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Central Garden & Pet Co. (CENT)

Q2 2023 Earnings Call

CORPORATE PARTICIPANTS

Friederike Edelmann

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

Timothy P. Cofer

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

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

J.D. Walker

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

John Hanson

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

OTHER PARTICIPANTS

William B. Chappell

Analyst, Truist Securities, Inc.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Andrea Teixeira

Analyst, JPMorgan Securities LLC

Hale Holden

Analyst, Barclays Capital, Inc.

Carla Casella

Analyst, JPMorgan Securities LLC

Karru Martinson

Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Central Garden & Pet Second Quarter Fiscal 2023 Earnings Call. My name is Camila 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 Friederike Edelmann, Vice President, Investor Relations. Please go ahead.

Friederike Edelmann

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

Thank you, Camila. 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. As usual, Tim will provide a business update, and Niko will discuss results for our fiscal 2023 second quarter ended March 25 in more detail. After the prepared remarks, J.D. and John will join us for the Q&A.

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

Before I turn the call over to Tim, I would like to remind you that statements made during this call, which are not historical facts, including the potential impact of COVID-19 on our business, earnings per share, and other

guidance for fiscal 2023, expectations for new capital investments, product launches, and future acquisitions are forward-looking statements, subject to risk and uncertainties that could cause actual results to differ materially from those implied by forward-looking statements. These risks and others are described in Central's filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K, filed on November 22, 2022. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events or otherwise.

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

Timothy P. Cofer

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

Thank you, Friederike, and good afternoon, everyone. I assume most of you saw our earnings pre-announcement last month. It was a challenging second quarter for our Garden business, but since we ended the quarter, trends have improved and we've taken additional action that builds confidence in our year-to-go outlook. So there's a lot to share on today's call.

Let me get straight to what I think are the three most important messages for this call. First, our quarterly performance. While the Pet segment largely met our expectations and we outperformed the pet supplies market as evidenced by our expanded share, it was our Garden segment that significantly under-delivered. Garden was unfavorably impacted by poor, early spring weather, including severe storms in the Southeast, heavy rain and snow in the West, and an unseasonably cold late March. As a result, total company performance fell short of both prior year and our expectations, with net sales of \$909 million, gross margin of 28.6%, and operating income of \$78 million. This translated to earnings per share of \$0.90.

Second, our cost and simplicity program. As we've shared on prior calls in fiscal 2023, we have a sharper focus on the costs pillar of our Central to Home strategy. In addition to the short-term actions we've taken in recent quarters, we are advancing our plans to more significantly simplify our business and improve our efficiency across the organization by rationalizing our footprint, streamlining our portfolio, and improving our cost structure. Our focus is on a number of key areas, including procurement, logistics, manufacturing, portfolio optimization and administrative costs. Today, we will share the first of many restructuring efforts with more to come in the quarters and years ahead.

And the third key message is our outlook for the year. For the remainder of the year, we are purposefully taking a prudent approach. We know that our Q2 fell short of expectations, driven by the poor start to the garden season. While we're cautiously optimistic that the garden season will normalize and inventory dynamics will stabilize, particularly given the encouraging signs we're seeing in April, we are unlikely to make up the losses from the early part of the garden season. Hence, our fiscal 2023 guidance takes a prudent view and importantly, it underscores our expectation that we will grow operating income and earnings per share in the second half.

Now let's look at the quarter from a segment perspective, starting with Pet. In line with our expectations, sales in the Pet segment were below prior year, largely due to the overall industry softness in durable pet supplies, and our decision to discontinue certain low-profit private label product lines, especially in pet beds. In contrast, we saw continued solid growth across our consumables business, including Dog & Cat Treats & Toys, Small Animal, Pet Bird, Aquatics and Reptile. Durable pet products such as fish tanks and small animal enclosures continue to be on a decline, as new pet adoption slowed lapping the strong COVID bump. We expect durables to continue to be a headwind through the balance of the year. In contrast, consumables are still growing. Our business is skewed to consumables, which generally have higher margin.

We're pleased that the investments we've made over the past couple of years to build capabilities around consumer insights, brand marketing, innovation, and category management continue to show results, as evidenced by broad-based market share gains in many of our key categories, including dog treats, dog toys, aquatics, small animal and equine. Our POS once again outperformed our net sales, continuing the trend of retailer inventory destocking that we experienced the past few quarters. As said in our Q1 call, we expect that to normalize in the second half of the year.

Shifting to Online, our eCommerce business continues to outperform brick and mortar. And eCommerce represents 23% of total Pet sales. Stronger programming, enhanced content, and improved customer service levels further increased our return on investments in digital and drove eCommerce share growth across our categories. As we consider the challenging economic conditions and the health of the pet parent consumer, we carefully monitor their behavior and sentiment. We know from prior recessions that pet is a resilient industry, even in difficult times. Recent data from Packaged Facts show that pet products and services are at the bottom of the list of household spending cutbacks, second only to human medicine and healthcare.

In most of the categories we compete in, branded products continue to outperform private label. However, in some of the categories, for example, dog treats, we've seen some consumers trade down to lower priced products, including private label. Given our wide dog treat portfolio across all price tiers, including some select private label offerings, we can weather these shifts and still grow market share. Overall pet supplies household penetration remains in line with prior year, and online shopping trips have increased even as consumers are making fewer trips to brick and mortar retailers. We believe 2024 will likely be a gradual return to normalcy in terms of pet category dynamics and trends like work-at-home, premiumization, humanization, health, wellness, and sustainability and all things digital, including eCommerce, should continue to support long-term pet industry growth.

Turning now to our Garden segment. As mentioned, we experienced broad-based softness across our Garden portfolio, primarily due to unfavorable weather leading to a later start to the garden season. While we hate to talk about the weather, it plays a meaningful role in the annual garden season performance. Let me share some facts to reinforce this point. Through mid-March, our Garden POS was up almost 10% versus prior year. But then came the last two weeks of the quarter. These are the two most important weeks of the quarter for Garden, as we're ramping up for the season. The third week of March was the coldest in 38 years, a full 18 degrees colder than last year, on average across the country. Then the fourth week was one of the wettest and snowiest in decades. So after a strong start to the quarter, our POS came in flat versus prior year. That's a huge swing in just a couple of weeks. Adding to the challenge, our top customers saw lower foot traffic than in prior years, [ph] and we saw a change in (00:10:53) pre-season ordering patterns, as retailers recalibrated their inventory expectations, relative to historic behavior.

With that as backdrop, our Garden sales declined 5% versus prior year. The volume decline also had a material impact on our gross margins. The lower volume impacted fixed cost absorption, and we cycled through some higher priced inventory that we expect to normalize in the back half. And while there is no doubt, it was a disappointing quarter for our Garden business, I'd like to call out four bright spots. First, our Pennington Wild Bird business continued its multi-year trend of growing sales and market share. Second, our Ferry-Morse Packet Seed business showed solid growth, and we're pleased with the sales, profitability, leadership and synergies associated with this acquisition we made in 2021. Next, our Pennington Grass Seed business significantly expanded market share again in both brick and mortar and online, and our Garden eCommerce performance was very strong, growing sales high teens supported by improvements in retail media, return on ad spend or ROAS and an expanded assortment. Before leaving the Garden segment, let me give you an update on the development of the

season. We now have good visibility into April sales and we see that when Mother Nature cooperates, there's strong consumer engagement and growing POS. This is an encouraging sign for Q3.

Now let's shift to our cost and simplicity program. As we've shared in prior calls, we're on a multiyear journey to reduce cost and simplify how we operate. It's increasingly clear that we have a meaningful opportunity to better leverage the scale of our \$3.3 billion Pet and Garden platform. We've identified a series of projects across a number of key areas, including procurement, manufacturing, logistics, portfolio optimization and administrative costs. In procurement, we want to better leverage the combined purchasing power to reduce input costs and build margin. In manufacturing, we seek to insource third-party production, reduce redundancies, improve manufacturing excellence, and drive efficiencies and synergies across the network. In logistics, we plan to lower the number of distribution points and drive scale benefits across transportation and warehousing. In terms of portfolio, we want to simplify our portfolio and focus on our higher margin, branded consumer products business. And last but not least in administrative, we plan to align our admin costs to a lean, agile, and entrepreneurial growth culture.

The outcomes we seek are clear. We expect to reduce complexity, which means fewer SKUs, fewer plants, and fewer distribution centers. We further expect lower cost of goods sold through lower logistics costs and better procurement, lower administrative costs through scale, leverage and efficiency. And a gradual shift in focus to our higher margin, higher potential branded Pet and Garden consumer products. We believe the results of these efforts will drive [ph] higher margin to (00:14:34) invest in organic growth and advantageous M&A, supporting our long-term financial algorithm.

Today, I will share a current example of our cost and simplicity program in action. You will recall in the last few quarters, we talked about the purposeful exit of low margin, private label, pet bed product lines, and our efforts to achieve a simpler, more efficient, manufacturing and distribution network, leveraging the supply chain synergies with our [ph] Outdoor Cushion (00:15:05) facilities. Last Friday, we announced the closure of a manufacturing and distribution facility in Athens, Texas. This decision comes with one-time charges of approximately \$15 million in Q3, the majority of which is non-cash. We expect this to deliver a cash-on-cash payback in less than two years and drive a meaningful step-up in operating income for our more streamlined pet bed business. This is one example of actions we're taking today, and yet we have so much more opportunity in the coming quarters and years ahead.

Our management team has a vision and conviction and we will prioritize executional excellence. This will be an evolution, not a revolution, with benefits impacting fiscal 2024, 2025, and beyond. Going forward, we will provide further updates on our plans to deliver sustainable, improved performance. While cost and cash were the priorities this year, we've not taken our eye off the opportunity to strengthen our brands and to drive organic growth for the future. Three growth spotlights for this quarter. First, we've embarked on a comprehensive Pennington master brand renovation. The goal of our work is to modernize and strengthen the Pennington brand, expand the portfolio into adjacencies and simplify lawn and garden care for our consumers. The brand team conducted extensive research to understand how millennials and Gen Z-ers approach lawn and garden. Encouragingly, a shared mindset was uncovered across age groups that should drive the category forward for years to come.

The brand is now united under a new purpose to nurture the roots you put down and have a new brand architecture and package design that reflects a more contemporary, vibrant, and sustainable lawn and garden expertise. This spring, we extended the brand into new gardening categories such as soils, organic packet seeds, and plant food. This is in addition to our brand anchors in Grass Seed and Wild Bird Feed. Some of our new products have already been launched and are in store now, but the full brand migration will be a multi-year

journey. Our retail partners are excited about the ambition and we look forward to bringing it to life, in-store and helping to drive both attachment rates and basket size, across total lawn and garden consumables.

Second, our Ferry-Morse Direct to consumer eCommerce site, ferrymorse.com has introduced a suite of innovative capabilities to help gardeners be successful. The Garden Matchmaker tool pairs the gardener's interest, skill level, and growing location with a personalized selection of seeds, plants, and guidance that match their needs. In March, we launched Ask Our Gardening Community, a digital Q&A center featuring real-time advice from Ferry-Morse brand ambassadors. Consumers can access the live Q&A chat function from home, their gardens or while shopping at their local garden center, to get answers right when help is needed. And once our garden enthusiasts have the tips they need as inspiration our ferrymorse.com site and our retail partners have all the fruit, veggies, herbs, and flower packet seeds, live plant links, and seed starter kits to make them as successful as the pros.

Third, our thriving dog treat and toy business launched new Nylabone innovation including novelty chew toy shapes, inspired by everyday objects with a fun twist. We launched a new line of healthy edibles, meaty center chew treats that are packed with flavor, while using limited ingredients and a new patent pending Sneaky Snacker refillable treat toy that combines a durable chew toy with dog's favorite healthy edible treats. And our leading Cadet brand is launching a patent pending line of all natural, highly palatable, and digestible, long-lasting chews called, Bully Hide, that offers all the satisfaction for your dog at a more affordable price.

Now before I turn the call over to Niko, let me say a few words about our outlook for the year. As I previously mentioned, given the Garden performance in the second quarter, we're taking a prudent approach to our fiscal 2023 outlook. As the year progresses, we're cautiously optimistic that the garden season will normalize and retailer inventory dynamics will stabilize. We expect operating income and earnings per share to grow in the second half. The visibility we have [ph] in the April (00:20:22) builds our confidence that the season is improving. And as we communicated last month, we're expecting fiscal year EPS of \$2.35 or better. This outlook excludes any impact from potential acquisitions or restructuring activities undertaken during the year.

So to summarize, we remain confident in the competitive strength of Central and our Central to Home strategy, our team's ability to navigate the current challenges, and the fundamental trends that support long-term Pet and Garden industry growth.

And with that, let me turn it over to Niko, who will share more details of our Q2 results. Niko?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, Tim. Good afternoon, everyone. Building on Tim's remarks, I'll share with you details of our second quarter results for fiscal 2023. Net sales declined 5% to \$909 million, as poor early season weather, lower foot traffic and changes in retailer buying patterns impacted the Garden category. While our Pet segment performed largely as planned and grew share in a number of categories, our durable pet products continue to be challenged.

Consolidated gross profit was \$260 million, a decrease of 9%. Gross margin of 28.6% was down 150 basis points, driven by the Garden segment, due to overhead absorption pressures in key Garden businesses such as Grass Seed and Live Plants, initial start-up costs associated with the Live Goods facility we acquired a year ago in Paris, Kentucky, and input cost inflation, all of which were partially offset by our pricing actions. SG&A expense of \$182 million was generally in line with prior year. However, SG&A as a percentage of net sales increased 110 basis points to 20% due to lower sales. Operating income declined by \$29 million to \$78 million, and operating margin

decreased 260 basis points to 8.6%. The decrease was largely driven by our Garden segment, largely due to unabsorbed overhead due to lower sales and input cost inflation, partially offset by lower commercial spend.

Net interest expense of \$15 million was in line with the prior-year quarter, net income was \$48 million compared to \$70 million a year ago. Our earnings per share was \$0.90 compared to \$1.27 in the prior-year quarter and adjusted EBITDA was \$107 million compared to \$131 million in the prior year. Our tax rate was 23.9% compared to 23.4% in the prior-year quarter, primarily due to a lower tax benefit from stock-based compensation and a higher impact of non-deductible executive compensation versus a year ago.

Turning now to our segments, starting with Pet. Pet segment sales declined 5% to \$475 million, overwhelmingly driven by durable products, especially in aquatics, pet beds, and small animal enclosures, as well as weather-related lower sales in Outdoor Cushions and our decision to discontinue certain low-profit private label pet bed product lines. However, our Dog & Cat Treat & Toys business had another record second quarter. Pet segment operating income decreased 9% to \$55 million, and operating margin declined 60 basis points to 11.6%, largely driven by lower volumes. Pet segment adjusted EBITDA was \$66 million compared to \$70 million a year ago.

Moving on to Garden. Garden segment sales declined 5% to \$434 million. Unfavorable early season weather, lighter foot traffic, and changes in retailer buying patterns led to lower sales in Grass Seed, Controls & Fertilizer, and Live Plants, partially offset by continued strength in our Wild Bird and Packet Seed businesses. Garden segment operating income decreased 30% to \$50 million. Garden segment operating margin decreased 400 basis points to 11.4%, mainly driven by lower volumes, initial start-up costs for a recently purchased Live Goods facility and input cost inflation. Garden segment adjusted EBITDA was \$60 million compared to \$78 million a year ago.

Now moving to the balance sheet and cash flows. Cash and cash equivalents at the end of the second quarter was \$61 million, compared to \$54 million a year ago. Net cash used by operations was \$34 million for the quarter compared to \$180 million a year ago. The decrease was mainly driven by lower working capital requirements. [ph] We entered (00:25:14) the quarter with higher inventory and built less inventory this quarter than in the second quarter a year ago. CapEx was \$13 million for the quarter, 76% below prior year. Remember last year, we significantly invested in capacity expansion across our businesses. This quarter we invested in capacity expansion and automation in our Dog & Cat Treat & Toys, small animal, live goods and our bird feed businesses.

Total debt of \$1.2 billion was in line with prior year. Our leverage ratio was 3.3 times at the end of the quarter compared to 2.9 times a year ago, well within our target range. We had approximately \$25 million in borrowings under our credit facility at the end of the second quarter. Depreciation and amortization for the quarter was \$22 million compared to \$18 million in the prior-year quarter, primarily driven by higher depreciation due to our recent investments in capacity expansion across our businesses. During the quarter, we repurchased approximately 75,000 shares or \$2.7 million of our stock.

And finally, turning to our fiscal 2023 outlook, we continue to operate in a challenging macroeconomic environment with continued cost pressures, changing customer buying patterns, and a consumer that is having to adjust their buying patterns in dealing with ongoing cost of living pressures. As we've indicated, we are planning for CapEx in the range of \$70 million to \$80 million, much less than in the prior year, the majority of which is carryover and required maintenance. While in the near term, we're taking a more deliberate approach to investments in our consumer growth agenda. We remain committed to our Central to Home strategy as our roadmap for long-term growth. As we previously said, this fiscal, we are focused on the cost pillar of our strategy. We've tightened our belt, including a pause on hiring, a reduction in travel expenses, and our teams are working hard on converting inventories into cash. In addition, we are advancing our cost and simplicity agenda to

streamline our businesses and improve efficiency across the organization in support of our long-term algorithm. We intend to execute these initiatives through a series of restructuring projects over the coming years.

As Tim mentioned, we are announcing the first restructuring activity of our cost and simplicity program. And in Q3, we are expecting approximately \$15 million of one-time charges related to the closure of our pet bedding facilities in Texas, including severance, liquidation of inventory, and related intangibles, the majority of which is non-cash. We estimate an annual benefit of \$4 million to \$6 million, a cash-on-cash payback in less than two years, and a meaningful step-up in operating income contribution from a streamlined pet bed operations. Thanks to our strong financial position and the amount remaining on our credit facility, we remain on the lookout for great growth and margin accretive companies in both Pet and Garden.

Lastly, we expect a tax rate of approximately 24% similar to 2022. All said, we expect EPS for the year to be in the range of \$2.35 or better. Our guidance reflects our belief in the competitive strength essential and the long-term trends supporting growth in the Pet and Garden industries. Consumers remain engaged in our categories, as demonstrated by our recent POS consumption trends. This gives us confidence in our full-year guidance and as we've indicated, we expect operating income and EPS growth in the second half. This outlook excludes any impact from potential acquisitions or restructuring activities undertaken during the year, including the closure of our pet bedding facility in the third quarter.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting a question and answer session. [Operator Instructions] And our first question is from Bill Chappell with Truist Securities. Please proceed with your question.

William B. Chappell

Analyst, Truist Securities, Inc.

Thanks. Good afternoon.

Timothy P. Cofer

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

Hey, Bill.

J.D. Walker

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

Hey, Bill.

William B. Chappell

Analyst, Truist Securities, Inc.

Hey. Just any plans for more color, kind of dollar amount, cost savings, stuff like that on the restructuring program? Or is that will we see that in the coming months? Just trying to understand, when we would either get a meaningful improvements or dividends from this kind of program. I understand it's a multi-year program. Just trying to, anything more you can put around it just so we can kind of start to think about it from a margin standpoint and a cost standpoint?

Timothy P. Cofer

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

A

Yeah. Thanks, Bill. As you heard, we've really advanced our work on what we're calling our cost and simplicity program. And as we've discussed with you, among others in the past, we think there's a significant opportunity here. It's pretty broad ranging in terms of its scope and I outlined those areas from manufacturing through procurement, logistics, some work we're doing on in portfolio simplification and admin costs. And the outcomes that we're looking for are clear as well. I think, we are a complex platform and there's opportunities to streamline it. And when we do, we think there's money to be saved and margin to be built and fuel to be created to put back in our growth agenda. And so, [ph] again, that's (00:31:13) going to be less SKUs and less facilities.

Today we gave that first tangible step, Bill, to your question, I know you're looking for some hard figures and further direction, but I think, it's a great example of stuff you will see going forward. Niko shared the numbers in the prepared remarks, closing the facility, one-time cost that's reasonable and a very quick payback. We're lining up projects that can follow in the quarters and years ahead. And, at this point, in terms of dollars and cents, we can only talk to you about the one we announced last Friday, but the expectation should be you're going to hear more from us in the quarter – quarters ahead and in our annual guide as we turned the corner to 2024.

William B. Chappell

Analyst, Truist Securities, Inc.

Q

Got it. And then just in a follow-up, maybe talk a little bit about inventory and retail and then we're coming up last year, where retailers were tightening inventory, cutting inventory, have you seen that in both Pet and Garden continue as we moved into – to calendar 2023 and do you expect that to continue for the next couple of quarters? Thanks.

J.D. Walker

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

A

Sure, Bill. It's J.D. I'll start and then I'll turn it over to John to speak to inventories. In Garden, we've certainly seen the inventories – or the retailers continue to take inventory out of their system, some of that was the destocking that's been widely reported. And then in addition to that, we saw a change in buying patterns this year versus historical standards. Typically, the retailers would ship a lot of inventory in at the beginning of January to set the stores for the upcoming season. What we've seen this year is a more measured approach with a shift more toward just in time ordering. So that's pushed inventory back into the – into our bonds, or waiting for the season to break. I do believe and we did not load the channel at the end of the quarter. So we feel like we're in very good position. They've taken inventory out, but I think what we'll see and we said all along we thought second half would be stronger and I think that will play out. Our inventories are in much better position than they were a year ago. And as we see consumption in Qs 3 and 4, we should see replenishment that follows. I'll turn it over to John.

John Hanson

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

A

Yeah. Bill, on the Pet side, we talked a little bit about it last quarter. We certainly saw it in Q1 and it continued a bit in Q2. We certainly – as our POS in Q1 and Q2 was stronger than our shipments, we expect the inventory levels in Pet to stabilize in the back half. We're seeing a little bit of that in Q2 and expect it to more or so stabilize in the back half.

William B. Chappell

Analyst, Truist Securities, Inc.

Q

Great. Thanks.

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

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

Hi. Good afternoon and thanks for taking my question. Just a follow-up on the Pet line of [ph] questions before (00:34:31), hoping you could talk a little bit more just about the outlook for demand at the POS level and how you're thinking about that. And then maybe if you can give us something more color on how much some of the product exits that you've done, how much mathematically that's impacting growth here to the category? Thanks.

Timothy P. Cofer

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

A

Yeah, Brad, I'll start. This is Tim. Look, overall, we've – as I've said in the comments, we feel good about our performance on Pet. It is a bit of a tale of two cities Brad for us in pet supplies between consumables and durables. I think, that is more than an important nuance to – for – to understand. In durables continue to see headwind, saw durables decline in the quarter both at a category level and Central Pet level. In contrast, saw consumables grow. And the good news is, our business does skew consumables and pretty heavily kind of 75%, 80% consumables to durables. But the headwinds on durables continue and we'd expect, through the year to do that. Remember that durables are more closely associated with new pet adoption. And so as we rolled off all that COVID spike, you did see things like fish tank, small animal enclosures, pet beds, et cetera, take more of a hit than the everyday consumables like food, treats, and supplies.

So as you roll into the back half of the year, we're feeling good. We're feeling good about our growth prospects. Quarter-after-quarter that durables impact will begin to moderate. And on the consumables side, I feel very good about our competitive position and growth, but also reinforce that as we look at it through Syndicated Data, Nielsen, as well as online data, we expanded market share in aggregate across, 8 or 10 of our key categories from dog treats to small animals, aquatics, reptile, equine, et cetera. And I think the last thing to say is, on the back half, we are [ph] lapping (00:36:33) slightly softer comps on the Pet side year-over-year from a sales side. So for all those reasons, feel good about current competitiveness and outlook on Pet.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

That's really helpful. And if I could ask a follow-up to Niko on the gross margin outlook, obviously in the current quarter [indiscernible] (00:36:53) that you're dealing with. But can you talk a little bit more about the outlook as you think about some of the tailwinds you have from pricing, coupled with what you're seeing on the input cost side? Thanks.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

Yeah, sure. Yeah, so as Tim mentioned in the back half, it's a little bit of an easier comp for us and we've got sort of 90% of our pricing is set, which is, another tailwind for us. So as we look into the back half of the year we are expecting some margin expansion, going into the back half. So feel pretty good about that, pretty encouraged by April and looking forward to a strong second half.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Really helpful. Thanks so much.

Q

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

Andrea Teixeira

Analyst, JPMorgan Securities LLC

Thanks, Camila, and good afternoon, Tim, Nick, J.D., John, Friederike. I appreciate the comment about the weather impact and J.D. you said that obviously [ph] as you expected (00:38:02), you gave a little bit of a color on the March numbers, especially the last two weeks, which are crucial. So I was hoping to see and I know you updated the outlook even before today, but I was just hoping to see what is in more detail embedded in there. In the case of patch, John had said that he expects at least for consumables, things to be pretty much inventory kind of mimicking or sell in, sell out mimicking consumption. In the case of gardening – Garden, it's probably a little bit more complicated from what I can understand. So I was hoping, if you can explain to us that point of traffic and all of that as I've said, obviously, if you miss a crucial times of the gardening, folks may not engage in gardening at all. So I was hoping to see if you were embedding some of their conservatives in there, in your outlook?

Q

J.D. Walker

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

Hi, Andrea, it's J.D. So yeah, I'll speak to that. I'd say first of all, we still are very optimistic. A lot of the season still lies in front of us. Over 50% of the business still is in Qs 3 and 4. And when we have reasonably decent weather, we're having great consumption. The consumer is still very engaged in our categories, which is, we feel incredibly positive about. As I said earlier, the inventory levels are at a point right now, where any consumption is going to drive replenishment. So they've taken quite a bit of inventory out of the system. We're not sitting on heavy inventories at retail. We think that's a tailwind for us as well. All things considered, I think if you look at Syndicated Data, we're also taking share in the key categories in which we compete from Grass Seed to branded controls to wild bird feeds. We also know from talking to our customers that we're taking share in Packet Seed as well. So we feel good about our key categories. We know that the consumers are engaged. We just need some decent weather. And the forward-looking forecasts, at least in the near-term, looks very favorable. So, we are, I'd say, cautiously optimistic, because the single biggest [ph] causal factor (00:40:23) is still out of our control. But we feel good about those controllables and that we're in good position there.

A

Andrea Teixeira

Analyst, JPMorgan Securities LLC

Very helpful. Thank you.

Q

Timothy P. Cofer

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

And...

A

Andrea Teixeira

Analyst, JPMorgan Securities LLC

Yeah, go ahead.

Q

Timothy P. Cofer

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

A

Yeah, and the last thing, Andrea, to build on J.D.'s point, he made this earlier, I think to Bill's question is our inventory is in good position, right. So I think, J.D. mentioned earlier, we didn't [ph] load retail (00:40:48) at the end of our fiscal Q2. So that means once we get the additional POS going, which we have visibility now into this quarter, those replenishment orders are going to flow through, and there's nothing stopping it from a retail inventory standpoint. So that's encouraging, and you mentioned that earlier J.D.

J.D. Walker

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

A

I did. Yes.

Andrea Teixeira

Analyst, JPMorgan Securities LLC

Q

Perfect. Thank you. Thank you both.

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

Hale Holden

Analyst, Barclays Capital, Inc.

Q

Hi. Good afternoon. I just – Sneaky Snacker might have been the best pet food name, treat name I remember in the long time, made me laugh out loud. So thank you.

John Hanson

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

A

That's true.

Hale Holden

Analyst, Barclays Capital, Inc.

Q

Two questions. So first one, just as a clarification, when you talk about margin expansion in the second half, that's on a year-over-year basis, not on a sequential versus first half basis, I just want to make sure I got that correct?

Timothy P. Cofer

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

A

Yeah, it should be both, actually.

Hale Holden

Analyst, Barclays Capital, Inc.

Q

Okay.

Timothy P. Cofer

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

A

Yeah.

Hale Holden

Analyst, Barclays Capital, Inc.

Q

And then the second one on some of the pet durable weakness, are you seeing that evenly across all your channel partners? Or is it more weighted to, mass or pet specialty or online? I was wondering if there's any differentiation there?

John Hanson

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

A

Yeah, we're seeing it pretty even across brick and mortar. We see, online being a little bit stronger, honestly, but it's pretty even across brick and mortar.

Hale Holden

Analyst, Barclays Capital, Inc.

Q

Okay. Thank you very much. I appreciate it.

Timothy P. Cofer

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

A

Thank you.

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

Carla Casella

Analyst, JPMorgan Securities LLC

Q

Hi. Thank you. You mentioned you're in a good inventory position. And I know last year, this time from second into third quarter, inventory stayed about the same. But that's – I don't think that's typical. Can you just say whether you see – should we get some working capital release in third quarter as you work through inventory? Or is there some reason it should stay kind of at the current level?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

No, Carla. We're going to continue to work through it. I mean, if you look at we saw some already this quarter, even though, the first half of the year, we – we're users of cash. We were users of much less cash in this quarter. So in the prepared remarks, we used like \$34 million of cash, in a year ago we were using \$180 million. So that's a nice sort of change up in the quarter. And then, the grass – the garden season, excuse me, is still kind of ahead of us. So, most of the inventory is on the Garden side. I'll just share this with you, our Pet inventory year-over-year is down. And so we expect more of that into Q3 and Q4, so we are very, very focused on working cap and inventories.

Carla Casella

Analyst, JPMorgan Securities LLC

Q

Okay, great. Did you say how much your guidance or what you think the working capital could be as a source for the year?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

No, we didn't share that.

A

Carla Casella

Analyst, JPMorgan Securities LLC

Okay.

Q

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Yeah.

A

Carla Casella

Analyst, JPMorgan Securities LLC

How about cash taxes? Are there any unusual tax items with some of the restructuring you're taking?

Q

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

No.

A

Carla Casella

Analyst, JPMorgan Securities LLC

Okay. So [ph] you're just saying the P&L taxes are your (00:44:22) cash taxes?

Q

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Yes.

A

Carla Casella

Analyst, JPMorgan Securities LLC

Okay. And just one thing, as, you know the marketing plans, as you said SG&A was about the flat at this quarter versus last year. How flexible is your SG&A, meaning if we see, weather weakness as we get through further into the season, how quickly can you pull back on any of that or should we expect to – does that stays relatively stable?

Q

Timothy P. Cofer

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

Yeah, no, it is flexible, certainly, when we talk about SG&A, if you go to the commercial expenditure side, marketing, sales, merchandising, et cetera that is flexible. And indeed, when I look at the two gentlemen that run their Garden and Pet here next to me, I mean, these guys are – stay very nimble and very agile. Particularly on the Garden side to your question, Carla, if for whatever reason, Mother Nature doesn't cooperate for an extended period of time, J.D. and his team have that contingency in that flexibility to pull back to match the type of demand environment we're in.

A

Carla Casella

Analyst, JPMorgan Securities LLC

Q

Okay. And then just one other housekeeping. Did you – can you just remind us, when you exited the private label business for those beds to pet beds you did, was that a recycled bed fully now?

John Hanson

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

A

Yeah, we – this is John. It's been a process over the last 12 months or maybe even a little bit longer. And it's been a continual process. So it's not fully cycled, to answer your question.

Carla Casella

Analyst, JPMorgan Securities LLC

Q

Okay.

Timothy P. Cofer

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

A

Thank you.

Carla Casella

Analyst, JPMorgan Securities LLC

Q

Okay, great. Thanks for all the questions – sorry answers.

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

Karru Martinson

Analyst, Jefferies LLC

Q

Good afternoon. With 90% of your pricing said, I was wondering, what are you seeing on input costs here in the second half and going forward?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

Yeah. So as we looked at input costs, they're still historically pretty high. Now they're not quite as high as they were a year ago. So we saw inflation this year of approximately half of what it was a year ago. And it's not as broad-based, right? So, for instance, containers coming in from China are much lower. I would say delivery expenses are lower. But, we have pockets of inflation like, we had some grass seed varieties that were up, things like potato starch, some actives in our life science business like PBO and pyrethrin. So there're still some pockets there, and so there are still some pockets there, but it's not nearly what it was a year ago. It's the way to think about it.

Karru Martinson

Analyst, Jefferies LLC

Q

And the feeling, given the margin expansion in your view in the second half, is the feeling is the pricing that you have said covers those costs, correct?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Yeah. Yes, that's correct.

A

Karru Martinson

Analyst, Jefferies LLC

Okay. And just interesting to hear is still on the M&A prowl, kind of what are we looking for in terms of tuck-ins or favoring one side of the business or another or you want a third leg to that stool?

Q

Timothy P. Cofer

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

Great question. Yes, we still are on the prowl. So we are actively looking. The pipeline has slowed, I would tell you. I think with the public markets being as volatile as they are, I think, there's less assets out there, less folks wanting, exposure to – well actually to expose themselves to this market. So it just the pipeline has definitely slowed, but we are still looking. And again, we view each deal sort of based on its own merit. We have done a number of Garden deals, so it'd be great to get a Pet deal here shortly. But we'll see – we have to see they all tend to take or have a life of their own and we'll have to see, but we continue to look.

A

Karru Martinson

Analyst, Jefferies LLC

All right. Thank you very much, guys. Appreciate it.

Q

Operator: Thank you. There are no further questions at this time. I would like to turn the floor back over to CEO, Tim Cofer for closing comments.

Timothy P. Cofer

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

Thanks, everyone, for joining today's call and your continued interest in Central Garden & Pet. We're happy to follow up with you with any questions, contact Friederike. Thanks. Have a good day.

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

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