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Central Garden & Pet Co. (CENT)

Q3 2022 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 2022 Third Quarter Earnings Call. My name is John 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] And 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, John. Good afternoon, everyone. Thank you for joining us. With me on the call today are Tim Cofer, Chief Executive Officer; Niko Lahanas, Chief Financial Officer; J.D. Walker, President, Garden Consumer Products; and John Hanson, President, Pet Consumer Products. Tim will provide a business update, and Niko will discuss our third quarter results and our outlook for the full year in more detail. After the prepared remarks, J.D. and John will join us for the Q&A.

Our press release supported earlier today and related materials are available at ir.central.com, and contains the GAAP reconciliation for the non-GAAP measures discussed on this call. All growth comparisons made during this call are against the same period in the prior year unless otherwise stated.

Please note that statements during this call, which are not historical facts, including the potential impact of COVID-19 on our business, earnings per share and other guidance for fiscal 2022, expectations for new capital investment, product launches and future acquisitions 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 our filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K filed on November 23, 2021. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events or otherwise.

With that, I will turn it over to Tim Cofer. Tim?

Timothy P. Cofer

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

Thank you, Friederike, and good afternoon, everyone. Let me begin by thanking the more than 7,000 dedicated and passionate Central employees, who are serving our consumers and customers across the pet and garden industries in these challenging times. Thanks to their hard work, Central is now listed as number 785 in the Fortune 1000 company rankings. We've climbed over 200 spots since our debut in 2018. Thank you, Team Central.

Let me highlight three key messages from this quarter. First, as you've seen in our press release, we expect to deliver full year EPS at or above prior year. And in Q3, we delivered EPS $0.02 above the prior year quarter. This is despite a muted garden season, primarily due to unfavorable weather. That, coupled with reduced foot traffic and changing retailer inventory expectations, led to softness across most of our garden portfolio.

Second, there is no doubt that we are currently in a difficult operating environment and that means our team is focused on controlling what we can control. More precisely, we are tightly managing our spending, more aggressively pursuing productivity opportunities, adjusting our inventories, and building a plan to successfully steer Central through this difficult environment.

The external landscape has changed materially over the last year. Like many other companies, we are faced with high inflation across commodities, freight and labor, a disrupted and elongated supply chain, evolving consumer behavior coming off the early pandemic years and adjusting to higher prices as they prepare for a potential recession. And our retail partners are experiencing reductions in foot traffic and realigning on inventory expectations. All of this impacts the consumer and unsurprisingly, we have seen category participation rates moderate, albeit still above pre-COVID levels and unit volumes decline in response to the high inflation and pricing.

In the third key message, while we acknowledge this difficult near-term operating environment, the fundamentals of the pet and garden industries remain strong. We continue to be bullish on the long-term growth potential of our industries. Both pet and garden are driven by multiple macro consumer trends that can support attractive growth rates. We expect the purposeful investments we are making in strategic areas today, together with our strong balance sheet and M&A agenda, will allow us to capture opportunities and generate long-term shareholder value.

Now turning to our third quarter results, net sales were down 2% versus prior year, driven primarily by the Garden segment. Maintaining our gross margins has been a focus of our team all year long. To offset inflation in commodities, labor and freight, we thoughtfully executed our pricing agenda. Together with recent margin accretive acquisitions and net productivity efforts, this resulted in year-to-date gross margin expansion of 50 basis points. While in the quarter, gross margin was down due to lower sales, higher inflation and unfavorable product mix, we expect to expand full year gross margin versus prior year.

Operating income grew 1%, even as we made purposeful investments in strategic areas, including capacity expansion and automation, consumer insights, brand building, innovation and e-commerce to drive profitable long-term growth. And finally, EPS came in $0.02 above prior year.

Now, let me share some color on the trends we are seeing across our customers and consumers in our two segments, starting with Pet. After an unprecedented increase in pet adoption and pet supplies category penetration in the pandemic years, this year, driven by increasing inflation and lifestyle changes, we have seen a modest decline in pet ownership and penetration rates, yet both are above 2019 levels.

Net sales and POS in our Pet segment were largely in line with last year on top of 10% growth in the prior year quarter. We held or gained market share in several categories, including dog treats and equine. And most of our Central Pet brands continue to outperform private label, reflecting the investments we are making in building and growing brands.

We've significantly improved customer service levels. And as new capacity expansion and automation projects are completed across key businesses, we expect to reach pre-pandemic fill rates by year end. Last but not least, our investments in digital capabilities continue to pay off. E-commerce grew 14% and now represent approximately 22% of our Pet branded sales, an increase of 200 basis points versus prior year.

Now shifting to Garden. Unfavorable weather, combined with broad inflation both at the macro and garden levels, resulted in lawn and garden consumers shopping less frequently this year. In addition, activities such as personal travel, entertainment and dining out are competing with time gardeners spend in their outdoor spaces, impacting near-term household penetration and consumption rates. These factors drove net sales in our Garden segment down 4% and organic Garden sales down 8% versus prior year. While these near-term dynamics are very real, we believe long-term trends such as rural revitalization, homesteading and sustainability can support lawn and garden business vitality for years to come.

In Q3, we experienced softness in most of our garden businesses in both organic sales and POS. However, there were a few bright spots to call out. First, we saw continued strength in our wild bird business with solid sales growth, new distribution and market share gains.

Next, you will recall over the last couple of year, we were challenged in our grass seed business. In our Q1 call, I referenced the launch of Pennington Smart Patch. Our team and our customers have been pleased with this innovation and we have gained market share in the overall grass seed category and most notably in patch and repair segment, reversing the share loss trend over the last few years.

We're keeping a close eye on consumer behavior, especially related to price sensitivity and the potential migration to value segments and private label. In Q3, we saw our brands continue to outperform private label and almost all of the lawn and garden categories confirming that strong brands still matter. Doubling the share of wallet in the last two years, e-commerce is becoming more relevant to consumers and to our garden business. However, brick-and-mortar still dominates the garden channel landscape. Our e-commerce business grew 15% and now represents mid-single digits of Garden branded sales.

Customer service levels in our garden business have further improved, now consistently in the mid-90s, and we expect to be back at historic rates by end of year, thanks to our investments in capacity expansion and automation.

Now I'd like to provide some updates on our Central to Home strategy in action, starting with the consumer pillar. As we discussed previously, we're committed to making investments to build and grow distinctive brands consumers love. A great recent example is our All for the Small campaign, launched for Kaytee, starring actor and comedian Rainn Wilson. This campaign included a first-of-its-kind digital short film featuring Rainn himself attempting to register his guinea pig, Kenneth, in the prestigious Westminster Dog Show.

Over 16 million households currently care for small animals and pet birds. This campaign demonstrated that these pets are just as worthy of recognition as dogs and cats, while also positioning our Kaytee brand as the champion for small animal well-being. The campaign was very well-received by consumers and garnered over 420 million earned impressions and a 500% amplification of our total media spend. If you haven't seen it yet, I urge you to check it out on YouTube or Instagram.

Let's now turn to the customer pillar. As we've said in prior earnings calls, we are investing in digital capabilities and e-commerce, our fastest growing channel across both segments. We're starting to see these investments bear fruit. We improved e-commerce fill rates, optimized digital investment levels and created more engaging content. These efforts led to higher return on ad spend, market share growth and mid-teens sales growth in both the Pet and Garden e-commerce segments.

On to the cost pillar, which is focused on reducing cost to improve margins and fuel growth. Let me share a few noteworthy examples of our recent capital investments. Expansion of our controls manufacturing plant in Greenfield, Missouri, which enabled us to insource the production of Ironite and Amdro from outside suppliers, as well as provide capacity for future growth. As a result, we expect to considerably improve gross margins in our controls business.

Our bird feed warehouse in Madison, Georgia ran out of space, given the strong growth of wild bird in the last few years. The expansion set us up for future demand and allowed us to consolidate a nearby rented facility, eliminating the rental and the cost to shuttle goods between locations, thereby improving margins. We expanded our Kaytee paper bedding plant in Chilton, Wisconsin, which was outgrowing its capacity. In addition to improving gross margin, the project enabled sales growth of more than 30% versus prior year and allows for future innovation.

And our Nylabone dog treat and toy business has been one of our most capacity-constrained brands in the last two years. Thanks to recent expansion of both extrusion and injection molding capacity, we not only significantly improved our service levels, but are now able to fulfill additional orders and better keep up with the continued high demand.

Lastly, on our culture pillar. This summer, our 150 top leaders from across all business units and functions came together for the first Central Leadership Council Summit. Over the course of the summit, we reaffirmed our conviction and ownership of the Central to Home strategy, shared best practices, celebrated accomplishments, and strengthened our winning culture. I certainly came away from that leadership summit inspired by the energy and talent of our top leaders and how we can take Central into its next chapter of growth.

In summary, we're pleased with the progress we've made in the first nine months of the fiscal year. For the remainder, we're clear on our priorities.

Given the evolving operating environment, we're pivoting our near-term priorities, while not losing sight of our long-term targets. First, managing through this inflationary period with a heightened focus on cost control, pricing and margin management. Second, developing a robust 2023 operating plan that reflects the current realities of the external environment and positions Central to leverage our strength in these challenging times. Third, driving meaningful progress on our long-term strategy by making purposeful investments in key capabilities, our brands and innovation agenda, while staying active and agile as we consider further potential acquisition opportunities. And importantly, maintaining a focus on our people by enhancing a winning culture and continuing to recruit, retain and develop the top talent in our industries. In closing, I'm confident in the ability of Team Central to successfully navigate in these challenging times.

With that, let me turn it over to Niko, who will share more details of the Q3 results and our outlook for fiscal 2022. Niko?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, Tim, and good afternoon, everyone. Let me start with net sales. Third quarter net sales were $1.15 billion, a decrease of 2%, was driven primarily by our Garden segment. Organic net sales declined 5%. However, looking at the growth over a two-year period, organic sales grew at a solid 9% CAGR. Consolidated gross profit decreased 4% to $308 million from $320 million in the prior year. Gross margin of 30.3% was 60 basis points below the prior year due to significant inflation in commodities, freight and labor, outpacing our price increases and productivity improvements in addition to the impact of our fiscal 2021 acquisitions.

SG&A expense decreased 7% to $194 million due to lower delivery costs, primarily in our Garden segment and lower variable compensation. SG&A as a percentage of net sales decreased 90 basis points to 19.1%. Operating income of $114 million increased 1% and operating margin improved 30 basis points to 11.2% despite continued inflation and purposeful investment spending in our growth initiatives.

Net interest expense was $14 million compared to $13 million a year ago, mainly due to higher average debt outstanding and higher average interest rates. Net income was $75 million or 1% below a year ago. Diluted GAAP earnings per share was $1.39 or $0.02 above prior year, and adjusted EBITDA of $141 million was in line with prior year. Our tax rate was 23.7% compared to 22.5% in the prior year quarter, primarily due to lower excess tax benefits from stock compensation.

Let me now provide some insights into the segments, starting with Pet. Pet segment sales of $505 million were largely in line with prior year sales of $508 million. Our strength in dog and cat treat and toys and outdoor cushions was offset by lower sales in pet beds as we intentionally rationalized low profit SKUs. Looking at the growth rate over a two-year period, organic sales increased at a 5% CAGR.

Pet segment operating income was $63 million, a decline of 12%, and operating margin declined 160 basis points to 12.4% due to inflationary headwinds in commodities, freight and labor, as well as purposeful investments in our initiatives to drive long-term growth. Pet segment adjusted EBITDA decreased 9% to $72 million.

Turning now to Garden, Garden segment sales declined 4% to $511 million from $529 million. Excluding the contribution from acquisitions, organic sales decreased 8% as softness in most garden businesses more than offset growth in wild bird. As Tim mentioned, the decline was driven by poor weather, evolving consumer behavior, reduced foot traffic and changing inventory expectations from our customers. When looking at the growth over a two-year period, organic garden sales increased at a 14% CAGR.

Garden operating income grew 13% to $76 million. Garden segment operating margin increased 210 basis points to 14.8% as our pricing increases and net productivity mitigated inflation in commodities, freight and labor in addition to lower SG&A as a percentage of net sales. Garden segment adjusted EBITDA increased by 9% to $85 million.

Now moving to the balance sheet and cash flows. Cash and cash equivalents at the end of the third quarter were $196 million compared to $517 million a year ago as we used cash to build inventory, invest in capacity expansion and automation and M&A. Given our liquidity position, we remain on the lookout for high growth companies with accretive margins in both pet and garden to build scale in core categories and adjacent categories and add capabilities around e-commerce.

Net cash provided by operations was $190 million for the quarter compared to $299 million a year ago. The decrease was mainly driven by working capital requirements largely due to our decision to maintain adequate inventory levels given our challenged supply chain in addition to inventory cost inflation. CapEx was $23 million, in line with prior year. Some examples of investments made in the quarter are incremental capacity in our live plant businesses and expanded capacity in automation in our branded controls business.

Total debt of $1.2 billion was in line with our prior year. Our leverage ratio was 2.9 times at the end of this quarter and a year ago, well within our target range. We had no borrowings under our credit facility at the end of the third quarter. Depreciation and amortization for the quarter was $20 million compared to $21 million in the prior quarter. During the quarter, we repurchased approximately 542,000 shares or $22.1 million 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 finally, turning to our fiscal 2022 outlook, as we've communicated in June, we expect to deliver GAAP EPS at or above prior year, despite the uncertain and inflationary economic environment and two years of extraordinary growth. While improving, our supply chain remains stressed. We continue to experience labor shortages across many of our businesses. And driven by the current geopolitical factors, we expect costs for raw materials and freight to increase further.

We have taken pricing throughout the first nine months, some of which will only come in effect in the fourth quarter. As we may not be able to offset all of the impact this fiscal year through pricing, we double down on our productivity cost agenda and seek to drive favorable mix to mitigate the gap. We continue to carefully monitor customer dynamics and consumer spending as they adapt to this high inflationary environment. Nevertheless, we are executing against our long-term strategy and continue to make purposeful investments to drive profitable long-term growth.

Considering all the above, we are expecting fiscal 2022 GAAP EPS at or above prior year. This outlook excludes any impact from potential acquisitions that may be undertaken during the year. Tim has already provided a first impression on our initial thoughts for fiscal 2023. And as always, we will provide guidance on our fourth quarter and fiscal year 2022 earnings call.

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

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. At this time, we'll be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of Bill Chappell with Truist Securities. 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. Just, I guess, first on the garden business. Your results certainly on both sell-through and actual sales better than Scotts in terms of your largest competitor and they mentioned that they had lost some share in grass seed and some other areas where you overlap. So maybe you can talk about what's behind the better than average trends? Were you seeing any consumer trade down? I know you have a pretty big position in private label at one retailer. Were you seeing consumers be more price sensitive? Or is it really just kind of a weather and comps-type issue and there's not too much to read into it? Thanks.

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

Thanks, Bill. This is J.D. I'll take a first swing at that and ask others to join in. But before I say anything, I'd say that this has been a challenging environment for all the reasons that Jim articulated in the script. But this year is unlike anything I've seen previously. Despite the headwinds, I'm incredibly proud of the results that the Garden teams have been able to post in a most unusual environment. Sales were softer than we had planned, but we've still posted strong gross margin, EBIT and operating margin metrics in a difficult environment.

I think Tim touched on some of these things, but we've seen the consumer now, an evolving consumer behavior, so the consumers going back to some of their pre-pandemic activities; household penetration, buy rate, both contracted versus prior year, but are still up meaningfully versus pre-pandemic levels. Retailer foot traffic was off this year or the weather was unfavorable. And I can go on and on about weather, but I know you've heard it elsewhere. It has been a most challenging year in that regard. And all the while we've been battling the inflationary environment.

Despite all that, we've been able to invest behind some of our strategic initiatives like the capacity expansion and automation, and also bring in resources and developing capabilities behind things like e-commerce insights, consumer insights and innovation. So I think we've been able to stay true to our long-term strategy.

Now, our portfolio is a little different. You ask to compare to our competitor. Our portfolio, I've said before, is different. And one of the reasons why we like the differentiation in our portfolio is some parts of that are counter-seasonal. So while some of our traditional lawn and garden categories have been softer than we'd like, we've seen some uptick in other areas like wild bird feed, which is not so weather-dependent.

Aside from that, I think it's just been a good operating rhythm within the organization, within the company and we're starting to see some of the benefits of our net productivity efforts as well as some of the pricing that we were forced to take to keep up with escalating cost of goods. So all those things combined, I'd say, contributed to our garden results.

And Tim, you want to build on that?

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

Yeah. The only thing I'd add, Bill, back to your question, obviously, I think J.D. captured it well and tough garden season. But I think versus the message we sent you back in June, as we re-guided on the year, it's now – it's coming in as we expect. We're controlling what we can control. And in particular, relative to your competition comment, as I said in the prepared remarks, I'm very proud of J.D.'s team around what we've been able to do on grass seed. That is one of our key positions, obviously, a key battleground.

I referenced at the beginning of the year, we acknowledge that in the prior couple of years we were a share loser in that category and we've reversed that trend. And the work that the team has done on the Smart Patch product, which is in a critical patch and repair segment, we've seen significant share gain in that segment and that has added – that has contributed to a total category share gain. And there's a new campaign behind it, new packaging, new formulation, and that's gone well. So it has been a down market this year. It has been a poor weather market this year. But within that context, that envelope, I think from a competitiveness standpoint, I'm encouraged by what we're seeing and grass seed, I think, is a very good example.

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

No. Thanks. Thanks for the color. And then just switching over to Pet, you indicated that, I mean, not surprisingly, you saw some, I guess, slowdown in pet ownership year-over-year after a couple of years of spikes. But I guess, maybe digging down, are you seeing meaningful drop-offs in some of the categories? I mean, prior to the pandemic, some of these categories like small bird and small animal and, I guess, reptile was okay. But a lot of the non-dog and cat categories struggled to grow on an annual basis. And so is there any concern that we're going to revert back to those historical trends or are they holding up pretty well? Thanks.

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

Yeah. This is John. Long-term, we feel good about where this category is going to go in the growth rates to historical low to mid-single digits, near term, we're lapping two significant years of growth in pet ownership and penetration rates across our categories. And we are seeing some softness across the board. I think we'll continue to work through it. Certainly, that – part of that's driven by inflation. Part of that's driven by consumer behavior changes. But we're still at a much higher level than we were pre-COVID. So that's where we're at.

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

A

And maybe one other piece of color for you, Bill, in addition to what John said. I would say one of the underlying dynamics where John and his team are paying closer attention to is a little bit of a mix shift between durables and consumables in pet. So durables, we have seen a more exaggerated decline than we are on consumables, right. So think of the cages and the habitats and products like that versus the food and the treats and the more rapidly consumable products. Well, that's something for us to keep an eye on and I think does connect with that bit of slowdown we're seeing in pet ownership and pet adoption, because those durables tend to come initially with that. And then, of course, you still need the consumables to keep it going. So that's an underlying dynamic we're looking at. I mean, the good news is our business does skew more to consumables versus durables, but that's a bit of a subscript to take for us to continue to monitor.

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

A

Well, and we've seen a decline in the live animals as well.

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

A

Yes.

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

A

So that hunts with the decline in the durables, because as you buy the live animal, you buy all the things to keep that live animal and then the further out, you have the annuity, which is the consumables so.

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

A

Spot on.

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

A

Yeah.

William B. Chappell
Analyst, Truist Securities, Inc.

Q

Great. Thanks so much.

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

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.

Q

Hi. Thanks so much for taking my question. Maybe to ask a margin related question here. I was just wondering, Niko and Tim, if you could talk a little bit more about how you're thinking about the margin outlook here with the category organic trends moving a little bit into negative territory here. I know you have a ton of opportunities on the efficiency side. But can you talk a little bit more about the puts and takes as you think about the next 12-plus months on operating margin? Thank you.

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

Sure. So if you look at the quarter, I think you kind of get a little bit of a precursor of what we're going to be doing in the next 12 months, which is really trying to control what we can control. So you saw a bit of a drop in SG&A. We talked about upping our game on the cost takeout, so automation, things of that nature. So really trying to control what we can control to continue to maintain and even expand margin.

And then, of course, we've got the headwind with commodities that continues. And we've been taking price historically against those commodities, but certainly, that cannot go into perpetuity. So that's how we're looking at Q4, as well as into 2023, which is very much becoming better at what we do and trying to maintain the margin that way.

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

Yeah. Brad, my build to everything Niko said is right, is if you start at that gross margin line, as we said in our remarks, Niko and I, I mean that's been largely a good news story in a really tough environment. And so, year-to-date, I think we're up about 50 bps or 0.5 point in gross margin. And then, as Niko said, we're really, and you saw it in this quarter, trying to tighten our belt on the SG&A line. Niko nailed it, that's going to be themes that we're going to continue to push on going forward.

Pricing this year has been extraordinary. At the beginning of the year, I think I shared with you and the others that we're going to price around a couple of hundred million, $200 million. That number has creeped up north of $0.25 billion as we look at closing the year. And then, of course, that doesn't cover all the inflation envelope. Then, of course, there's the cost out. There's the favorable mix, the accretive acquisitions. So all that's played a role. But we're definitely keeping a very keen eye in this environment on margins, and as Niko said, doing our best to control what we can control.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.
Q

That's really helpful. And I'd love to hear your updated thoughts on how you think about the opportunities for acquisitions, again, in this backdrop where perhaps the demand outlook is getting a little bit more challenging, perhaps that brings multiples down a little bit for targets for you. But does it make it more likely for you to find opportunities or make it more challenging for you?

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

Yeah. We agree with you. Multiple should come down. But the activity level is not what it was, call it, 18 months ago. So we're still out in the market very actively pursuing a number of deals. But that pipeline is not quite what it was 18 months ago for pretty obvious reasons. I think folks out there are sort of rethinking the timing in which – when they want to sell and hoping for a bit of a market rebound. But we're going to continue to look and we're going to be disciplined as we look at acquisitions around valuation, strategic fit, strong management teams, all the things that we normally look for. We're continuing to do that and to have the best outcome possible for the company.

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

And [ph] any of the balance sheet support it, (00:37:01) right?

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

Yeah. That's right. So, our liquidity remains really good and we feel great about the balance sheet in terms of cash position and availability on the ABL.

Bradley Thomas
Analyst, KeyBanc Capital Markets, Inc.
Q

No, that's great. Thanks, Niko. Thank you, Tim.

Operator: And our next question comes from the line of 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 question.

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

Hey, Jim.

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

On the manufacturing and automation projects, did any of those come online in third quarter? Did you see any benefit from that yet? Or is that still largely to come in the future?

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

Yes. So the first – I guess, the first part of your question, these came online at various stages in this year and into the third quarter. And so, I gave four examples in the prepared remarks. And when you look at all those, those are all projects impacting this year and either we're in process or completed in the third quarter. So as said, that does two things for us. One is it helps our service levels, and we've seen that.

And as I said, J.D.'s business now is up consistently in the mid- to upper-90s. So that's great. That's where we need to be. And our pet business is in the low-90s, and both on a very positive trajectory. So that's the first benefit of those big projects.

The other benefit is every one of them also has a margin benefit. Most of them are leveraging enhanced automation. There's some labor rationalization that comes with it and/or some things like insourcing of what previously was produced by a third party, so that's a margin that we can capture or in the case of the wild bird example, I gave in Madison, the ability to forgo a rental cost of an additional facility that we had.

So, all smart projects. These are all projects Niko and I approved over the last year or two. Some of them like the greenfield Missouri facility was a massive build and has taken over a year to get us where we are now, right, J.D.? I mean, it's a big project. But we are starting to see those manifest in their benefits here in the third quarter.

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

Q

Great. And then, can you just give us a sense of where retail inventory levels are for each segment? And if you see those continuing to decline over the next couple of quarters? Thanks.

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

A

Hi, Jim. It's J.D. I'll take the – that for the Garden segment. So we see our retail inventory, and I'm talking in aggregate here across our big three inventory levels in the mid-single digits, up mid-single digits in dollars, down low to mid-single digits in units year-over-year. And the reason for that, the driver behind that is, a year ago, we had some out-of-stock issues on the shelf.

So we had some poor service levels that we had communicated to the Street. We've worked on those and got those service levels back into a much better position than where we were a year ago, primarily in bird, pottery and our vendor partner or our distributed business. We had some opportunities, let's say, year-over-year. So I think it's better in-stock levels. It's driving that to a positive number. But we have seen that number start to decline. And that is, as you've heard from others, the retailer inventory initiatives, where they're taking the inventory out of the store, reducing inventory overall has affected our replenishment orders. So we're starting to see that take inventory down at a store level. John?

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

A

Yeah. On the Pet side, we think our inventories are in pretty good shape. But as retailers are seeing the softening demand, inventory management is becoming a much bigger focus for them. And I think we'll continue to see that as we go throughout the next near term, for sure.

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

Q

All right. Thank you.

Operator: And our next question comes from the line of William Reuter with Bank of America. Please proceed with your question.

William Michael Reuter
Analyst, BofA Securities, Inc.

Q

Hi. Just following up actually on the very last comment you just made there. You mentioned that pet inventories are in pretty good shape. So I assume what you mean there is that inventory levels are low. And then you were kind of talking about the potential for some softer demand. I guess, do you expect that retailers in the pet space are going to reduce their inventory levels in what may be a, I guess, a slightly challenged environment?

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

A

Yeah. This is John, again. I would say that customers are very, very focused on inventory levels. And as the consumer demand has softened a bit from two years of extraordinary demand, there is much greater focus on it. So we're seeing – it's not – it's a customer-by-customer, business-by-business situation. Overall, I believe, our inventory levels are in pretty good shape. But we're going to stay all over and work with our customers.

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

And William, I will build on it – this is J.D. – and it goes back to Jim's question as well. Some of the inventory initiatives that we're seeing is not because our inventory levels are elevated by any means, they're over-inventory across the store, across the box, and that's impacting their ability to order even in our category. So while the sales may warrant [ph] the turn (00:42:59) orders or the replenishment orders, we're seeing some efforts by the retailers to reduce that replenishment activity.

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

Good point.

William Michael Reuter
Analyst, BofA Securities, Inc.
Q

Okay. And then just one more question on the Pet segment, when you look at your products that are more consumable in nature, such as Kaytee, how are the sales trends comparing to some of the products that might be kind of more one-time-ish in nature associated with the new pet?

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

Yeah. As Tim mentioned, we are seeing more softness in the durables. And that does go with pet acquisition and the attachment sales when a consumer acquires a new pet, where the consumable is much more of kind of an annuity, right, the pet population's installed in the base. So we are seeing better trends on consumables and softer trends on durables.

William Michael Reuter
Analyst, BofA Securities, Inc.
Q

Are those durables and units down 10% or more?

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

Yeah. I'd say probably high-singles to 10%, feels about right in terms of unit decay. Yes.

William Michael Reuter
Analyst, BofA Securities, Inc.
Q

Perfect. Okay. That's all for me. Thank you.

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

Thank you.

Operator: Thank you. And our next question comes from the line of Carla Casella with JPMorgan. Please proceed with your question.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

Hi. I mean, you talked a bit about your e-comm growth in both segments. I'm wondering, is e-comm accretive or dilutive to margins at this point?

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

A

Yeah. We feel very good about the e-comm business, Carla. And the short answer is accretive, particularly on the pet side. This has been a real focus area for this team over the last year or so. And the quick highlights is, number one, we've brought in some just terrific talent on our e-commerce desks. New head of Pet e-comm, new head of Garden e-comm, new head of Amazon, new head of Chewy, et cetera. So some great talent. We've really built a lot of team capability. We've gotten far more focused on the e-commerce flywheel. We've significantly enhanced our content. Our ratings and reviews have improved.

This last quarter, we've really seen a change in our ROAS, or return on ad spend, as we've gotten sharper with our investment tactics. And all that has led in both businesses to mid-teens growth. I'd also tell you, if you look at Amazon data, if I look at the last month and quarter of Amazon data, we've turned a really strong share growth on the pet side. I think, John, we've got [ph] six to eight (00:45:57) of our categories...

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

A

We do.

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

A

...in Amazon share growth now. Obviously, Carla, our pet e-commerce business is much bigger than our garden e-commerce business. So that's just kind of order of magnitude. That's the bigger size.

And then, back to the core of your question on top of all that, it is broadly when you look at e-comm on the – especially on the pet side versus brick-and-mortar, it is a parity and, in many cases, accretive, and so that's encouraging. We've been quite purposeful in the SKU selection in the PPA, the price pack architecture, which is a key part of making sure that the economics work and that it is accretive. Because there's no doubt, I mean, that's the fastest-growing channel. Our e-comm business grew 15%. Our total business was flat. So you can imagine what brick-and-mortar did. So that is a mix shift that's here to stay and hence, your question is a very important one, but it's one we feel good about.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

Okay. Great. And then just one question. Did you give your labor cost inflation? I'm actually – I'm curious about labor on two fronts. One, the cost inflation that you're seeing, and then if you're planning or any changes to your workforce given kind of the changes you're making to the business?

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

A

Well, I mean, labor has been an inflationary headwind for quite a while now. We're firm believers in continuity. So, we feel like we've got great employees and we want to keep them and we want to keep them happy. Certainly, some of our automation projects have cut out some of the labor to make us a little bit more efficient across the company. But it's just one of those things that is with us, and we don't think it's really going to unwind going forward. So we feel overall good about it.

If you're asking, is there a risk in the cards, I – we don't see one. We're going to be very deliberate about what we do in terms of labor going forward. But right now, we feel quite good about where we are as a company.

Carla Casella
Analyst, JPMorgan Securities LLC

Q

Okay. Great. Thank you.

Operator: And our next question comes from the line of Hale Holden with Barclays. Please proceed with your question.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Great. Thank you. I had a question around the $250 million or so in pricing that you've taken year-over-year?

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

A

Yeah.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

So I was wondering, as you think about a potentially weaker consumer going into the spring garden set in calendar 2023, how you are planning inventory and the potential for trade-down and what you think that was going to do to kind of buy rates of the premium level that you sell?

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

A

Well, it sounds like it was a bit more garden skewed. Do you want to take the first short, or I'm happy to, J.D.?

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

A

Sure. I'll take the first shot and then you can add color. The – so Hale, I'd say that the way we're approaching the season for next year would be very similar to the way we've approached the last couple of years. I'd say that we haven't seen a lot of trade down to private label from our branded products, number one. Secondly, we've seen strong consumption when the weather has been favorable. So we feel that the consumer is still very much engaged in this category. It was just an unusual year. I think the retailers are still committed to the categories and I think their support will be behind our branded products and new news that we bring to the marketplace. That's what they'll be promoting.

I still think that we have a highly engaged customer and consumer. So there won't be major changes going into next year, because we still see a lot of people talk about price elasticity, but I think we have a lot of other causal factors impacting the business that have made it very difficult to see the impact of the price increases.

And Tim, I don't know if you want to add to that?

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

A

Yeah. I'd say on top of that, we priced kind of in that 8% to 10% range on the year, or if you think about year-to-date and kind of our outlook, and I'm talking on the garden side. And we've seen, on the volume side, a similar giveback, right, in terms of unit decay. So it's more or less what we expect. I don't think it's any worse than what we expected. That's obviously a big ticket, right, when you see [ph] a 8%, 10% (00:50:45) price increase.

But I think back to some of the earlier analyst questions, one of the barometers around that, too, is market share and how you're faring versus some of the competition. And a number of these places, and we point to two of our bigger businesses, grass seed and wild bird, were holding up quite well and actually expanding market share.

So I think, overall, this is one where we needed to protect margins. This has been a highly inflationary environment. And we needed to protect those margins. Pricing is part of it. It's not the only thing. It's pricing, it's productivity, it's favorable mix. It's having the benefit of margin-accretive recent acquisitions. So all those are levers that we pull. And yes, in an inflationary environment, when you pass some pricing on, there's going to be some giveback in units. And it's something for us to, obviously, continue to monitor as it relates to other knock-on effects like fixed cost absorption. But I would say. overall, we are – we're feeling as good as one could do on that situation.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Great. And my second question was, are there any signs on the horizon that either labor or major commodity baskets buys – might be starting to ease or even potentially even get lower in terms of cost as you go forward, understanding it takes a little while to work through inventory in terms of stuff that you do buy?

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

A

Yeah. As I mentioned before, I think labor is pretty hard to roll back, the hourly wage. So we're really focused on productivity around labor and around manufacturing. We have seen some muting on the ocean freight. So containers have come down from a year ago. We've seen some stabilization in commodities, albeit they were at and continue to be at a fairly high level historically. If you look at grains and what goes into fertilizer, those are really impacted by what's going on in Europe with the war in Ukraine. So we're going to continue to keep our eye on that. But they're not going up like a hockey stick the way they were. So we feel a little bit better about that.

Hale Holden
Analyst, Barclays Capital, Inc.

Q

Great. Thank you so much. I appreciate it.

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

A

I think that's it.

Operator: Thank you. We have reached the end of the question-and-answer session. And I would now like to turn the call over to Tim Cofer for any closing remarks.

Timothy P. Cofer

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

Thank you very much for joining our Q3 earnings call and your continued interest in Central Garden & Pet. And we'd be happy to take further questions as a follow-up through Friederike and our IR team. Have a good day.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation. Have a great rest of your day.