06-Feb-2019

Central Garden & Pet Co. (CENT)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Central Garden & Pet's First Quarter Fiscal Year 2019 Financial Results Conference Call. My name is Jessie, and I will be your conference operator for today. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to turn the call over to 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, Jessie. Good afternoon, everyone. Thank you for joining us. With me on the call today are George Roeth, Central's President and Chief Executive Officer; Niko Lahanas, Chief Financial Officer; Howard Machek, SVP , 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 first quarter ended December 29, 2018 is available on our website at www.central.com and contains the GAAP to non-GAAP reconciliation for any non-GAAP measure 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 earnings per share guidance for 2019, expectations for new product introductions, long-term organic growth goals, future acquisitions and future revenue, cost savings 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 filings, including our Annual Report on Form 10-K filed on November 20, 2018. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events or otherwise.

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

George C. Roeth

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

Thank you, Steve. Our first quarter was typically our smallest quarter of the year, last year representing just 10% of non-GAAP earnings, but the challenging one from a year-over-year perspective. But having said that, aside from some unanticipated key customer shipment timing issues, the quarter played out mostly as we expected. I'm pleased to say that we remain on track with our strategy and to deliver our fiscal 2019 EPS commitment of $1.80 per share or higher.

As we said last quarter, we expected our first quarter comparisons versus last year to be the most challenging for the year, with higher cost largely absent any corresponding price increases until our second quarter and higher interest expense to be issued unique to the quarter. We also noted that our recent acquisitions would have a significant negative impact in both the first and second quarters and that a higher effective tax rate and additional shares outstanding would be a drag on our earnings for the entire year. That is all playing out to be true.

In Q1, we grew overall sales 5% driven by our fiscal 2018 acquisitions. On an organic basis, sales declined 2%. However, excluding a timing shift in a large Garden customer's orders as compared to last year, organic sales for the company would have increased. It's important to note that our January sales saw increases over the prior year, consistent with this shift.

Reassuringly, our garden consumption, while off-season, was nevertheless up substantially, plus 9% at our largest customers in the first quarter. Organic sales for the first quarter were also negatively impacted by challenges in our pet animal health business where sales declined, as a new competition from a former supplier and the behavior modification market continued to impact the results during a time of some product performance challenges.

We are launching a product improvement mid-to-late second quarter, and we expect to be investing behind this business throughout the remainder of the fiscal year. Having said all of this, I'm pleased to tell you that total company sales for the fiscal year-to-date period through January are right where we expected them to be.

Operating income, EBITDA and EPS declined in the first quarter, due not only to the factors I just mentioned, but also due to the inclusion of our recent acquisitions, Bell Nursery and General Pet. These acquisitions have aided sales that negatively impacted margins and profitability in the quarter. Bell losses are substantial in the first quarter, consistent with the extreme seasonal nature of the business and historical norms and we're not in last year's first quarter earnings for our company. That made for a difficult year-over-year comparison. And General Pet being a distribution business earned relatively low margins.

A third factor impacting operating margin and EBITDA were higher freight, labor and raw material costs. However, a range of price increases were implemented in January, which will help mitigate the cost inflation pressures. With this and our cost savings initiatives, we continue to project margins to grow in the back half of the year.

As a whole, we continue to expect results for the second half of the year to be more favorable, driven by the lapping of the Bell and General Pet acquisitions at the end of the second quarter, the array of price increases effective in January in conjunction with less challenging cost increases versus last year, and importantly, sales growth due to innovation and distribution gain to key customers.

In addition, we expect several other factors will also aide year-over-year comparisons for the back half of the year. These are more normalized weather patterns, as unfavorable weather significantly impacted last year's second half Garden results and certainly of our animal health businesses. Our more favorable projected mix of sales after a negative mix impact over the last several quarters due in part to unfavorable weather, the ramp-up of our lower margin pet distribution Kroger business, and the aforementioned challenges in our behavior modification business. And lastly, the positive impact of continued cost savings of 1% to 2% annually.

Please keep in mind that we do expect to also be spending more on demand-creation activities this year than we did last year, as we dialed back spending a year ago to offset weakness in results due to the unfavorable weather. Nonetheless, we still estimate operating margins to improve in the second half of the year.

I do want to point out that while our second quarter will benefit somewhat from the timing shift that impacted January and the recent price increases, it still faces a difficult comparison with the second quarter of last year due to the dilutive nature of the recent acquisitions, difficult year-over-year cost comparisons, and comping a 6% organic sales gain in the period a year ago.

So, while we currently expect organic operating income in the second quarter to be flat to modestly up versus a year ago, total operating income will very likely be down, negatively impacted by the Bell acquisition. Second quarter EPS, much like the rest of the year, will also be burdened by a higher tax rate and greater number of shares outstanding. However, we do remain optimistic about the full year and are reaffirming our previous guidance.

Now, I want to give you some detail on the new products we're launching this year. We expect the new products will be debuting to help Central continue to build on its share gain of the last few years. In the Garden segment, we are introducing Pennington Lawn Booster, a new combination of grass seed, fertilizer and soil enhancement that we believe is a technological advancement in the category. We've also developed a new technology we are utilizing in our Pennington Smart Blend grass seed products which will be launched this month.

In addition, we'll continue the rollout of a new active ingredient for Sevin product, which is effective against a greater number of pests and lasts longer than both our old formulation and our competitors' products. We introduced the Sevin reformulation last year and we've expanded distribution in 2019, while displacing competition at major retailers.

Finally, we are deploying new technology in some of our private label fertilizer and control products, as we continue to improve product efficacy and our value proposition. We're excited about the potential of all these new garden products and the value and benefits they bring to consumers. We believe that the advanced technology we bring to the marketplace is a clear differentiator for Central and enables us outperform in a competitive marketplace.

Our Pet segment also has a number of new products rolling out this year. One is a new brand of minimally processed dog treats and chews called Farm to Paws. This collection of single and limited ingredient products was developed for the pet independent and big box specialty channels.

In our animal health area, we are launching a new foaming flea and tick shampoo innovation that has rapidly gaining distribution at major retailers. And in the aquatics area, we are leveraging our unique strength to help our retail partners solve complex category issues and grow sales. For example, we are introducing nano shrimp in the United States. While popular in Europe and Asia, nano shrimp is an untapped market in the U.S. because nano shrimp thrive in soft water, which is not prevalent here in the U.S. Segrest breeding capabilities enabled us to develop a nano shrimp that thrive in hard water environment.

And with our Aqueon brand's complementary innovation on tanks and filters, we have developed a comprehensive solution for our customers. We've already tested the initiative with one major retailer and have an agreement to expand our platform more broadly with them.

On a negative note, we have learned in the last few weeks that a major retailer is exiting the live fish category. Where there will be an impact to Central, we expect it to be manageable and is incorporated in our go-forward estimates. Importantly, we'd be looking to recapture the demand that will go elsewhere.

The aquatics opportunity is still rather large, and in fact, we have already partnered successfully with the largest pet specialty chain that didn't carry live fish to supply live fish equipment and consumer supplies. What started as a test in a couple of stores is now expected to be expanded over the next two years.

Finally, on the M&A front, we just closed on a deal to buy the remaining 55% stake in our joint venture with Arden Companies. Arden is the leading manufacturer of outdoor cushions and pillows. We took a 45% position in Arden back in March 2017, with an option to purchase the rest in the future. Over the past year-and-a-half, we have had the opportunity to assess the business more thoroughly and decided to acquire the rest of the company. We closed on this transaction on February 2.

While a relatively modest transaction, Arden is in a whitespace that makes sense for us. We acquired it at a price that was at the bottom end of our historical multiple range. We already did business with the same customer set as Arden. And the mechanics of the business are not dissimilar to the dog bedding businesses we have acquired over the last few years.

We believe there are significant synergies between these businesses that we can take advantage of. We will be reporting this acquisition as part of our Garden segment, and I'll leave it to Niko to go over the financial implications of the transaction.

On the broader M&A front, we continue to have an active pipeline and are evaluating deals of various sizes. Unfortunately, we can't guarantee when and if deals will close. It's just the nature of the beast. Rest assured, we remain active, disciplined and motivated seekers of value-creating deals and remain bullish.

I'd now like to turn it over to Niko, who will give some additional details around our results.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, George. Good afternoon, everyone. We issued our first quarter press release with our financial results earlier today. I'll give you some more details on the results and then turn it back to George for his closing comments.

First quarter sales rose 5% versus prior year to $462 million from $442 million in the first quarter of last year. Our recent acquisitions of Bell and General Pet were the drivers, accounting for $27 million of revenue in the quarter.

Organic growth was down 2%, as the timing of customer orders at one large retailer and lower animal health sales more than offset higher sales in our wild bird feed businesses, which benefited from early harsh winter weather throughout much of the country.

Second quarter started off well with January sales increasing, benefiting from the timing shift which hurt first quarter. Consolidated gross profit for the quarter declined $2 million and our gross margin decreased to 160 basis points to 28.2%, impacted significantly by the inclusion of our Bell Nursery and General Pet acquisitions, which we acquired at the end of the second quarter last year.

After the acquisitions, organic growth margins still declined in both segments due in part to higher raw material and labor costs with little in the way of price increases to offset those pressures until prices were raised early this calendar year.

SG&A expense for the quarter increased 10% or $11 million versus a year ago, and as a percent of sales, was up 130 basis points to 26% due primarily to higher freight and warehouse costs. Like many companies, we've seen trucking costs in particular increase and higher labor costs across our businesses have also had a negative effect on profits.

Company operating income for the quarter decreased 55% to $10 million and operating margin declined 290 basis points to 2.2%. Roughly a third of the decline in the operating income and margin was due to the inclusion of the acquisitions, with the rest due to the lower volumes, lower gross margin in the organic SG&A expenses, which for us includes our logistics costs. EBITDA for the quarter decreased 33.1% to $22.5 million.

Turning now to the Pet segment. Pet segment sales for the quarter increased 5% or $15 million to $340 million, with organic sales declining less than 1%. The decline in organic sales was driven primarily by our animal health businesses, with some offsetting gains in our wild bird and aquatic businesses.

As George mentioned earlier, we had a decline in our behavior modification products, which had to contend with an aggressive new competitor and some isolated product issue. Later this quarter, a newly improved product will launch, which we believe will drive higher sales for us in this attractive category. The benefits of the launch are expected to be realized in the back half of the year.

Pet segment operating income for the quarter declined by $6 million or 18% compared to the prior year to $30 million while Pet operating margin decreased 240 basis points to 8.7%. Higher freight, labor and raw material costs, unfavorable product mix, and the lower profits in the animal health businesses were factors in the decline. Pet EBITDA for the quarter decreased 13% to $38 million.

Turning now to Garden, for the quarter, Garden segment sales increased 4% or $5 million to $122 million due to the inclusion of Bell Nursery. Organic growth declined 5% in what is our seasonally smallest quarter, as the order timing dynamic for the large retailer impacted the majority of the Garden category.

Garden's operating loss was $5 million in the quarter compared to an operating gain of $2 million in the first quarter of last year. Operating margin decreased 580 basis points to negative 3.8%, with Bell Nursery responsible for a little less than half of the decline. Higher raw material, freight and labor costs made up most of the remainder of the decline. Price increases implemented early in the second quarter, which were accepted by our customers, should help mitigate the cost increases and result in higher margins in the back half of the year. Garden EBITDA decreased to negative $2 million from $4 million.

Now getting back to our consolidated results. In the first quarter, we had other expense of $200,000 compared to other expense of $3 million a year ago. The improvement was due primarily to lower losses for one of our startup business investments. The dynamic of this line item will change from what it was in fiscal 2018 as a result of our Arden purchase.

Arden was a 45% owned JV last year, and as such, 45% of their net income flowed through in this line and therefore was not part of our operating income. Going forward, Arden will be reported as part of our Garden segment and will be part of Garden operating income. This will obviously increase reported Garden revenue. It is too early to ascertain Arden's impact on the company's profitability, as we still have to assess purchase price accounting and other factors related to the acquisition.

Net interest expense increased $1 million to $8 million primarily due to incremental interest expense on our new notes that we issued in December of 2017. Our tax rate for the quarter was 14.3% as compared to a tax benefit in the first quarter a year ago. The prior-year quarter included a provisional tax benefit of $16.3 million. Absent the provisional tax benefit, the tax rate last year was 17.3%.

Turning to our balance sheet and cash flow statements. Cash at the end of the quarter was $479 million, up from $283 million at the end of the first quarter last year. The increase reflects inclusion of the proceeds of the equity offering we closed in August of 2018. Total debt was $692 million, relatively unchanged from last year.

Our leverage ratio at the end of the quarter was 3.2 times compared to 3.3 times a year ago, well within our target range. We also have $357 million of availability on our credit line at the end of the quarter. For the quarter, cash flow provided by operations was $7 million versus cash used by operations of $24 million in the first quarter a year ago, due primarily to working capital changes. CapEx was $8 million, unchanged from the first quarter of 2018. Depreciation and amortization for the quarter was $12 million, up from $11 million a year ago, primarily due to recent acquisitions.

Now I'll turn it back over to George.

George C. Roeth

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

Thanks, Niko. The year, despite the initial challenges, has so far played out largely as expected, and we continue to believe that the remainder of the year we'll see more favorable results in comparison to a year ago, driven by organic growth and higher margin. As I mentioned earlier, we are reaffirming our guidance of EPS with $1.80 or higher for fiscal year 2019. This excludes any impact from Arden.

While we don't give quarterly guidance due to the volatility and seasonality of our business, this year with so many moving pieces, we thought it best that we give you some thoughts on how we expect the rest of the year to play out. We estimate our second quarter will show organic operating income and EBITDA growth flat to modestly up versus a year ago. We will, however, face headwinds from our Bell and General Pet acquisitions, as well as higher tax rate and a greater number of shares outstanding, which will likely cause EPS to fall well below last year's level.

As a reminder, we had a very strong second quarter last year with sales up 6%, well above the growth both the garden and pet industry has experienced in the quarter. In contrast, our third quarter organic sales growth was flat, under industry growth rates, despite share growth. This is where the bumpiness of expectations comes in. So we don't – so don't expect us to make up the first quarter difference versus a year ago in our second quarter, but rather in the second half of the year when sales and cost comparisons are much more favorable. Please note that our fourth quarter is expected to show the largest gain in non-GAAP EPS over the prior year.

Again, we caution folks to remain focused on our annual estimate and expect quarterly volatility. We are focused on executing our strategy to drive organic growth by investing cost savings to drive innovation and demand creation, closing M&A deals when ready and [ph] not on smoothing quarters (19:51). Our track record has demonstrated our success driving superior shareholder return, and we expect this year to be no different.

Now, I'd like to open up the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question is 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 and Chief Executive Officer, Central Garden & Pet Co.

A

Hey, Bill.

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

A

Hi, Bill.

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

Q

Hey. Want to zero in on the large customer getting out of live fish. I remember we saw this – it's probably seven, eight years ago when Walmart deemphasized or got out of most of the live fish in their stores. And it had kind of ramifications for both the current year and future years. So I guess the question is, one, can you give us a little more color on why the retailer is doing this? And then, two, when you say it's factored into your guidance, was that meaning you knew this was coming when you gave guidance back two months ago or this – you already had some cushion to your numbers that's now going away?

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

A

Hey, Bill. This is Rodolfo. So I'll take that one. Let's start with the guidance question. No, we didn't know. This was something that was announced last week. What we did is, obviously, we have many different levers in our plan and we move things around in order to make sure that the guidance remain. So that's the first part of your question.

On the second part, you're right that when a customer few years ago went out, the category did suffer for some time. Probably the biggest difference now is our vertical integration and the ability we have to not only rive the category but actually drive it. Yeah. So we're already working with different customers to either drive more fish into their business, yeah, which George mentioned in the call, one of the largest pet specialty chains is [ph] letting now (22:12) fish, which they didn't before, or actually with the customers who are still in the category figuring out how to bring consumers to their stores. So what I would say is that, what's clearly not good news, it's a short-term pain already reflected in the guidance. In the long term, we're confident that our vertical integration and partnership with the customers will enable us to get our successful place.

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

Q

So, just to clarify, I understand, I guess, on the live fish and redirecting, but on the hard goods, do we have an issue where there is discounting and clear-outs in sales like that that negatively affect near-term sales in other channels?

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

A

Bill, thanks. Great question. They are not exiting the hard goods category. There is only an exit of the live fish category. So there's no de-emphasis or anything like that.

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

Q

Okay. I appreciate that. And then second is, you talked about pricing, and I think you said pricing would improve margins. Does that imply you have price increases that will support and expand margins from here or you price for kind of dollar profit?

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

A

The way I would look at it, Bill, is when you combine pricing, our cost synergy initiatives and volume leverage, we expect our margin to expand.

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

Q

Okay. And then the last one, at least for now, is trying to understand the overall landscape for Garden. I understand there's a timing shift, but we heard from Scotts that there was actually some actual pull-forward into the March quarter of some orders as the retailers were geared up even more so for the upcoming lawn and garden season. Did you see that or are you seeing that in your numbers, or is it just different product mix of kind of grass seed versus soils that you're not having that kind of impact?

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

A

So, Bill, this is J.D. I'll take that question. We did see some retailers pull forward a bit into Q1 on a very small scale. A large retailer though that typically loads in late in Q1 to set their stores in Q2 for their upcoming lawn and garden season, they pushed or shifted the timing of their shipments into Q2. So let's put that in perspective. Literally, it was just a few days. A year ago, there were orders shipped the week between Christmas and New Year, the last week of December. This year, they shipped a few days later, the first week in January. So that had a pretty profound impact on our business.

But, to be clear, those shipments, that's not driving consumption. Our consumption was very strong during the quarter. As George said in the script, where we are right now later in January, we're in perfect shape; we're exactly where we wanted to be from an inventory standpoint. So we've caught up. And the retailers are still being very aggressive in preparing for the season. So we are extremely optimistic. That was strictly a timing issue.

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

Q

Okay. And actually one last one. Are you still expecting the full-year tax rate to be between 24% and 25%?

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

A

We are – we expect in fact the rate to be closer to 24% for the year.

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

Q

Okay. Great. Thank you.

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

A

Thanks, Bill.

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

Christopher M. Carey
Analyst, Bank of America Merrill Lynch

Q

Hi. Thank you. So I guess I'm trying to marry the commentary around the quarter playing out how you expected, excluding the shipment shift in Garden but also had being a bit underwhelming relative to the growth rates. I suppose we've become accustomed to and the step-up in competitive activity there and the lost obviously distribution of live fish that we were – that we were just discussing.

So I guess, can you kind of bridge that gap for me? Because it does feel like maybe the quarter was a bit underwhelming even relative to the expectations that you had. And can you just talk to your go-forward expectations for head organic sales growth over a sort of medium to longer term price? Because it does sound like given the timing of innovation this year that the recovery in that business will be a bit more back-half weighted.

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

A

So I'll start kind of on the company level. If you think of our portfolio, we have a highly diverse portfolio, which I would rate as a good thing. There's usually puts and takes. So when we say the quarter one is expected, I would think about it on a total company level. Within the businesses, there's always businesses that do better and worse. I would tell you that Garden's 9% consumption growth, I don't think we would normally predict that in the quarter nor we would have predicted the degree of maybe some of the headwinds on the pest behavior modification business.

I would challenge the point that pets' growth rates have not been good. In most recent three quarters, they've averaged 3%, 4%, and 6%. This was definitely a slower quarter. And you can expect a little of that going forward just because of the headwinds of the live fishes we talked about and until we get our behavior modification fix out there. So some of that would be true, but we also have positives in other areas and we're still feeling good about reaffirming our guidance.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch

Q

Okay. Thanks. And just on the guidance, right, it does imply something like 25%, 35% operating income growth in the back half of the year. And so just kind of the confidence around that and obviously you've gone through various items on the call, with innovation, which is coming back, and pricing, which really rolls through, and obviously comps just being easier as well. But I suppose I'm just looking to a little more from you on the confidence around the ramp that you're kind of expecting for the back half of the year and if I've kind of covered all the items that you've talked to.

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

A

Yeah. You – Chris, you covered off a lot of them. I would just add to that. The assumptions going into that back half would be a more normalized type weather pattern. And with that comes a more normalized product mix within our portfolio. And then the other thing I would add is a stabilization, if you will, of costs. So labor, delivery stabilizing a bit as well. So those are sort of our thinking going into the second half. So far, we feel good about it. So, very confident about that second half.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch

Q

Okay. Thank you.

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

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, good afternoon, and thank you for taking my questions.

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

A

– Brad. Sure.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

I wanted to follow up about the sales outlook to see if there was any more refinement of what I think your full-year guidance had been at the start of the year for, I believe, 2% to 3% organic growth and mid-single digits overall growth. Any more refinement on those numbers at this point?

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

A

No. We're sticking to those ranges. That's pretty good.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. And then with respect to Arden, let's say here, can you tell us how much you paid for that? And then I know you're working through some of the accounting of how it'd hit the income statement. But at this point, are you thinking that it could end up being accretive to earnings?

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

A

Well, as far as this year goes, we're not sure if it's going to be accretive. We still have some purchase accounting to work out, as we've mentioned earlier. Obviously from a cash flow standpoint, it'll help us. It's just working through the purchase accounting. And the reason behind that is we are buying it at peak season. So the inventory levels are very high, and part of purchase accounting is you have to mark up that inventory. And so we end up with less profit and less EPS. So it's probably more than you wanted to know. As far as the acquisition price, so we staged it in two. We took 45% of it at $9.3 million and then the remainder was at $13.4 million plus the assumption of debt.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. And then just a last one from me. It's kind of a housekeeping item. What at this point is assumed in your guidance in terms of tariffs?

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

A

We have tariffs embedded in the guidance. Just to reiterate what we said in the past, we only have about 10% exposure on our total cost of goods to tariffs. So, unlike a lot of other companies, we are a bit underexposed and we feel like we've taken sufficient pricing as well as taken cost out to accommodate those tariffs. So we – we're fairly comfortable with where we sit right now on that.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. And are you assuming they stay at the 10% level or can you – are you expecting them to step up in terms of how you're looking after -?

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

A

Well, that – we're assuming that for now, but we have triggers in place too to go up if the tariffs were to go up from there. So we're all set.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. Thank you all so much.

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

A

Thanks.

Operator: Thank you. Our next question is from the line of William Reuter with Bank America Merrill Lynch. Please proceed with your question.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Good afternoon. I don't remember if you guys touched upon this last call, but in terms of the line reviews for the coming – upcoming lawn and garden season, do you know how your shelf space may have changed on a year-over-year basis in your brick-and-mortar customers?

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

A

William, this is J.D. I'll take that question. We do. We have a very good understanding of how our distribution has changed year-over-year, and we're optimistic. First of all, we're optimistic because the retailers are – they're extremely bullish on the upcoming year. And I think year-over-year from an – first of all, we had great innovation. George touched on a few of those items. Pennington Lawn Booster, Pennington Smart Blend, our Sevin enhancement for the upcoming season. There are plenty of other items I won't go through right now, but we have reason to be extremely optimistic for the upcoming year.

One of the metrics that we look at year-over-year is our SKU store combinations. This is strictly a mathematical calculation. Number of stores listed versus the number of items. So new items and the number of stores they're listed in. Pure points of distribution. And year-over-year, we have a mid-single digit increase in points of distribution, which for a company that's mature like ours, that's a significant increase year-over-year.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Yeah. That makes sense and sounds pretty good. In terms of e-commerce, I think lawn and garden has not been – had very much penetration. Has there been any change in that recently? And I guess what percentage of lawn and garden sales are done by e-commerce retailers?

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

A

Great question. That is a – it is building. It is increasing, yes, but we're working up still a fairly small base. The capture rate for lawn and garden products, especially in lawn and garden consumables in which we play, if you think about many of our products, many of those are high cube low-cost items difficult to ship long distances and profitably anyway. So we're seeing more movement toward e-commerce, but again, very small base.

And I know that last year, it was estimated that just a little over 1% of all lawn and garden sales were through e-commerce. I think that number is growing, but it's growing at a much smaller pace than other consumer packaged goods. So what we're focusing on is making sure that we have content online. Our products are available, but making sure that we have A-plus content, so that when people look online they understand how to do the project, the advantages of our products, and then buying those typically in store as a result.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

Okay. And then just lastly from me, wondering how comfortable you are operating for an extended period with the cash balance that you do now. And I guess if we were sitting here come November and you hadn't put that to use for M&A, whether you would consider taking out your 2023 maturities.

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

A

Well, it's a great question. We obviously have an active pipeline as far as M&A. My first order of business would be to put that money to use via acquisitions. I really would rather not be purchasing debt back. In fact, if I were to rank how we want to put the money to work, it would be acquisition, first; second would be internal projects as far as CapEx, either cost savings projects or growth initiatives; and then the third – distant third would be looking at our capital structure. So I would list those two well ahead of taking out bonds or any stock repurchase.

William Michael Reuter
Analyst, Bank of America Merrill Lynch

Q

I assumed as much, just wanted to ask. Okay. Thank you.

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

A

Yeah, yeah. No, it's a great question.

Operator: Thank you. The next question is from the line of Christina Brathwaite with JPMorgan. Please proceed with your question.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Hi. Good afternoon, guys.

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

A

Hi.

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

A

Hi.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Just a clarification question. Can you just quantify how much the pull-forward effect was on the Garden sales?

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

A

The pull-forward effect for Q1 was...

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Yeah.

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

A

...was relatively minor. We're talking – you're talking about the customers that I said that did pull some into Q1 from Q2. Relatively minor. So, I'd say low-single digits.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Low-single digit. Okay. Perfect. And then I'm just trying to – thinking about your overall business rates, the Garden side, it was just a timing impact but the fundamental business is still performing well. But the Pet side of the business, it sounds like it was weaker than expected in terms of the animal health business and then now this incremental headwind from the fish – the live fish business. I'm just – and this is your most – your easiest compare of the year. I'm just trying to understand what can really drive the business to return to organic sales growth in the back half of the year?

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

A

Perfect. So, Christina, this is Rodolfo. So I'm going to take that question. I'll take a step back, and as George mentioned, we do have some lumpiness also in this business. While it's not as seasonal as the Garden business, we do have some seasonal parts of our business. Also, we have promotions from the customers. We have growth that have been as high as 7% in the last couple of quarters, which is also way ahead of the category. So I would not overreact to one quarter.

Specifically, in Q1, to also be very clear, we had two year-over-year challenges. Yeah. The largest one was the behavior modification one, and we planned for that one. So that was not a surprise. And it's not only about the new competition; it's also about lapping a fairly sizable inventory liquidation we did last year before launching our new items. So there's a double effect on that one.

And the second piece is our equine business is moving to in-season selling versus preload. That is what was historically done. So that gives us a lot of confidence on what will happen in the rest of the year versus before. So those are the two main pieces of Q1 that now in the second half of the year will turn into positive. Then, if you're pricing on top of that, plus the fact that we have enough categories growing shares, that gives us confidence for the second half of the year.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Okay. That makes sense. And then just understanding the discrepancy between the Nielsen data – I mean, in Nielsen, the pet business in particular was really excellent over the quarter. So the primary delta there...

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

A

Thank you.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

...is the animal health business and challenges in a non-track channel. I'm just trying to understand what's driving the discrepancy.

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

A

Yeah, absolutely. As we mentioned today, animal health business that we discussed, is the equine load, which again you wouldn't see in Nielsen. So, as said, we're same as we were growing 7%, our shares were not exploring. Now they were a bit more flat, the shares are not declining. And we have strong growth in channels that are not measured like farm and flea, [ph] clam (39:44) and a few others.

Christina Brathwaite
Analyst, JPMorgan Securities LLC

Q

Thank you.

Operator: Thank you. Our next question is from the line of Jim Chartier with Monness, Crespi & Hardt. Please proceed with your question.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Hi, good afternoon. Thanks for taking my question.

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

A

Hey, Jim.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Can you guys give us the POS for the Garden business? Any chance you can tell us what the point of sale for your Pet business is and help us understand how much the timing of equine shipments might have impacted that?

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

A

I'll take it and then maybe Rodolfo can chime in. The challenge with the Pet business is we're in so many different channels, a number of them not tracked. It's difficult to give you a specific number. We tend to look at shipments as a proxy for it. So most quarters, as Rodolfo pointed out, we've been running 5%, 6% growth rates, categories growing more in the 1% to 2% range. So we've been consistently growing share. And doing it largely in untracked channels, Club being a big one. You could probably hypothesize this quarter given the flattish. We might have been ticked down in share, largely driven by our animal health business on the behavior modification, which we talked. That helped?

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Yes. And then the equine products, so when do you expect to kind of make up that shortfall in the first quarter? When will you see the benefit of the timing issue there?

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

A

It's across the next three quarters. So it's not all of it lumping back to Q2. It's across the next three quarters.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Okay. And then you – the color on second quarter was helpful. And the meaningful decline in second quarter EPS, I mean, could it be greater than what we saw in the first quarter, that $0.16 decline, or should it be more modest than that?

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

A

That's tough. We start getting into giving out specific numbers and that's a slippery slope. So I'm not going to be able to help you on that one. Hopefully we get – by giving you some of the EBITDA and operating organic numbers, you can kind of come at it pretty close, but it was going to be substantial when you looked all in.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Okay. Thanks. I thought I would try.

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

A

I think part of the problem with the first quarter too is the folks thought in terms of percentages versus absolute numbers too. So I had to look at it both ways.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

Right. Okay. Well, that was – I guess the last is just any update on the shop and shop rollout at Kroger and opportunities outside of Kroger?

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

A

I'll tell you that our number one objective is to make sure we service the Kroger business correctly, which so far so good. And we're meeting or exceeding every target that they had for us and that we had for the business model. So we're very excited on that one. And we're now embarking on exploring the alternatives, but those will not happen in the short-term. It takes some time to get to them. But we're presenting them right now to customers.

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

A

Yeah. It's not a short selling cycle -

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

A

Yeah.

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

A

– of these deals. You typically will have to test as well before you fully roll out.

Jim A. Chartier
Analyst, Monness, Crespi, Hardt & Co., Inc.

Q

All right. Thanks, and best of luck.

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

A

Thank you.

Operator: Thank you. The next question is from the line of 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 is on a quarterly pacing from the freight and labor costs. I just wanted to confirm that the expectation was in the back half of the year, you'd stop seeing as much pressure just from a year-over-year comparability standpoint, so sequentially it's kind of the same, it hasn't gotten worse?

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

A

Yeah. So we were actually looking at the delivery expenses just a few days ago, and what we noticed was in our Q3, we saw – we saw a spike, and in our Q4 and Q1, we've seen it level off. So the expectation is that it will continue to level off. However, I don't have a crystal ball. I'm not going to call the bottom or the top. So our expectation is that it stabilizes, and that's how we're viewing the rest of the fiscal.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Fair enough. And then, on the Farm to Paws product that you're rolling on pet specialty and pet independents, is that an exclusive with one player? I just was curious because you've – you've been relatively negative on that channel for most of the last year.

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

A

No, they're exclusive to the channel, but not a specific player.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you very much.

Operator: Thank you. [Operator Instructions] Our next question is from the line of Chris Carey with Bank of America Merrill Lynch. Please proceed with your question.

Christopher M. Carey
Analyst, Bank of America Merrill Lynch

Q

Hi, everyone. I'm all good. So we'll take offline. Thank you.

Operator: Thank you. It appears we have no additional questions at this time. So I'd like to pass the floor back over to Mr. Roeth for any additional concluding comments.

George C. Roeth

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

I just want to thank everyone for spending the time to be with us today. And have a good day. Thanks.

Operator: Thank you. Ladies and gentlemen, this does conclude today's teleconference. Again, we thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.