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# Central Garden & Pet Co. (CENT)

Q3 2019 Earnings Call

## CORPORATE PARTICIPANTS

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### George C. Roeth

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

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### J.D. Walker

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## OTHER PARTICIPANTS

### William B. Chappell

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Ladies and gentlemen, thank you for standing by. Welcome to the Central Garden & Pet's Third Quarter Fiscal Year 2019 Financial Results Conference Call.

My name is Kevin, and I'll be your conference operator for today. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session. Instructions will be given at that time. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the call over to Steven Zenker, Vice President, Investor Relations, FP&A and Communications. Please go ahead.

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### Steven Zenker

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

Thank you, Kevin.

Good afternoon, everyone, and thank you for joining us.

With me on the call today are George Roeth, Central's President and Chief Executive Officer; Niko Lahanas, our Chief Financial Officer; Howard Macheck, our SVP of Finance and Chief Accounting Officer; J.D. Walker, our President, Garden Branded Business; and John Hanson, our new President of Pet Consumer Products.

A press release providing results for our third quarter ended June 29, 2019 is available on our website at [www.central.com](http://www.central.com) and contains the GAAP to non-GAAP reconciliation for the non-GAAP measures discussed on this call.

Before I turn the call over to George, I'd like to remind you that statements made during this conference call which are not historical facts, including adjusted EPS guidance for 2019, expectations for new product introductions, long-term organic growth goals, future acquisitions, and future revenue, cost savings and profitability are forward-looking statements subject to risks and uncertainties that could cause the actual results to differ materially from those implied by forward-looking statements. These risks and others are described in Central's Securities and Exchange Commission filings including our Annual Report on Form 10-K filed on November 28, 2018. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events or otherwise.

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

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## George C. Roeth

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

Thank you, Steve. Good afternoon, everybody.

Before I begin my comments on the Q3 business results, I do want to take a minute to more formally introduce John Hanson who has stepped off our Central Garden & Pet board to assume the responsibilities of Rodolfo Spielmann, our former President of Pet Consumer Products who departed last month. We all wish Rodolfo well in his future endeavors. Rodolfo helped build our digital capabilities, increased our consumer focus and led key strategic acquisitions and we are fortunate to have John with 25 years of consumer products experience to step in and continue to drive change in the Pet segment.

John has previously held a number of leadership roles in sales, marketing and general management most notably at ConAgra. John spent almost 17 years at ConAgra and was President of its Frozen Foods Division for four years. In that role, John grew the business from approximately \$1.7 billion to over \$2.5 billion in sales growing both organically and through acquisitions. After leaving ConAgra, John has focused on strategic and operational consulting including M&A in the consumer products industry. In fact, over the last year, John has been consulting for Central on a range of issues including our Pet businesses and we know his capabilities well. Importantly, he is in a position to hit the ground running. John will officially become a full time employee and assume his new role on August 6 and will be supported by the strong cadre of leaders who continue to run our individual Pet businesses.

Now, turning to the business and Q3 results, I'm pleased to announce that our overall company third quarter sales rose 7% and our operating income was up 13% of the third quarter a year ago. The sales gains were led by a healthy 18% sales increase in our Garden segment driven by our Arden acquisition and 4% organic growth from the remainder of the Garden businesses despite challenging weather. This is in line with both Garden's third quarter and year-to-date point-of-sale increases of around 5%. Bell Nurseries was a standout this quarter surpassing our already bullish organic growth expectations for this business that we acquired a little over a year ago. Overall company organic sales were up 1%.

The total company 13% gain in operating income was driven by the Garden segment, which posted year-over-year increase of 30%. Importantly, the company's overall operating margin expanded 50 basis points, continuing the trend of sequential year-over-year gains once our pricing actions took effect in tandem with our ongoing cost savings. And I should say sequential quarterly year-over-year gains.

Our financial results versus a year ago were tempered by our Pet business where sales were down 1%. Pet operating income was also down, off 11%, largely driven by our animal health businesses particularly our professional business, which faced significant and unexpectedly severe headwinds, historically bad weather across our major regions of strength from Kansas up to the Great Plains, a challenged dairy market and tariff pressure on exports, which all negatively impacted customer usage rates and their inventory levels because of the economic uncertainty.

It's truly unique time in the agricultural sector. On the weather front, we have seen 100-plus year annual rainfall records being eclipsed which negatively impacted both livestock and grain production. Compounding the situation was at the most impacted segment, livestock, which is largely cattle and [ph] swine-fly abatement (00:05:23) products and grain insect protection carry above-average company margins. While the issues are industry-wide and not company specific, they are painful nevertheless.

Having said that, we do not believe these are long-term norms. This has historically been an attractive business from both a growth and margin perspective and we fully expect this business to rebound over the next year. While our animal health business has had an outsized impact on our Pet profitability, our Pet organic sales were down 2% versus the base of up 7% a year ago due largely to the animal health weakness and timing issues in our pet bedding business. I should note that branded sales increased 1%. Reassuringly in our pet bedding business, roughly two thirds of our orders for a strong Q4 are already on the books. Net-net, we continue to expect solid organic sales growth in the fourth quarter.

On the acquisition front, at the beginning of June, we purchased C&S Products, the leading player in the wild bird suet market which contributed just under 1 point of overall Pet segment sales growth in Q3. Suet is a unique wild bird feed product that looks like a seeded wafer and is favored by certain types of birds. The purchase of C&S while relatively modest bolsters our leading portfolio of wild bird feed products as we didn't previously manufacture suet. The current management team will continue to run the business and C&S will be reported as part of our Pet segment. As is typical for us, we expect to report their sales as inorganic for the first year. We would expect C&S to be accretive in all of fiscal year 2020.

While we are pleased with the C&S acquisition, we admittedly are disappointed at not having closed on larger transactions this fiscal year to date. I can assure you that is not for a lack of effort or possible targets. We have gotten down the road on some, but it just not worked out and unfortunately this is a situation where you are not successful until you are. We remain focused on this strategic imperative and continue to believe that the opportunities are worthy of the effort and patience.

Now, I'd like to turn it over to Niko to talk more deeply about the financial results for the quarter. Niko?

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## Nicholas Lahanas

*Chief Financial Officer, Central Garden & Pet Co.*

Thank you, George. Good afternoon, everyone.

Third quarter total company sales increased 7% or \$49 million to \$707 million from \$658 million in the third quarter of last year. Our recent acquisitions of Arden and, to a much lesser extent, C&S were drivers of the sales gain accounting for \$45 million of the revenue in the quarter. Organic sales growth was also a positive contributor, growing \$4 million or 1% driven by again in our Garden segment.

Consolidated gross profit for the quarter increased \$17 million and our gross margin increased 30 basis points to 31% benefiting by the inclusion of Arden. Organic gross margin was also up. SG&A expense for the quarter rose 6% or \$9 million versus a year ago, due primarily to acquisitions. As a percent of sales, SG&A declined 20 basis points to 21.3%. Our corporate expense was flat to the prior year. I do want to call out however two atypical items included in corporate SG&A. One is expense related to an unanticipated resolution to a legal matter. The other is cost related to our CEO search. Together these items negatively impacted our reported Q3 EPS by over \$0.02. And we do expect to have further CEO search expenses in our fourth quarter as well.

Central operating income for the quarter increased 13% to \$69 million and operating margin increased 50 basis points to 9.7%, both due in large part to the Arden acquisition. On an organic basis however both were up as well. Price increases taken earlier in the year and the impact of cost savings initiatives aided results. EBITDA for the quarter increased 12% to \$82 million. Turning now to our Pet segment. Pet segment sales for the quarter decreased 1% or \$5 million to \$350 million and were down 2% on an organic basis. Sales were negatively impacted by continued challenges in the Animal Health business and the mix of sales and the timing of promotions in the quarter versus a year ago, both of which also impacted margins and more than offset stronger results in our Aquatics and Dog Treat businesses.

The Animal Health businesses continue to be impacted by weather-related challenges and difficult economic conditions for the agricultural markets. George touched on some of these challenges earlier, but certainly a late breaking season, record rainfall made for challenging environment even when comparing to a modest comp last year. Lower sales of other manufacturers products was also a factor in Pet sales decline for the quarter. Pet segment operating income for the quarter declined by \$4 million or 11% compared to the prior year to \$35 million. Pet operating margin decreased 110 basis points to 10%. As I stated earlier, timing and mix were factors as were the dynamics in the Animal Health business. Pet EBITDA for the quarter decreased 8% to \$43 million for the same reasons as the decline in operating income.

Turning now to Garden, for the quarter, Garden segment sales increased 18% or \$53 million to \$356 million due in large part to the Arden acquisition as well as organic growth of \$12 million or 4%. The organic growth was led by stronger sales on our Bell Nursery business and higher sales of other manufacturer's products. Bell benefited from new markets and categories. Sales of other manufacturer's products were aided by home center distribution gains offsetting some of that strength weaker results in the control category, as weather has been unfavorable for insect control products. Garden operating income was \$53 million for the quarter compared to \$41 million in the quarter of last year. Garden's operating margin increased 140 basis points to 14.9%. The inclusion of Arden and Bell's increased volume in the quarter drove much of the game.

The third quarter is typically the strongest for both of these businesses. Few words about Arden, owning a 100% of Arden for the quarter proved to be favorable versus the impact of holding 45% as part of the joint venture last year. As you may recall, the joint venture income showed up in other income line last year. Some of this favorability for Garden should be reversed in our fourth quarter, when we absorb a 100% of Arden's losses in the Garden segment versus only owning 45% last year and reporting it in other income line. The weaker controls revenue and a negative impact from the Pottery and Wood products businesses we are exiting offset some of Garden's operating income and margin gains. But both operating income and margins were still up on an organic basis.

Garden EBITDA at \$57 million increased 29% to \$13 million versus a year ago. Now getting back for our consolidated results. In the third quarter, we had other income of \$200,000 compared to other income of \$2.1 million a year ago. The decline was due primarily to the absence of Arden in the numbers. Net interest expense decreased \$1.5 million to \$8.5 million due primarily to interest earned on our higher cash balances here versus a

year ago. We also benefited from a higher interest rate earned on that cash balance. Our tax rate for the quarter was 23.5% as compared to 21.5% in the third quarter a year ago. Turning to our balance sheet and cash flow statements. Cash at the end of the quarter was \$446 million up from \$204 million at the end of the third quarter last year.

The increase reflects the inclusion of the proceeds of the equity offering closed in August of 2018 as well as stronger cash flow from operations during the quarter. For the quarter cash generated by operations was \$172 million versus \$112 million in the third quarter a year ago due primarily to higher earnings and stronger working capital management. CapEx was \$7 million down from \$9 million in the third quarter of 2018. Total debt was \$693 million relatively unchanged from last year. Our gross leverage ratio at the end of the quarter remained at 3.3 times – 3 times that as the same as the year ago and well within our target range. We also had \$400 million of availability on our credit line at the end of the quarter. Depreciation and amortization for the quarter was \$13 million in line with the year ago. During the quarter, we repurchased approximately 555,000 shares or \$14.3 million of our common stock under the board's previously authorized share repurchase program. The goal of these purchases was to offset the share creep price that is a direct result of equity compensation programs. There's approximately \$21 million remaining under that authorization.

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

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## George C. Roeth

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

I'd like to close by saying we remain committed to our fundamental strategy of systematic cost reduction to fund capabilities and programs to drive consistent organic growth. We plan to deploy a strong and growing cash flow on our M&A capabilities to celebrate overall company growth and drive shareholder value. We were very pleased to see the return to expanding margins once our pricing action took effect on top of our cost savings program and we fully expect to see an acceleration on organic growth going forward as we put our Animal Health professional industry challenges and some of the tech consumer brands timing issues behind us. In terms of guidance, we are lowering our EPS to \$1.72 or higher.

The reduction is driven by short-term challenges in our Animal Health businesses and an estimated \$0.03 related to non-recurring administrative expenses associated with the resolution of the legal matter and CEO transition costs not included in our previous guidance. While admittedly this has been a bumpy year with the inclusion of two quarters of losses from a highly seasonal business [indiscernible] (00:15:15) last year's results. The dilution from our August equity raise and a historic disruption in the agricultural markets just to name a few issues. I am immensely proud of how our team has weathered the storm no pun intended. And fortunately, we expect a normal operating environment going forward. We continue to grow. We were up 7% in sales, 13% in operating income and had a significant increase in cash provided by operations. We have leading market positions and a balance sheet set up for accelerated growth. Importantly, we have approximately \$8 a share in cash at the ready to deploy in M&A to drive increase shareholder value, rest assured that we were working hard to make that happen.

With that said, I'll now turn it over to questions from the audience.

## QUESTION AND ANSWER SECTION

**Operator:** Thank you. We'll now be conducting a question-and-answer session. [Operator Instructions] Our first question today is coming from Bill Chappell from SunTrust Robinson Humphrey. Your line is now live.

William B. Chappell

*Analyst, SunTrust Robinson Humphrey, Inc.*

Thanks. Good afternoon.

Q

George C. Roeth

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

Hi, Bill.

A

Nicholas Lahanas

*Chief Financial Officer, Central Garden & Pet Co.*

Hey, Bill.

A

William B. Chappell

*Analyst, SunTrust Robinson Humphrey, Inc.*

Can we – and just going back – I don't fully understand kind of the legal and especially kind of the CEO, unexpected CEO transition costs. Can you give me a little more color there especially on the CEO transition, how big that could be and why that's kind of being pulled out other than kind of normal business?

Q

George C. Roeth

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

Bill, when we gave the estimates on – guide to the beginning of the year, we didn't include CEO transition costs, because frankly, we didn't know, we could all end up in there. Not only the recruiting charges that you're obviously paying consulting, but also potential compensation issues. So it was so widely variable. We're pretty clear we didn't include that in the guidance. Today, we've identified the recruiting costs as we've been hit by the date, which affect our numbers to some degree, fairly – fairly low admittedly. But until we get final conclusion of this the number is still highly variable and hence we wanted to call it out. In terms of the legal issue that was a case where there was a settlement, it was above our normal reserves for that. That's pretty unusual and hence, we felt the need to call it out, it wasn't something we had expected when we gave you the guidance.

A

William B. Chappell

*Analyst, SunTrust Robinson Humphrey, Inc.*

But I guess the \$0.03 so far is majority legal and just smaller on that or is it 50/50? How do I look at that, especially modeling fourth quarter?

Q

George C. Roeth

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

It's more legal than not and we would consider both non-recurring.

A



William B. Chappell

*Analyst, SunTrust Robinson Humphrey, Inc.*

Q

And – but is it – should I assume that the comment that CEO transits expenses will continued into 4Q that we're not really close to finding a replacement?

George C. Roeth

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

A

Actually, I wouldn't say that at all. So we are making good progress. We looked at a terrific slate of candidates some of which I've met, and I would say that we're – you can never promise a 100% for sure, but we're on track to have someone in seat to replace me before I leave.

William B. Chappell

*Analyst, SunTrust Robinson Humphrey, Inc.*

Q

And then switching to the Animal Health, I'm just trying to understand, because it sounds like it's more broader, more commercial business than just a typical stuff that I'm buying at PetSmart, PETCO, so can you maybe give me a little more color there?

George C. Roeth

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

A

Yeah. It's a very different business, I'll let Niko kind of walk you through it.

Nicholas Lahanas

*Chief Financial Officer, Central Garden & Pet Co.*

A

Yeah. So we we've got the Consumer side and the Professional side, and when it comes to the margins, we're really talking about the Professional side. And I'll just give everyone a little bit of background on that; really the Professional side be, it's a B2B business, so it's not a Consumer business, first of all. Secondly, bottom line is, we sell active ingredients that control insects and primarily flies, mosquitos and fleas and tick. It really – we operate in sort of six distinct markets, three are very ag-centric dealing with farmers, ranchers, things of that nature. And then the other side of the business, the other three verticals are really just taking our active and our technology and selling them to other businesses.

As you can imagine, the ag market has been hit incredibly hard this year; you had all the flooding in the Midwest, you got a thousand calves died or a million calves die this year, a record number of bankruptcies, the tariffs and the trade issues are not helping. And so we've you know we've been – we have exposure to that market and that's what's going on there. And it just so happens that in that ag vertical is some of our higher margin business that from a mix standpoint just hasn't been very favorable. So the Pro business has suffered and then consequently the Pet business suffers along with that Pro business from a mix standpoint.

George C. Roeth

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

A

And the only thing I would add is we – under any circumstances we would not call this a normative year. So, our full expectation is we will return to more normal rate going forward. I don't think we're being overly optimistic about the bounce back, but surely the state of affairs that we've seen this season are highly unusual.

William B. Chappell

*Analyst, SunTrust Robinson Humphrey, Inc.*

Q



Got it. And then in terms of Garden just – if I look at your key competitor's numbers they seem stronger across the board in the core consumer than your numbers. They actually talked about grass seed in particular being up 18% which I know is you're kind of key market. Should I – did you give back some market share in this quarter or do we really just look at this is all weather?

J.D. Walker

*President-Garden Branded Business, Central Garden & Pet Co.*

A

Bill, its J.D. I'll take that question. I think it's as you know it's difficult to make a direct comparison to our competition. We compete in some categories in which they don't, wild bird seeds, pottery, we're in the lab goods category. They have [indiscernible] (00:21:17), which we don't, rodenticides things like that. But I heard their numbers as well, they had a strong quarter we had a very strong quarter with 4% organic growth on the sales line and POS it's actually outpacing our sales. Having said that, you asked specifically about a couple of categories, there's only a few categories where we overlap with them. In grass seed I think they represented a plus 18% comp year-over-year.

Ours is positive, but not as positive as that. I think we have given back some share there. And I would say this we go into every season with the intention of growing our holding share. However, having said that, there is some promotions that we won't chase. So this year we elected not to go after particularly opening price points type promotions where the – was margin dilutive. So we did get back some share. We still have a very high share in that category and a very mature market. The other where we overlap with them is in fertilizers where our POS comps compare favorably to our competition. So I would say in general and aggregate as you look at it we're holding share with very little overlap with that particular competitor.

William B. Chappell

*Analyst, SunTrust Robinson Humphrey, Inc.*

Q

Got it. Thank you.

**Operator:** Thank you. Our next question is coming from Chris Carey from Bank of America Merrill Lynch. Your line is now live.

Christopher M. Carey

*Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.*

Q

Hi, good afternoon.

George C. Roeth

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

A

Hey Chris.

Christopher M. Carey

*Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.*

Q

Hi. How are you?

George C. Roeth

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

A

Great.

Nicholas Lahanas

*Chief Financial Officer, Central Garden & Pet Co.*

A

Good.

Christopher M. Carey

*Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.*

Q

Good. So I think I heard there was a leadership change in Pet, right, and I guess besides these external headwinds like weather that you discussed, maybe what in the business do you think needs to be addressed, right? And I thought I heard the comment that you expected growth in Pet in Q4. Did I hear that correctly?

George C. Roeth

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

A

Yeah.

Christopher M. Carey

*Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.*

Q

And I guess I'm just trying to get comfort on why that would be the case?

George C. Roeth

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

A

Well, number of things. First of all, if you look at our branded Pet business kind of the area you think about the consumer [indiscernible] (00:23:26) we were up 1%. That's probably short of a category which is difficult to measure. But we typically say growth 2% to 4% and we've seen it on the lower end of that, but we say the category is growing roughly 2% and we're up 1%. We are down that's been largely attributed to our Health and Wellness business in which Behavior Modification is a big portion of. If you remember there was a major new entrant, matter of that they used to be the supplier of our product, which immediately hurts us, and then we had product issues in our response to that that didn't go well.

That's kind of been going on. And we launched a the new product this last quarter. It's taking a while to work through the inventories as the old products so we haven't been able to be as aggressive [indiscernible] (00:24:06) we'd like. But we expect to do that in Q4 and dial it up significantly next year. In terms of the Pet bedding business, we are the leading Pet bedding company in North America. We have our Dallas manufacturing and we have [indiscernible] (00:24:20) bedding. I will tell you that Q4 is well set up, so we're going to have a fantastic fall and holiday season. We have two thirds of our orders already on the books on those businesses so which should be an aggressive growth in Q4. So we have a fair amount of confidence around our Pet business growing in the fourth quarter.

Christopher M. Carey

*Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.*

Q

And I guess just structurally the business you're comfortable where it is outside of the dynamics, which have occurred in the Animal Health business, which I assume would continue for another quarter or two until those fully get lapped?

George C. Roeth

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

A

Yeah. I mean I would say we're never satisfied. So I don't know if I would call it structural, but there's capabilities with the company that we need to continue to mature and be aggressive on. The first being digital and driving the e-commerce business. We have built a fairly significant capability from where we were a couple of years ago, matter of fact I can talk about situations for example with Amazon where we have artificial intelligence that will tell us what changes we need to make in terms of how we are presenting the products and information in order to increase – get us up on the buy box, for example. The beauty of our company is we're the largest Pet supplier, therefore we can back technologies like that and deploy them and leverage them across multiple businesses where smaller Pet companies would be difficult to replicate that.

So that's been a big area of emphasis and that's an area that we need to continue to develop. The other one quite frankly is around innovation. So I don't think our innovation capabilities is mature as we would like for them to be across all of our businesses. Our challenges on the Behavior Modification product I think are an example of that. And I'll just tell you that we're bringing in the right people and looking at the appropriate changes to improve, not only the output of our innovation which I think is pretty good, but also the quality and size of our innovation. Those are areas that I think John is going to be focused pretty strongly on going forward.

Christopher M. Carey

*Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.*

Q

Okay. So in Garden, I think I heard that POS is outpacing the organic sales and that's quite a bit different than your competitor where organic sales are outpacing POS quite a bit, right? So have you seen purchasing patterns of your top retailers changing this year relative to other years? I just I find it interesting that there is such a divergence.

J.D. Walker

*President-Garden Branded Business, Central Garden & Pet Co.*

A

Yes. Chris, it's J.D. again, I'll address that. That's exactly what we're seeing. We're seeing some destocking with a couple of our large customers, which they've done from time-to-time, I won't say it's unprecedented. We feel good about where we are right now with in-store inventories. I know it's a complete departure from what you heard yesterday, but our POS is outpacing our sell-in and we feel that that's positioning us well going into Q4 and to beginning of our [indiscernible] (00:27:23).

Christopher M. Carey

*Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.*

Q

So just on that the destocking, I guess your competitors' results would imply the opposite, so is that category-specific, is that retailer-specific?

J.D. Walker

*President-Garden Branded Business, Central Garden & Pet Co.*

A

I think it's a combination of both. I think that, it can be – I'm sure that some of the retailers that I'm talking about are impacting their selling as well. But having said that, there's going to be some deviation by category as well, I would expect.

George C. Roeth

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

A

The only thing I'll add to that is our retail inventories are in line with year ago where we felt good about them. So our POS and organic sales are fairly equivalent, and going into the end of the year with a hangover in inventory is

not necessarily a good place to be, when you get into talking about write downs and slowdowns and sell-ins for the next year. So we're very happy with where we're at.

Christopher M. Carey

*Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.*

Q

Okay. All right. Thanks. And then last question, then I'll step back. Does the pace of M&A, or the intent to do any M&A, or use the balance sheet, does that take a step back without a new CEO, does it make more sense to wait until you have a new leader in place, or do you think that you can move without that move happening?

George C. Roeth

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

A

No, we absolutely feel like we can continue to move forward with, without the new CEO at the helm. We really view M&A as a team sport. We have a strategic direction of the company, active pipeline that everyone bought into, and we continue to work that. So the transition really is not slowing us up any. We have done four deals in the last call it 18 months, not a flagship deal that I think most people are anticipating. But we've had few misses and we're just going to continue to plug along. What we won't do is, rush into something just for the sake of doing something. So we're going to continue to be disciplined to our approach and very methodical and thoughtful and the right deal will come along.

Christopher M. Carey

*Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.*

Q

Thank you.

**Operator:** Thank you. Our next question is coming from Brad Thomas from KeyBanc Capital Markets. Your line is now live.

Bradley Thomas

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Hi. Good afternoon. Thanks for taking my questions. Just to follow up on the Pet segment I was wondering if you could give us a little more color, you touched on this a little bit, but a little more exclusive color maybe on what you're seeing from some of the different channels and how that's been evolving?

George C. Roeth

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

A

Not a lot of new news on that front, as you know, that independent pet and pet specialty big box has been declining. I would say some of the big box declines have somewhat ameliorated although they continue and particularly one of those customers has been very much focused on I would just call private label, but those have been consistent trends and I wouldn't say there's been any change in the trajectory. What has been growing and we've been taking advantage of is the mass channel and in particular Costco. Costco is now our number one pet customer and we have very robust growing businesses with that partner and we're truly a partner with them on the Pet business. It's been a great relationship.

And then e-commerce obviously has been a strategic focus for us the last couple of years. It continues to be the highest growing channel for us and we have been quite successful there and feel good about that going forward. And I think one of John's charges is to continue to drive that even harder. We don't see that ameliorating anytime soon. And it can be a competitive advantage for us I believe as I talked earlier, we have the scale and leveraged

technologies and capabilities across \$1 billion worth of business where others are doing around \$100 million or \$50 million smaller pet competitors because we compete mainly against pet supply companies, not big pet food companies.

**Bradley Thomas**

*Analyst, KeyBanc Capital Markets, Inc.*

Q

That's helpful. Thank you, George. And to follow up on the changes you're making in the core business, could you just help size-up, maybe a little bit more, what the revenue impact is going to be from exiting those operations and maybe how much that might be able to help operating income or EBITDA from making those changes?

**George C. Roeth**

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

A

Brad, I can't give the specifics on the revenue, but I'll tell you a little bit about the business. What we're exiting here is our glazed pottery and wooden planter business. We've been in this business for a long time, it's a challenging supply chain with a long lead time, most of these products are sourced overseas, I think from 11 different countries, we were sourcing products, and we were a major provider to big box stores, as well as independent garden centers. It's a bit of a fashion category, so there's a high amount of assortment turnover on an annual basis. And when that happens, you're oftentimes left with residual inventory. Ultimately, it just wasn't a profitable segment of our business.

And really, this is nothing more than portfolio management. It's similar to what we did a few years ago with – we mentioned GKI which was décor business that we exited. It was seasonal décor for holiday. We exited that a few years ago, [ph] it's too had (00:32:46) profit challenged just like this portion of the décor business. Importantly, we will stay in the pottery business in terra cotta where there's very little changeover year to year and it's still a profitable and important piece of our portfolio. But by exiting these unprofitable segments, it allows us to focus more on the profitable segments of our business and look for M&A to replace that.

**Nicholas Lahanas**

*Chief Financial Officer, Central Garden & Pet Co.*

A

And what we can tell you is this is roughly about half of the décor business we got out of and what's not profitable.

**Bradley Thomas**

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Got you. Okay. And if I can squeeze one last one in here, just around the topic, de jure of tariffs, maybe could you just give us a little color on how you've been managing the 25% tariff that we'd had on List 3, and any additional color you can give us on the exposure you have here to List 4 that now looks like it's getting a 10% tariff?

**Nicholas Lahanas**

*Chief Financial Officer, Central Garden & Pet Co.*

A

Yeah. So, what I can tell you is about 10% of our goods come in from China. So, it's not a huge exposure for the company. We have been successful working with our vendor partners to lower cost, in some cases changing the point of production, some cases bringing in-house. And we're not ultimately, if we have to passing this through, the tariff to our retail partners, we do it in a very transparent way. So, as it comes through, we take the price increase and if it goes away, we'll retract the price increase. We've been fairly successful, I'd say largely successful doing that. This next round was not unanticipated or where this should be happening, we have some areas that we work through on how to deal with it and be very much the same as I just described.

Bradley Thomas

*Analyst, KeyBanc Capital Markets, Inc.*

Q

And in terms of sizing, how does the size of the List 4 compared to List 3 for you in terms of that 10% coming from China?

Nicholas Lahanas

*Chief Financial Officer, Central Garden & Pet Co.*

A

I don't think we're giving out that number, and I don't know what off the top of my head. I don't think there's a dramatic difference. That's the best I can tell you at this point.

Bradley Thomas

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Okay.

George C. Roeth

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

A

I wouldn't say it's a major change from what we've seen to date in terms of degree of the first round.

Bradley Thomas

*Analyst, KeyBanc Capital Markets, Inc.*

Q

Got you. Thank you so much, and good luck.

**Operator:** Thank you. Our next question today is coming from Christina Brathwaite from JPMorgan Chase. Your line is now live.

Christina Brathwaite

*Analyst, JPMorgan Securities LLC*

Q

Hi. Good afternoon, everyone.

George C. Roeth

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

A

Hi.

Christina Brathwaite

*Analyst, JPMorgan Securities LLC*

Q

I just want to pick up – I want to pick up first on something that Chris was asking about on the Garden side of the business. Just given the destocking that you're seeing in your key competitor, its premium priced product, they're seeing more space. I was wondering if you're having a different conversation with your retailers lately and if the focus from them have shifted at all to maybe [ph] owing to (00:35:33) to premiumize their space or if there has been any of that conversation?

J.D. Walker

*President-Garden Branded Business, Central Garden & Pet Co.*

A

So, Christina, it's J.D. here. I'm not sure I fully understand where you're going, but let me just say that I think that what we're seeing here is a competitor that has been much more aggressive this year with promotions I think that

that's allowed them to flow more product into the stores. And in terms of space in the store, it doesn't always equate to additional space in the store, it's more shipments, but not always more display space on the floor.

In terms of our discussions with our retailers, we've been pretty promotional over the last couple of years and we maintain that this year and we intend to do so going forward, but I don't know that it's a different discussion than what it's been in the past.

**George C. Roeth**

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

A

Yeah. I would tell you at the beginning of the season, I would very much want sales to be much higher than the consumption trend. Toward the end of the season, having those out of WACC leads to a lot of inventory challenges with customers in terms of write-down and challenges selling in the next season. So, I'll come back to we like where we are at with our retail inventories...

**J.D. Walker**

*President-Garden Branded Business, Central Garden & Pet Co.*

A

Yeah.

**George C. Roeth**

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

A

...fairly close to a year ago and point-of-sales increases which were robust to 5% being in line with what we're seeing in terms of organic sales growth.

**Christina Brathwaite**

*Analyst, JPMorgan Securities LLC*

Q

Okay. That's fair. Thanks. Okay. So, then on the Pet side of the business, I was just surprised that we haven't talked about it yet, I was surprised to see that distribution side down 9%. Can you just talk about what's going on there, maybe a little bit more about the performance of general pet supply now that's within the organic comp base? Is that what's driving the declines there?

**Nicholas Lahanas**

*Chief Financial Officer, Central Garden & Pet Co.*

A

Yeah. On the distribution side, the decline was really the loss of two food vendors. So that happens because in many cases they end up going direct to larger customers and that was predominately the case here. What I will tell you is, our distribution business has gone through a lot of changes as far as expanding and also a focus around profit. So, what we were really pleased with this quarter was a nice uptick in profit on that distribution business. So, we're actually quite pleased with it.

**Christina Brathwaite**

*Analyst, JPMorgan Securities LLC*

Q

Okay. So, then would you expect – [indiscernible] (00:37:50) that would be that happened during the quarter and that's going to kind of continue to pressure results the [indiscernible] (00:37:57), right, until next year?

**George C. Roeth**

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

A



No, I wouldn't say that. First of all, the Pet distribution in terms of – on profit contribution, the division is fairly small relative to sales just because the operating margins on the distribution business are significantly less than the manufactured product. And I would even reemphasize what Niko said, we've had a profit focus, not a volume focus driven on that business. We've made major operating efficiency improvements and we've taken fairly broad pricing multiple times actually across the portfolio so that significantly improved the profitability on Pet D despite the lower sales volume. So we feel good about where the quarter is at.

And I would also say the other thing I would tell you, vendors do come and go and you do get bumpy sales sometime on this business. But the impact is no near what you would think. For example, if this has happened in animal health Pro and you have very high margins and small sales differences make a big difference. Here sales differences don't make that big a difference actually in terms of the bottom line profitability.

Christina Brathwaite

*Analyst, JPMorgan Securities LLC*

Q

Okay. I guess, then the last thing I had specifically, it sounds like from earlier answers, earlier that you're expecting the animal health – the challenges in the Animal health business to get a little bit better, and I know it's only temporary, but the issues that you named like the bankruptcies, the tariffs. So it sounds like there should be a headwind going forward for at least the rest of the year. So can you just give us an idea of what makes you comfortable that things can get better in 4Q?

Nicholas Lahanas

*Chief Financial Officer, Central Garden & Pet Co.*

A

Yeah. So, we've seen our recent sales trends and the recent sales trends have improved. I wouldn't say, it's been a complete rebound. So hence, we're being cautious in our guidance going forward. I was mainly in those words talking about next year as we think about next year. I wouldn't say that we would expect the rebound to the best year we've ever seen or even average, but we would expect an improvement over such a low base this year. These are really pretty unusual circumstances, particularly the weather. I mean, I think there was a record for 125 years the highest rainfall we've seen...

[indiscernible] (00:40:05)

George C. Roeth

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

A

...and while that may not matter, in some places literally cattle were dying and wheat once again planted in the fields and it caused major havoc and I just don't see that happening again to the same degree.

Christina Brathwaite

*Analyst, JPMorgan Securities LLC*

Q

Okay. Yeah, that definitely makes sense [indiscernible] (00:40:21). And just last question from me, I wanted to take a step back on the margins. It sounds like the majority of the increase in 3Q was related to including Arden, but that should reverse in 4Q. And then, the challenges in the animal health business, which is dilutive to margins, but you've shown that again pretty healthy level of expansion in 4Q in your guidance. So what gives you the confidence that you can get there and is there any benefit that you're baking in from the acquisitions that we should be thinking about?

Nicholas Lahanas

*Chief Financial Officer, Central Garden & Pet Co.*

A

As far as margins go on the acquisition side Arden actually will weigh us down in Q4. But overall, the organic margins were up, we feel really good about that and that's really a direct result of the pricing we took earlier in the year. And really our cost savings initiatives, which is part of our continuous improvement program. So we are continuing to see margin expansion and really the mix was unfavorable and I think that's a real testament to the pricing as well as the cost savings initiatives.

Christina Brathwaite  
*Analyst, JPMorgan Securities LLC*

Q

Okay, thanks.

**Operator:** Thank you. [Operator Instructions] Our next question today is coming from Jim Chartier from Monness, Crespi & Hardt. Your line is now live.

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

Q

Hi. Thanks for taking my question.

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

A

Hi, Jim.

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

Q

Just kind of following up – hi – following up on the discussion about the impact of weather on the Pro business. Yeah, so we've heard preventive planting, number of acres for that program could be anywhere from two to three times the previous record levels, and four to six times kind of the normal levels. Does that kind of correlate with what you guys are seeing, are those crops and acres not being planted, does that correlate with the trends in your business there?

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

A

I'm not sure I completely understand the question. So, let me try and take a crack at it here. The bad weather did prevent, in some cases, the fields were planted or they were planted late, and they're planted late. Our products are used when you store the grain. So, there's less opportunity to potentially store the grain and use our product. The other phenomena that's happening, and it also happened in our livestock business, as the farmers and ranchers have come under increasing economic pressure and cash flow becomes an issue, folks take discretionary spending, say, hey, can I live without this protection product this year or yeah, to basically just skip it.

So, pretty unusual circumstances, the weather is a factor to it along with the others that we described. I wasn't sure what you meant by the two times and four times part of the question.

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

Q

So, the government programs that pay farmers not to plant crops, and my understanding is that this year you could see anywhere from 8 million to 15 million acres of crops not planted in order to receive that insurance and normal is 2 million acres and the previous record was 4 million.

George C. Roeth

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

A

I can't say that's not happening, that's not – but most of the feedback we heard from our customers and our distributors, it's mainly been around wet fields and late planting and not planting because of the conditions.

Jim A. Chartier

*Analyst, Monness, Crespi, Hardt & Co., Inc.*

Q

Okay.

Nicholas Lahanas

*Chief Financial Officer, Central Garden & Pet Co.*

A

And margins, margins being challenged at the rancher and farm level due to really the tariffs and the trade war.

Jim A. Chartier

*Analyst, Monness, Crespi, Hardt & Co., Inc.*

Q

Okay.

George C. Roeth

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

A

I'd tell you, I've learned a lot about farming and dairy in the last three years, it's interesting.

Jim A. Chartier

*Analyst, Monness, Crespi, Hardt & Co., Inc.*

Q

And so, on previous calls you had mentioned the Behavior Modification re-launch and the impact in the previous quarters as a drag. How did that re-launch go, are you seeing kind of market share recapture that you expected?

George C. Roeth

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

A

Yeah. I think we're transparent that the re-launch has gone slower than we would have liked. The product was ready and the product was shipping on time. What we've seen is we're dealing with some retail inventories of old products that we have to work our way through before we do the aggressive spending to make sure that the spending is going against driving trial on the new product.

We're seeing the light at the end of the tunnel on that. We expect in Q4 that we'll be able to flip the switch fully on on our marketing support. And I'll tell you our fiscal 2020 plans anticipate us spending quite aggressively in that area. And I think about Behavior Modification it's unfortunate that this all happened, but the good news is household penetration is well less than 1% and it's a high need category. We believe this has a long-term potential and we're committed to the category and we'll do the things we need to do to win.

Jim A. Chartier

*Analyst, Monness, Crespi, Hardt & Co., Inc.*

Q

Great. And then on the pet bedding shift, how much of an impact was that on third quarter sales?

George C. Roeth

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

A

The way I would describe it is our pet bedding business had some operational challenges as we've grown so quickly during the winter. That's kind of put a hindrance on our sales rates, particularly in this last quarter. The business is still by far and away the leader and a business we feel great about, but there was just some growth challenges I'll call them. The good news is a lot of the business is done in the fall and kind of holiday season. You get early bookings for that. We've gotten everything we expected from our key customers, and matter of fact, new business with some more profitable customers that we're quite excited about. And the good news is they booked those orders quite early. I will tell you Q4 predicts fairly robust growth in our pet bedding business. And at least a few days ago, we had two-thirds of the orders for the quarter on the books already, which we feel great about.

Jim A. Chartier

*Analyst, Monness, Crespi, Hardt & Co., Inc.*

Q

And then finally, the competitor in the Garden business mentioned July POS continued to be very strong and one of the strongest Julys [ph] I think 2018 and (00:46:18) recent years, have you guys seen a continuation of the strong POS into July?

J.D. Walker

*President-Garden Branded Business, Central Garden & Pet Co.*

A

Yes, we have, Jim. It's J.D. We've seen consumption remain strong during the month of July and sell-ins very strong as well, which you would expect with – given the gap between our consumption and sell-in numbers.

Jim A. Chartier

*Analyst, Monness, Crespi, Hardt & Co., Inc.*

Q

Thanks. Best of luck.

George C. Roeth

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

A

Thanks.

**Operator:** Thank you. We've reached the end of our question-and-answer session. I'd like to turn the floor back over to management for any further or closing comments.

George C. Roeth

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

I just want to thank everybody for attending the call today and have a great afternoon or evening.

**Operator:** Thank you. That does conclude today's teleconference. You may disconnect your line at this time, and have a wonderful day. We thank you for your participation today.

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