, largely driven by the impact of initial inventory-related purchase accounting adjustments from our recent acquisitions and cost inflation headwinds which were only partially offset by our pricing and net productivity efforts. Operating margin increased 180 basis points to 11.2%, driven by operating efficiencies. And importantly, we delivered EPS of $1.32 per share on a GAAP basis, an increase of 69% over prior year. Given our strong organic performance in the first half of the year, we are raising our EPS outlook for fiscal 2021, and Niko will share more details in a minute.

Now a few words on our two segments. In Pet, the surge in pet adoption in 2020 continues to drive consumer demand across all categories. Dog ownership is up 8%, cat households were up 5%, and all other pets grew 11%. This translates to over 4 million new pet owning households. And we know that approximately one-third of existing pet owning households added an additional pet. It's also important to note that these new households are younger, more digitally savvy and more concerned with health and wellness. We believe all of this bodes well for the continued strength of the pet industry and it offers meaningful growth opportunities for Central in the years to come.

Our record sales and EBIT in the pet segment were driven by our small animal business as well as dog and cat, pet distribution and our outdoor cushion business. We're also pleased with the recovery in the supply for live fish, pet birds and small animals. We gained share in dog treats, waste management and aquatics. And our eCommerce business, which as I mentioned earlier grew over 50% versus prior year, now represents approximately 21% of pet branded sales.

Shifting to Garden, we had a record quarter across the segment driven by the 8 million households who entered the lawn and garden consumables category since the outbreak of the pandemic. Importantly, about one-third of these were millennials and Gen Z consumers, which suggests future growth for our industry. Our distribution business, controls and fertilizers, wild bird and grass seed drove the robust organic growth in our Garden business. And our three new acquisitions, DoMyOwn, Hopewell and Green Garden added $76 million in sales. We gained share in fungicides and fertilizers, and our eCommerce business now represents 6% of total Garden sales.

Now a few comments on our supply chain. The ongoing heightened demand for our Pet and Garden brands continues to put pressure on our manufacturing capacity, and our service levels are not yet where we expect them to be. As we pointed out in prior calls, we are investing in capacity expansion and automation to meet the continuing strong demand. Evidence of our commitment in this area is we are doubling our CapEx expenditures in fiscal 2021 versus prior year, with most of the capital expenditures directed at incremental manufacturing capacity.

Additionally, we continue to face the inflationary pressures that have resulted from the COVID-19 operating environment, including significant increases in costs for key commodities, labor and freight. As such, we remain focused on how we can offset these inflationary pressures with an increased attention on our net productivity agenda, leveraging our scale across the enterprise and pricing.

Finally, as we look toward the second half of the fiscal year, we're focused in three areas. First, driving organic growth by delivering another great garden season and continuing to fuel the momentum in Pet; second, integrating our acquisitions with excellence; and third, building capacity and capability, specifically executing significant capacity expansion to improve our service levels and investing to improve our consumer fundamentals across insights, innovation and marketing to drive organic growth in 2022 and beyond.

With that, let me turn it over to Niko, who will share more details of our Q2 results and our outlook for the fiscal year. Niko?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, Tim. Good afternoon, everyone. We continue to be extremely pleased with the performance of our business. Second quarter net sales reached $935 million, an increase of 33% or $232 million, driven by organic growth in both segments. Organic sales increased 23%. Our three recent acquisitions added $76 million in net sales.

Consolidated gross profit increased $65 million to $272 million. However, gross margin decreased 40 basis points to 29.1% due to the impact of initial purchase accounting adjustments related to our three recent acquisitions, as well as cost inflation in key commodities, labor and freight, in particular ocean freight.

SG&A expense increased 19% to $168 million, driven by the inorganic increases related to our recent acquisitions as well as higher payroll-related and logistics costs resulting from our increased volumes, partially offset by lower travel and entertainment expense. Conversely, SG&A decreased 220 basis points to 17.9% of net sales, driven by improved operating leverage.

Operating income increased $39 million to $105 million, driven by higher sales volumes, partially offset by higher SG&A expenses. Operating margin increased 180 basis points to 11.2% due to improved operating leverage. EBITDA increased 56% to $123 million.

Turning now to our Garden segment, Garden segment sales increased 49% or $146 million to $443 million. Excluding acquisitions, organic sales increased 23% and were broad-based across the segment, with the most notable growth coming from our garden distribution, fertilizers and controls, wild bird feed and grass seed businesses. And our acquisitions added $76 million in net sales.

Garden segment operating income was $66 million, an increase of 53%. Garden segment operating margin increased by 40 basis points to 14.9%. The improvement was driven by the organic growth mentioned previously as well as SG&A efficiencies. Garden segment EBITDA increased 63% to $75 million.

Turning now to Pet. Pet segment sales increased 21% or $87 million to $492 million. Sales increased across all categories with particular strength in small animal supplies, distribution, dog and cat, and our Arden outdoor pillow and cushion business, which we moved from our Garden segment into the Pet segment as of the first quarter of fiscal 2021.

Pet segment operating income increased by 43% to $62 million and operating margin increased by 190 basis points to 12.6%, driven by strong sales contribution as well as improved operating leverage. Pet segment EBITDA increased 35% to $71 million.

Now getting back to our consolidated results, other income was $700,000 compared to other expense of $1 million a year ago. The difference was primarily due to favorable foreign exchange impact in the second quarter of fiscal 2021, compared to unfavorable foreign exchange impact in the prior year.

Net interest expense was $10 million compared to $9 million a year ago. The increase was driven by higher debt outstanding. Net income grew 71% to $73 million from $43 million a year ago. Diluted earnings per share increased 69% to $1.32 from $0.78 in the year prior, driven by organic strength and $0.07 accretion from our recent acquisitions.

Our tax rate was 22.7%, in line with the prior-year quarter. Cash and cash equivalents at the end of the second quarter decreased to $40 million from $332 million a year ago. During the quarter, we paid approximately $653 million in cash and additional funds from our ABL for the acquisitions of DoMyOwn and Green Garden. Net cash used by operations was $84 million for the quarter, up from $75 million a year ago, as higher EBITDA was more than offset by unfavorable changes in working capital, primarily due to increased demand for our products.

As we have pointed out, we've heightened our focus on capacity expansion and increased our CapEx 98% over the prior-year quarter to $19 million. Some examples of investments made in the quarter are automation and warehouse expansion in our wild bird and controls business, capacity expansion of our dog and cat business, and consolidation of locations in our branded chemicals and fertilizer business.

Total debt was $979 million, up $285 million from the same time last year. Our gross leverage ratio, as defined in our credit agreement, was 2.5 times at the end of the quarter compared to 2.9 times a year ago and well within our target range. At the end of the second quarter, we had $190 million of borrowings under our $400 million credit line. Depreciation and amortization for the quarter was $19 million compared to $13 million in the prior-year quarter, primarily driven by our recent acquisitions.

During the quarter, we did not repurchase any of our stock. There remains $100 million under the board's previously authorized share repurchase program, as well as additional shares under the board's equity dilution authorization. And after the close of the second quarter, we issued $400 million in senior notes at 4.125% to replenish our cash position. As Tim mentioned, we continue to be on the lookout for great growth and margin accretive companies in both Pet and Garden.

And finally, turning to our fiscal 2021 outlook. While we are pleased with our Q2 and first half results, we still have a significant portion of the garden season ahead of us. And we are up against near-ideal gardening weather in 2020. That said, we anticipate our strong business momentum to carry on and, as mentioned previously, we are leaning in with increased strategic investment spending to expand our capacities and drive future profitability and growth.

In the near-term, however, our supply chain remains stressed, including outstripped capacity and labor shortages, and we are bracing for further increase in costs for raw materials and freight. While we have and continue to take pricing, we do not expect to be able to offset all the impact this fiscal year. And finally, there remains the uncertainty around the impact of lapping COVID tailwinds in the second half of fiscal 2021.

Taking all of this into consideration, we are increasing our guidance and now anticipate full-year 2021 GAAP EPS of $2.25 or higher. This compares to our previous guidance of 2021 GAAP EPS of $1.90 or higher and translates to 2021 adjusted diluted EPS of $2.42 or higher. Please note, this outlook excludes the impact of acquisitions as we are still finalizing purchase accounting.

While we are not yet ready to include the acquisitions in our outlook, our early estimates indicate that they will be accretive for 2021 EPS, somewhere in the range of $0.11 to $0.16. The good news is that all three are off to a great start, adding $0.07 to Q2 EPS. We also expect them to be accretive for the fiscal year 2021.

And with that, we'd like to open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be having our question-and-answer session. [Operator Instructions] Our first question comes from Bill Chappell with SunTrust. Please proceed with your question.

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

Thanks. Good afternoon.

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

Hey, Bill.

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

Hey, Bill.

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

Hey. I wanted to – I appreciate things are still in flux in terms of the recent deals. But can you give us maybe a little more color on sales contribution this year and probably more importantly EBITDA contribution? Because EPS, it's tougher to kind of understand if we don't especially know what the kind of D&A will be with those deals.

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

Yeah. Well, the sales for the quarter were $76 million for the quarter.

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

Sure.

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

So we've got that. And then EBITDA was fairly de minimis honestly because the bulk of it was taken out via purchase accounting. So it wasn't a huge EBITDA contribution there, Bill.

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

Well, I guess, when I'm looking at the sales, I know there's some that are seasonal businesses. Is $76 million a good number to use going forward, or how should I be thinking about that?

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

Yeah. I mean, the way to think about it is two of the three, so Hopewell, Green Garden are highly seasonal. DoMyOwn is a little more what I would say spread out even keeled over the year. But for instance, DoMyOwn is – or excuse me, Hopewell is going to do – have a really big Q3. And in fact, it's a lot like Bell which we did back in 2018 where the bulk of their, if not all their, EBIT will hit in that one quarter. The other three quarters will be losses, similar to Bell. So that's the way to think about it.

And then Green Garden, also seasonal – kind of think the same sort of seasonality as Garden as a whole, although I would say their season sort of kicks off earlier and then, of course, ends a little bit earlier. So they're already past kind of their peak revenue is the way to think about it and they're kind of on a little bit of a decline now going forward.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Okay. And then just as I look at the Garden business, I mean, Scotts earlier today talked about taking pricing to offset commodities but not doing it till kind of the end of the fiscal year, which is similar to your fiscal year, just because where the season will be largely over, I guess. Are you thinking that same way that you need to take some prices to offset commodities but don't let mean to take it necessarily near-term?

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

A

Hi, Bill. It's J.D. I'll take that question.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Hey, J.D.

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

A

What I'd say in terms of pricing, we have taken some pricing already this year in categories where we saw dramatic increases in cost of goods. Specifically there, the wild bird food category where we saw a spike in the grain costs. So we will take it if we see significant movement in our cost of goods. Going forward for this year, I mean certainly there's inflation. Niko touched on it earlier. Commodities will impact this in fertilizer with the N, P and K grains, and then some is still unknown like grass seed for example because that harvest is still in front of us. But we do anticipate some inflation. Earlier Tim talked about our net productivity work to try to offset that inflation, but we do plan on taking some pricing. It won't be this year. We will take our pricing in concert with the customers on their normal cadence, their cycle with the upcoming year for F 2022.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Okay. And then last one for me just on Pet. Appreciate the strength of the business and certainly Pet is on trend. But maybe you could talk a little bit more beyond companion pets. And just in terms of were the growth rates of aquatics and reptile and bird similar to the overall category? Were they lot lower? Was companion pet that much higher? Just kind of understanding what the makeup of that growth was.

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

A

Hey, Bill. This is John. Yeah, we're seeing solid growth rates across all animal types. And as you know, we've got a live animal business that had strong double-digit growth rate in Q2. And we also believe it's got a good start to Q3 and we also believe there's a lot of pent-up demand for more animals. So it's very widespread across animal type.

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

A

Maybe putting a finer point on it, Bill, if you're – when you say companion animal, are you saying dog and cat?

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Correct.

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

A

Different people have different definition. Okay, fine.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Yeah. And more with the gerbils and guinea pigs and fish and birds, or everyone.

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

A

Totally. And that's where I was going, Bill. As you know that rest of the kind of animal kingdom beyond dog and cat is a big part of our business. That's where we've got some great brands and strong leadership position. So, if you start with the animal itself, what our data shows is dogs overall in this COVID period are up about 5% in terms of households owning dogs. Cats are up at around 5% as well – sorry, dogs is up 8%, cats are up 5%. And then all other pets are up about 11%.

So we're seeing really strong growth in that all other what you call companion animal. And to John Hanson's point, we're seeing that reflected in the POS as well. And so we had real strengths, for example, in our aquatics business, our small animal business, our pet bird business and supplies, their food and supplies. So we're seeing good growth in those other animal classes beyond the conventional dog and cat.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

No, that's great color. Thanks so much.

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

A

Thank you.

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

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Hi. Good afternoon. Congrats on the continued momentum here. I wanted to follow-up on some of the questions with the Garden segment and see if maybe, Tim, you or J.D. could give us a little more color about what you're hearing from your retailers as we get into May? How were trends going as we comp the increasingly difficult comparisons? How are inventory levels? And do the retailers want to keep those inventory levels up or are they pulling back at all on their orders?

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

A

Sure. J.D.

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

A

Hi, Brad. It's J.D. I'll take the question. First of all, I'd say we're just now starting to comp against the COVID spike from last year, the last couple of weeks. Until then, business was pretty much the way – the strength of the business was very similar to the way it was over the prior three quarters. So we're just now starting to see some of the anticipated headwinds.

I'd say the retailers are remaining very engaged and optimistic about the business, and they've reflected that with their – you asked about inventory. They took a very aggressive position in getting the stores ready for the season and that's helped with POS as well.

So, at this point, I think we're all waiting to see how the season unfolds. We're two weeks into it. The weather hasn't been ideal. So we're starting to worry about weather maybe for the first time in the last year or so. And I think that in terms of the stores being ready, they're certainly ready. We're ready from an execution standpoint.

The big unknown here is consumers, as they start to perhaps travel and gather, how engaged will they remain in our categories. And we believe that through demand creation and the retailers continuing to stay in the business, the consumer will stay engaged as well. But too early to tell. I'd say the next six weeks or so will shed a lot of light on this.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Yeah. That's very helpful. Thank you, J.D. And if I could ask a follow-up about guidance, I'm just thinking about high-level moving pieces. You clearly had a great quarter here. You've raised the full-year guidance, which is at least kind of number. You've given us commentary around how much acquisitions could add.

I guess, when we think about your outlook for the underlying organic business and we think about some of the investments you may be making and some of the rising input costs, etcetera, how are you thinking about the level of investments versus the performance of the core business as we think about what you've assumed for the balance of the year?

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

A

Well, I mean we're plot committed on the investments. We talked about the CapEx on the call being up 100%. And that's going to have a two-fold impact. One, it's going to allow us to expand capacities and meet those fill rates and be a better service provider to our customers; and two, to combat the commodity, inflation and the labor issues is we're trying to automate more. So, take cost out, consolidate different businesses into one location and really work on becoming much more efficient in terms of how we produce product.

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

A

And the other part of the investment envelope, as Niko said, first part and the key part is CapEx, and the other is we will take this opportunity again in the back half of fiscal 2021 to further invest in our consumer-oriented growth agenda. And that will include investments in sharpening consumer insights across both Pet and Garden. We've got some brand investments planned on four or five of our biggest power brands across both Pet and Garden. The benefits of that work will start to show up in 2022. And then finally, the innovation agenda against those brands.

So we're – as we have exceeded some of our expectations here in the front half and given the call up of the year, we're taking some of that favorability, consistent with the algorithm that Niko has shared at Investor Day and reinvesting that back in our business in the back half.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Really helpful. Thank you, Tim. Thank you, Niko.

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

William Michael Reuter
Analyst, BofA Securities, Inc.

Q

Hi. I'm not sure what you can provide here, but you mentioned your most of the price increases are going to go kind of when retailers reset towards the end of the year, except for those that were taken on some of the bird seed milo-millet products. I guess, is there any way for us to get a sense for what type of cost of goods inflation you're estimating this year? I know you said there's some that's yet to come, but if you were just to put an estimate on it?

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

A

Well, first of all, I'll jump in and then Niko can build as well. I mean, first, I think the – kind of first part of your question premise, that is rooted on the Garden side. So, on Garden, conventionally you price at the beginning of the season and kind of intra-season price increases are things that our customers and we tend to like to avoid because the planograms are set and the season is executed. And so, to your point, that's what J.D. covered in his earlier comments.

On the Pet side, we have more flexibility given the seasonality of the business to price more as needed and I would say there are more frequent price increases on the Pet side, including this year, than what we're seeing on the Garden side. In general, the pricing this year we believe when the year settles out will be insufficient in covering the entire inflationary headwinds facing our business. That'd be inclusive of the commodity increases, the labor inflation, the freight inflation, particularly ocean freight, as Niko said earlier.

So, on a dollar basis, we'll fall a little short of covering all of that. We've got plans in place, as J.D. said earlier and same on the Pet side, to put in a fresh round of pricing at fiscal year-end into the 1st of next year to recoup that. And I don't know, Niko, any further builds?

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

A

No. I think you summed it up really well that the inflation piece is absolutely staggering. If I were to add any color, I would say the bulk of it is coming from commodities and transportation. And we're going to be aggressive on price, but we also believe it won't be enough to cover it completely. And we're going to have to figure out creative ways to take cost out of the business to try to maintain our margins. That'll be the challenge going forward.

William Michael Reuter
Analyst, BofA Securities, Inc.

Q

That's all helpful. I guess, I might get one more shot at it here. There's things like urea that are up 50%. Ocean freight are up 200%. Is there any number, so for the lawn and garden side is where I'm speaking at specifically here, those which you usually take when you have your shelf space resets at the end of the season? Do you have a number you could give us, just because these numbers are so big, it's hard to even guess at what the total inflationary number may be?

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

A

William, this is J.D. With regard to urea specifically, really all of the inputs from diammonium phosphate, urea, potash, all of those are escalating this year. I think one of the good things from our standpoint is most of our goods for this year were already built. So the impact for this year will be – we'll feel it but it won't be as significant. For next year, we'll take pricing in our lawn reviews for the upcoming year. I know you're looking for a specific number here, but that's something we typically don't disclose.

William Michael Reuter
Analyst, BofA Securities, Inc.

Q

Okay. Thanks for taking the question. I'll pass to others.

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

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

Hi. Good afternoon, and congrats on the results. I was hoping if you can elaborate a little bit more on your assumptions for the categories. I know it's tough because obviously you're lapping tough comps ahead on the second half. But if despite these tough comparisons, obviously you called out the category, as you said, 11% for companion animals, ex cats and dogs. And that in gardening obviously more people having that.

Is there any other metric you can share for organic where you're still assuming like distribution gains or on top of the pricing to help us kind of bridge how we should be thinking on the second half? Obviously, you're probably going to go negative. I mean, your guidance, the minimal of is still kind of embeds a really wide range of possibilities. I think you probably are conservative. It kind of implies as if – at the bottom implies that you'll go negative on the top line. So can you help us like how negative like we should be assuming going forward? That would be super helpful. Thank you.

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

A

Sure. This is Tim. I'll take a broad shot at your question, Andrea. I think, first, you got to step back and talk about Garden versus Pet, because the dynamics are different. From a kind of sales guidance standpoint, I'd go back in terms of long-term and guide consistent with what Niko and I guided at Investor Day. And that is our objective is to grow at or above the categories in which we compete.

For us, if you take out the COVID period, that's a low-single-digit number. And that's what we're trying to do over time. We want to be the leaders in our categories and grow at or above that rate. Obviously, COVID threw a wonderful tailwind and wildcard into it. And so, if – I think your question is a little bit more about the back half.

If you look at the front half, let's start with Garden. You're having POS trends in the mid-20s on brick-and-mortar basis in terms of growth versus prior year. But as J.D. Walker said earlier, we are now getting into the key comp timeframe of last year's. First of all, incredible weather garden season and, of course, all of the favorable stay-at-home COVID gardening impact.

And so we are definitely seeing in these last few weeks a slowdown of POS as we lap those huge mountains of last year. And as J.D. Walker said earlier, very honestly on the Garden side weather does play a really important role. These last few weeks, particularly in the Southeast, has been unfavorable weather, a lot of severe weather. It's been a wet weather. That's not good for garden season. And so we're taking a cautious approach on the Garden side but I think a prudent one, and that's reflected in our guidance.

On the Pet side, you're also seeing very strong POS growth again kind of right now in the 20s type of brick-and-mortar number and then north of 50% on the eCommerce number in terms of growth versus prior. We're also now just beginning to lap those early impacts of COVID prior year. And we're seeing a slight slowdown but less than we're seeing on the Garden side. And I think that's supported by that incremental pet adoption that I went through earlier on the call across dog, cat and all other animal classes.

And so, on that one, we're I would say a little bit more bullish that the sportier trends can continue through the back half. And I think that's about as far as we'll go. We don't guide on sales intra-quarter. So we're not going to give you a number. But hopefully that helps you in terms of long-term expectations and then a few of the dynamics across the two industries.

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

That's super helpful. Thank you very much. I'll pass it on.

Operator: Thank you. Our next question comes from Hale Holden with Barclays. Please proceed with your question.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Hi. Thanks for taking the call. I just had two questions. The first one was, I was wondering if the increased sales velocity this quarter than what you've talked about a little bit on the margin cost side, plus the three acquisitions you just closed, changed your working capital assumptions kind of for the remainder of the year or not.

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

A

Definitely. These acquisitions come with inventory and the big bump in inventory was largely driven by the acquisitions. And then, secondarily, our organic revenue grew substantially and so with that comes higher inventory levels and more AR. So we definitely ramped up and I would say we ramped up earlier on the working cap. So we saw the peak kind of hit earlier than what we normally experience.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Got it. And then my second question is, when you guys are thinking about the distribution center upgrades that you're doing and then the stuff you talked about at the Investor Day in terms of eCommerce strategies, I was wondering if you were getting any pushback from some of your wholesale clients to do direct distribution ships from your DCs?

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

A

Actually, it's more of a partnership where they're actually asking us to engage with them and to help them fulfill the direct-to-consumer type of shipments. So we're starting to do a little bit of that and creates a really nice relationship with the retailer. We also have to be mindful that it needs to be profitable. So we're very clear on what our cost structure is and how to price that. And so far, we think it's working pretty well. We do have a ways to go in terms of getting better at it. So we're taking a continuous improvement mindset, but we feel like with the ship points that we have, it creates a nice extension for the retailers.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Great. Thank you very much.

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

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

Q

Hi. Thanks for taking my questions. I just wanted to circle back on the acquisitions. Maybe I think in the cash flow statement, your $734 million were spent on acquisitions. Maybe you can give us a blended multiple EBITDA on what you paid, on what you think maybe normalized EBITDA for those businesses is?

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

A

Yeah. I'll give it a shot. I would say it's going to be a high-single-digit multiple on what I would say a normalized kind of sustainable level. Two of them were, one was double-digit, the big one again if you do the math, it looks really reasonable. But we did normalize it so that ups that multiples, but I would say it's high-single digit.

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

Q

Great. That's very helpful. Thanks. And then on the expansion projects, where are you? Are those on track? Are you expecting to still get some benefit this year? And then, are there opportunities for similar projects to undertake next year? Thanks.

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

A

Yes. They are underway across the patch. It's pretty broad-based, Jim. So, for example, significant investment in our dog and cat facilities that make both edible and plastic dog treats and toys and chews. Also significant investment in capacity expansion in our aquatics business, small animal and pet vetting, wild bird and grass seed and controls. So, really across both Garden and Pet, we have put the tens of millions of dollars to work that Niko referenced in his commentary, doubling our CapEx budget. And, yes, Jim, to your question, I would say – let's call it maybe two-thirds of that begins to come online in the back half of fiscal 2021, the balance coming online in fiscal 2022.

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

Q

Great. And then I guess how much sales do you feel like you've missed over the last 12 months in those categories where you're expanding capacity in?

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

A

Yeah. Always a little difficult to put a fine point on it, but I would say, Jim, it's on the timeframe you inquired about. It's in the tens of millions of missed opportunity associated with our capacity relative to the extraordinary demand presented over the last 12 months from COVID.

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

Q

Great. Thanks. And best of luck.

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

A

Thank you. And we're on it. We are not yet satisfied with our service levels to our retail partners. You can imagine that's an important part of our dialogue each day on both the Garden and the Pet side. But per the earlier commentary, we are on it in terms of adding capacity and recapturing that opportunity.

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

Q

Right. Thank you.

Operator: Thank you. Our next question comes from Carla Casella with JPMorgan. Please proceed with your question.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

Hi. One question just on you raised your EPS guidance for the year and talked about cost increases. Does that imply that how much of the increase in the EPS is driven by this quarter sales outperformance versus expected sales through the remainder of the year? Or are there any other below the line items, SG&A or something below even the EBITDA line?

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

A

Well, we – typically our policy is just to guide for the year. So we're not going to necessarily break out a quarter or first half versus second half. I will say that the first half has definitely exceeded what we thought it was going to be. That said, we do see continued momentum in the second half. I think if you look at the magnitude of the raise in guidance, it's going to incorporate both halves. It's not just a first half story.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

Okay. Great. And then can you talk about what you're seeing from an M&A pipeline standpoint? If any, that's on hold because you're focused on investing in your facilities.

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

A

Well, I would say that we have a team of five that are conducting corp dev type of activities and we still have a very robust pipeline. One really doesn't have anything to do with the other. We have different people working on the expansions and then others working on deals. So I would say that won't slow us down. The only thing where we could have a little bit of a bottleneck would be on the integration side because we did all three one after the other. We've got to get the accounting and the IT stuff synced up as far as integrating. But having cash and the capacity to do deals, we still have that. We just need to be mindful of our internal resources.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

Okay. Great. Thank you.

Operator: Thank you. Our next question comes from Karru Martinson with Jefferies. Please proceed with your question.

Karru Martinson
Analyst, Jefferies

Q

Good afternoon. Just a follow up on that with kind of a high-single-digit acquisition multiples out there, where are you guys comfortable for taking leverage too while you integrate any potential acquisitions?

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

A

Sure. So, as we've stated pretty consistently, our comfort zone is in that 3 to 3.5 times. For the right deal we would stretch and go to 4 times and then de-lever as quick as we could back to that comfort zone of 3 to 3.5 times.

Karru Martinson
Analyst, Jefferies

Q

Okay. And then just on the labor inflation you guys mentioned, but I was curious as to the labor availability. We've been hearing that that's becoming a bit of a bottleneck. And is that something that you are seeing as you guys look to increase incremental capacity?

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

A

Yeah. We can certainly confirm that dynamic. We are not immune to that. We are finding it more difficult in the last few months in particular and I would say post the stimulus – most recent stimulus in attracting and retaining hourly employees in a number of our key facilities. We're addressing that on a case-by-case basis, location-by-location. We are making some select adjustments to our compensation scheme, either temporary or permanent, based on that. We're doing competitive market scans to understand and ensure that our rates are fair and competitive to other labor choices in that kind of radius of our plants and our DCs. But to your point, we can definitely confirm that pressure. And that's one of the call-outs we made in my and Niko's comments is that we are seeing some labor inflation in that kind of low- to mid-single-digit range.

Karru Martinson
Analyst, Jefferies

Q

Thank you very much guys. Appreciate it.

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

And I think, operator, with that we're at time. So I'll take the opportunity to thank everyone for joining this quarter's call. Thank you for your interest in Central Garden & Pet. And if you have any further questions, please don't hesitate to reach out to Friederike and our Investor Relations team. Have a good day.

Operator: Ladies and gentlemen, this concludes today's webcast. You may now disconnect your lines at this time. Thank you for your participation, and have a great day.