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Central Garden & Pet Co. (CENT)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Central Garden & Pet's Third Quarter Fiscal 2020 Financial Results Conference Call. My name is Devon and I will be your conference operator 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 is being recorded.

I would now like to turn the call over to Howard Machek. Please go ahead.

Howard Machek

Chief Accounting Officer, Central Garden & Pet Co.

Thank you. Good afternoon everyone. Thank you for joining us. With me on the call today are Tim Cofer, Central's Chief Executive Officer; Niko Lahanas, Chief Financial Officer; J.D. Walker, President, Garden Branded Business; and John Hanson, President, Pet Consumer Products. Our press release providing results for our third quarter ended June 27, 2020 is available on our website at 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 Tim, I would like to remind you that statements made during this conference call which are not historical facts including the potential impact of COVID-19 on our business, expectations for new product introductions, long-term organic growth goals, future acquisitions and future revenue, margin expansion,

cost savings and profitability are forward-looking statements subject to risks and uncertainties that could cause actual results to differ materially from those implied by forward-looking statements.

These risks and others are described in Central's Securities and Exchange Commission filings, including our Annual Report on Form 10-K filed on November 27, 2019. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events, or otherwise.

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

Timothy P. Cofer

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

Thanks, Howard. Good afternoon everyone and thank you for joining our Q3 earnings call. I hope you, your colleagues and loved ones are all safe and healthy. Thankfully, the Central team has continued to see a relatively small number of cases of COVID-19 and our facility team – and our facilities remain diligent about maintaining the highest health and safety standards. Thanks to our team's hard work, all of our manufacturing facilities and distribution centers remain open and fully operational.

I'm very proud to share that Central Garden & Pet's third quarter was the best-performing quarter in our company's history. As you saw in our press release, overall sales for the quarter increased 18% versus prior year. Our sales growth was driven by broad based organic strength of 16.5% with contributions from both segments as well as the inorganic contribution of our C&S acquisition.

As I reflect on all our company has been managing over the past few months, I attribute our strong performance to a few factors. First and most importantly, our people. I continue to be inspired by the resilience and dedication of our employees across the company as they collaborate with each other, with their communities, and with customers to ensure our business operates safely and as seamlessly as possible in these truly unprecedented times. This has required incredible commitment and coordination. In recognition of our frontline workers across manufacturing, logistics, and merchandising, I am pleased to share that we recently awarded a well-deserved special bonus to thank them for their unwavering dedication.

Second, the attractiveness and resilience of our industries. Despite the volatility and [ph] off a (00: 04:51) downward pressure seen across various industries over the last few months both the Pet and Garden industries have remained strong, proving that they can weather tough storms and maintain a resiliency in recessionary environments. Our retail partners have done a great job too, both online and offline, to ensure shoppers can satisfy their needs in our categories.

Third, strong consumer fundamentals. There is no question, we are seeing robust consumer demand. This growth goes beyond the initial COVID-19 pantry loading. Now more than ever, consumers see great value in beautifying their gardens and finding joy and comfort with their animal companions. We are seeing expanded consumption, driven by both incremental household penetration as well as higher spending from current consumers. In addition, we believe the distribution of stimulus checks drove higher consumption as consumers used a portion of discretionary dollars to engage with Pet and Garden products.

And fourth, early wins from our evolving strategy. As I've mentioned in previous earnings calls, we embarked on a comprehensive strategic review early this year and we've developed a new strategy named Vision2025. This strategic roadmap outlines areas of focus and commitment to build core capabilities in areas like e-commerce, digital marketing, innovation, and cost control.

We are seeing the early signs of the effectiveness of these efforts and our teams have done a great job responding with agility to pandemic-related shifts. Most notable is the online demand surge which we believe is a step change in consumer spending habits that will not likely reverse after the pandemic subsides. You'll hear more about our Vision2025 strategy at our Virtual Investor Day later this year.

Despite these favorable drivers, it is important to recognize that our supply chain remains stressed during these challenging times where we've seen an unprecedented rapid increase in demand and higher costs in some areas to ensure the safety of our employees. We're committed to serving the needs of our consumers and to that end, our employees are working around the clock to meet demand while at the same time, we're actively engaged in long-term capacity expansion plans.

Now, I'd like to provide some color around what we saw in the quarter including trends and implications for our business related to the pandemic. As I said earlier, we experienced strong growth in both segments with organic sales of 18% in Garden and 15% in Pet.

Let's look at the Garden segment. Gains were seen in our distribution business, controls, and fertilizers, wild bird feed, as well as a late-season strength in our grass seed business. In terms of COVID-related impacts, the Garden industry is clearly benefiting from consumers spending more time at home and turning to Garden products to beautify their lawn and gardens and make being outdoors even more enjoyable. This drove increased consumption among existing consumers and attracted new users into the category, a benefit that we believe will extend into the future. This is similar to what we've seen in prior recessionary environments where consumers find themselves spending more time at home and enjoying their lawn and gardens.

Also, as I mentioned earlier, we saw a clear shift forward in e-commerce, an area where Garden products have historically been underpenetrated. We believe this may be a lasting change to consumer buying habits, which reemphasizes the importance of our strategic focus on e-commerce and digital marketing.

Finally, while our live goods business delivered a slight decline for the quarter versus prior year, we experienced a late-season rush as retailers loosened metering stances mid-quarter. We're particularly pleased with this turnaround, given that live plants were under great pressure early in the quarter when retailer restrictions were most austere and consumer foot traffic was limited. It's also important to note that weather patterns this year have been the best we've seen in many years and nearly ideal for gardening. All said, it was a great quarter for the Garden segment.

Now, let's turn to the Pet segment. Gains were seen in consumables, distribution, animal supplies and health, and pet bedding. However, we continue to face headwind in live fish. In terms of COVID-19 related impacts, the pet industry is also experiencing benefits from consumers being at home. In addition to some continuance of the consumer stockpiling of edibles that we saw in late Q2, we are seeing record levels of pet ownership. It's estimated that pet ownership has increased 4% this year. This is a fundamental driver of the demand strength in the quarter and a likely tailwind in the coming quarters. As a result, we're seeing healthy household penetration increases across the dog, cat, small animals and reptile categories. These factors have inspired strong demand in habitats, bedding, animal supplies, and health products, as well as dog treats and other pet consumables.

Also, similar to Garden, our Pet segment saw a clear acceleration in e-commerce where pet retailers, distributors and manufacturers have been quickly pivoting to meet the dramatic increase in online demand by enhancing e-commerce capabilities, launching store and curbside pickup options, and diversifying delivery modes. Our e-commerce business now represents about 20% of total Pet consumer brand sales. That's a material increase

over last year. All indications are that this shift in consumer behavior will not likely revert back to pre-pandemic levels and we're accelerating our efforts in the strategic focus area.

Conversely, one area where we continue to experience COVID-related pressure was our live fish business. This was one of the Pet categories hardest hit by the pandemic as many retailers imposed restrictions on live animals early on. And more recently, stress has shifted to the supply chain. The good news is, we're seeing this category steadily open back up and we're in constant communication with both suppliers and customers in order to meet demand. Overall, a great quarter for the Pet segment as well.

Now, shifting back to total company results, our strong top-line performance in both segments coupled with 40 basis points of gross margin improvement and meaningful SG&A efficiencies culminated in an EPS of \$1.27 for the quarter. That's up \$0.47 compared to an EPS of \$0.80 in the third quarter of 2019. I wanted to take a moment to expand a bit on the SG&A trends as COVID-19 is having a rather pronounced impact in this area both from a year-over-year perspective as well as timing across fiscal 2020.

Since the onset of the pandemic and the rollout of shelter-in-place mandates, travel and entertainment spending has seen dramatic decreases. In addition, given sharper traffic restrictions and a focus on essential products, promotional opportunities have been limited. While travel-related spending is likely to remain depressed for the remainder of the fiscal year, we are committed to stepping up investment spend on smart and profitable opportunities. As such, I challenged our teams to lean into our strategic investments in Q4, investing behind our current momentum and laying the foundation for sustainable profitable growth in the future consistent with our Vision2025 strategy. Accordingly, we expect increased levels of investment spending in the final quarter of the year, and this will impact Q4 earnings.

As a reminder, the fourth quarter is generally a smaller earnings quarter for us. And this, coupled with the heightened investment spending lead us to anticipate a slight loss in Q4. All said, considering the progress we've made to-date and our aggressive investment plans for the future, we currently anticipate full year 2020 EPS to be at or above \$1.90, representing strong growth over our prior year EPS of \$1.61.

Shifting gears, I also want to make sure I address the important social justice movement that received worldwide attention during the quarter. At Central Garden & Pet, we stand in solidarity against racism and violence. As part of our Vision2025 strategy, we are committed to continuing to build a great place to work and a winning growth culture that embraces diversity and inclusion as a fundamental area of focus. To support our agenda, we're creating a diversity and inclusion council made up of employees from across our company to guide our efforts. We will also embed diversity and inclusion training, education, recruiting, and development as part of our new strategy. The Central leadership team and I are pursuing this work with passion and we will continue to be ambassadors and champions for open conversation. We are committed to this work.

As I previewed during the past few earnings calls, in addition to continuing to deliver on our day-to-day business priorities, we have been diligently working on building and executing against our evolving long-term strategy. We will share more details of our Vision2025 strategy at an Investor Day that will coincide with our Q4 earnings report. This virtual event will take place over a few hours, and participants can expect to learn more details of our new strategy, hear from our key leaders and participate in a live Q&A session where we will field questions about our fiscal 2020 results and our Vision2025 goals. The exact date and registration details will be communicated later.

In closing, I want to reiterate my sincere thanks to every Central employee for their role in helping the company deliver a historic quarter. I'm proud of all the hard work and efforts that went into making this quarter such a

success. I'm also proud that our company can continue to play an essential role in our consumers' lives during this unprecedented time. And I look forward to sharing more about Vision2025 and our framework to deliver sustainable profitable growth when we meet later this year.

So with that, let me turn it over to our CFO, Niko, to share more of the Q3 details of our company and across both Garden and Pet segments. Niko?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, Tim. Good afternoon everyone. Third quarter total company sales increased 18% or \$127 million to \$834 million from \$707 million in the third quarter of last year. Acquisitions contributed \$10 million of revenues in the quarter. Organic sales were up 16.5%, aided by gains in both segments, particularly in e-commerce channel as Tim described earlier. Consolidated gross profit for the quarter increased \$43 million and gross margin increased 40 basis points to 31.4%, driven by favorable mix of product sales and pricing.

SG&A expense for the quarter increased 5% or \$7 million versus a year ago. This increase was driven by a number of factors including higher variable compensation accruals and logistics costs in conjunction with strong results, inorganic spending from our C&S acquisition, as well as PPE costs. These increases were partially offset by lower travel and entertainment and promotional spending.

Our corporate expense increase was primarily due to higher variable compensation accruals and PPE costs. As a percent of sales, SG&A decreased 240 basis points to 18.9%. Central's operating income for the quarter increased to \$105 million and operating margin increased 290 basis points to 12.6% due to higher sales and gross margin as well as accretion from the C&S acquisition, partially offset by higher SG&A expenses. EBITDA for the quarter increased 44% to \$118 million.

Turning now to the Garden segment. For the quarter, Garden segment sales rose 18% or \$64 million to \$420 million. The increase in sales, which was all organic, was driven by growth in garden distribution, controls and fertilizers, wild bird feed and late-season strength in grass seed, partially offset by the decline related to our exited pottery business.

Garden segment operating income for the quarter increased by approximately \$25 million or 46% compared to prior year to a total of \$78 million. Operating margin also increased by 360 basis points to 18.5%, driven by the organic strength mentioned previously, as well as lower selling, general and administrative spending. Garden EBITDA for the quarter increased 44% to \$81 million.

Turning to Pet. Pet segment sales for the quarter rose 18% or \$63 million to \$413 million and grew 15% on an organic basis. As Tim mentioned, organic sales were aided by strength in pet consumables, distribution, animal health, and small animal supplies. These gains were partially offset by continued headwinds in live fish.

Pet segment operating income for the quarter increased by approximately \$16 million or 45% compared to the prior year to a total of \$51 million. Pet operating margin also increased by 230 basis points to 12.3%, driven by strong sales contributions as well as improved overhead leverage. Pet EBITDA for the quarter increased 37% to \$59 million.

Now getting back to our consolidated results, in the third quarter we had Other Expense of \$3.5 million, compared to Other Income of \$200,000 a year ago. This change was primarily due to the impairment of two JV investments that were impacted by the COVID-19 pandemic. Net interest expense increased \$3 million to \$11 million, due

primarily to lower interest income earned on cash balances as the softer market drove interest rate declines. Our tax rate for the quarter was 22.6% as compared to 23.5% in the quarter a year ago.

Turning to our balance sheet and cash flow statements, cash at the end of third quarter increased to \$495 million, up from \$446 million at the end of the third quarter last year. For the quarter, net cash provided by operations was \$182 million versus \$172 million in the third quarter of the year ago due to increased EBITDA, partially offset by changes in working capital largely related to strong demand, whereas you would expect receivables, payables and liabilities were all up while inventory was down.

CapEx was roughly in line with the third quarter of 2019 at \$7 million. Total debt was \$694 million, up \$1 million from the same time last year. Our gross leverage ratio at the end of the quarter decreased to 2.4 times, within our target range. At the end of the third quarter we had no borrowings under our \$400 million credit line. Depreciation and amortization for the quarter was \$13 million, in line with the prior year period. During the quarter we repurchased approximately 194,000 shares or \$5 million of our stock. There remains \$100 million under the board's previously authorized share repurchase program and an additional 600,000 shares under the board's equity dilution authorization.

And finally, turning to our fiscal 2020 outlook. Looking forward to the final quarter of the fiscal year, we anticipate a continuance of strong business momentum we saw in Q3 as well as heightened strategic investment spending to drive future profitability and growth as Tim discussed previously. This step-up in investment coupled with Q4 generally being a smaller earnings quarter for us, lead us to anticipate a slight loss in Q4 and full-year 2020 EPS of \$1.90 or higher. This represents strong growth over prior-year EPS of \$1.61.

Now, operator, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of Peter Graham with JPMorgan. Please proceed with your question.

Peter Graham Malone

Analyst, JPMorgan Asset Management (UK) Ltd.

Q

Hey, good afternoon everyone and congrats on a great quarter. Really impressive.

Timothy P. Cofer

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

A

Hey, thanks, Peter.

Peter Graham Malone

Analyst, JPMorgan Asset Management (UK) Ltd.

Q

So, I just wanted to touch on the cadence in the quarter. And to the extent you are willing to share, could you maybe speak to the trends you kind of saw in April and May, and then kind of June as restrictions were lifted? Is there anything that we need to be aware of from a sell-in versus sell-out standpoint?

And then my second question – I know Q4 isn't a huge quarter for your business, but the company is [ph] cycling through (00:25:27) kind of more one-time costs and I kind of was hoping you could help me bridge to your

guidance. You mentioned top-line momentum is expected to continue. Does that mean similar strength versus Q3 in that – any benefit from that strong growth? Will you be fully reinvested? So, just anything you're willing to share on Q4 will be great. Thanks.

Timothy P. Cofer

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

A

Sure, Peter. This is Tim. I'll give it a start and others can kick in. I think your first question, we definitely saw shifting dynamics as you went through the quarter. So, you said hey, what about April-May versus June. So, if you go back to that kind of March early days of pandemic and those first shelter-in-place orders that started taking place mid-March through really early April, that was an unfavorable period for us and we saw that particularly in the Garden side as a number of our retail partners took certain decisions to either close the open garden center or [ph] meter/limit (00:26:33) the traffic into the Garden area. And that made for a difficult and challenging start to the quarter.

On the Pet side, we saw some similar dynamics in terms of some Pet independents not opening, as well as in particular on the live animal business, really a shutdown of that entire business for a period of time through retail partners. As quickly as that developed, in the kind of mid-March to mid-April timeframe, Peter, things began to open up on the other side. And so by May and then June we saw just a completely different dynamic. We saw all of our retail partners opening up and we saw quite honestly unprecedented consumer demand in both of our categories, both Garden and in Pet. That was driven fundamentally by increases in household penetration. We have data through the end of June that reinforce that this demand was a combination of both existing category users in Garden and Pet increasing their buy rates, spending a little bit more in terms of purchase per occasion, dollar per occasion, but importantly, incremental households. And as you would know, that is one of the more challenging and one of the more positive aspects, especially in mature categories like Garden and Pet.

So we're seeing two, three points of incremental household penetration across the various categories. And as I referenced in my prepared remarks, we see that pets themselves increased by about 4% in US households through June versus prior year. So that's a little bit of the, kind of narrative on the quarter: started rough, and by the end it finished very strong. That obviously put some pressure on our supply chain to make that significant pivot. At the beginning of the quarter, we were managing some downside risks and by the end we literally are in a position now where we are rallying, working around the clock and in some cases really testing our near-term capacity limitations.

Therefore – shifting to the second part of your question – as we go into the fourth quarter, our plan here is to really capitalize on this momentum, capitalize on the net favorable status we find ourselves in, both from a category basis, as well as I will tell you, excellent execution on the part of the Central Garden and Pet teams.

And we plan to invest in the fourth quarter. We plan to invest in a number of areas that are consistent with our long-term strategy, invest more into e-commerce, invest more into brand digital marketing, into innovation, into the opportunity for expanded distribution next year, as well as into capacity expansion, because in some cases we're now at a place where we need to accelerate prior capacity expansion plans. All of that, therefore, Peter, does put some, I would say limit on earnings in the fourth quarter and that explains the guidance that both Niko and I provided.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

Peter, this is Niko. I would just add to what Tim said. Think of the investment in Q4 more or less as a timing shift. What we talked about a couple of quarters ago was our growth challenge in incremental investment that we

wanted to make. The pandemic kind of threw that on its head a little bit and we backed off in Q2 and Q3 on investment, waiting to see how it played out. We've seen our businesses perform rather well during the pandemic and we want to execute on the overall strategy and continue to invest in the business. It's just now shifted to Q4 as we move forward. So, I think that's really the right way to think about it.

Peter Graham Malone

Analyst, JPMorgan Asset Management (UK) Ltd.

Q

That's helpful. Thanks. I'll pass it on.

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

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

Hi. Good afternoon. Thanks for taking my questions and let me add my congratulations as well on a nice quarter, nice execution here.

Timothy P. Cofer

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

A

Thanks, Brad.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

Thanks, Brad.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

Sure. Sure. I want to first ask about some of the performance in the Pet category. We get a lot of questions from investors about the sustainability of some of the trends in the market and I was hoping you could share some details perhaps on trends within the type of animal what you're seeing out of dog, cat, versus other and then maybe the nature of some of the more repeatable purchases of items that you sell versus items that might be more one-time in nature and may not continue with the same strength that we saw in this quarter. Thanks.

John Hanson

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

A

Sure. This is John. Really good question. You know as Tim mentioned in the remarks, we saw increase in pet ownership of 4% in total and it was pretty much across the board, small animal, dog and cat. And with that we saw increase in household penetration of many of our categories, combined up 3%. And because of this, we saw the type of POS consumption increases across brick-and-mortar and then explosive growth in e-com.

And we look forward, we anticipate continued momentum in Pet. You know, we got this tailwind in the front half of fiscal 2021 until we lap the first wave of COVID-19, which would be late Q2 early Q3. I would say after that it will become much more difficult to predict what longer term demand might look like. But certainly with new pet ownership, it's a good indicator of sustained increase in the category consumption versus pre-COVID. Hopefully that answers your question.

Timothy P. Cofer

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

A

Brad, I would add – Brad, I would add one other thing too is, one of the more fractured parts of the Pet industry has been the live animal supply chain. And so we've seen a lot of folks that actually wanted live animals that can't get them. And so I think you're going to see probably a little bit of a reloading there, where more live animals become available. And so, we're not convinced that we're done with the cycle of the penetration rate. That could go on for a little bit longer just because that supply chain has been really, really fractured.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

That's really helpful. Thank you, guys. And if I could add a follow up just about how to think about modeling 4Q. I guess, Niko, can you give us any more quantification of the magnitude of what the investments would be that you're making in 4Q specifically, for one. For two, should we think of that as a new step-up in our run rate? I mean, are there things like [ph] advertising that will (00:33:51) continue through next year? Are they more one-time in nature? And just any more description of what exactly you'll be spending on in the quarter. Thanks.

Timothy P. Cofer

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

A

We're not going to guide on the amount of the investments. But what I would tell you is, the way to think about it is more of a run rate. We aim to invest in the business and continue to invest in the business. So it's by no means a one-shot kind of deal. So that's the way we feel. We want to look really long-term. And we have nice momentum right now to build off of. And a lot of these investments will be CapEx. And I can't think of a better way to invest in a business from a long-term perspective, and it really demonstrates conviction behind our business as we invest in CapEx and capacity. So it's going to be substantial. We're not going to guide on it. And I think, look for more investment as we go down the line.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

Understood. Well, congratulations and looking forward to even more detail when you hold your event in November.

Timothy P. Cofer

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

A

Thanks, Brad.

John Hanson

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

A

Thank you.

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

William Michael Reuter

Analyst, Bank of America

Q

Hi. Thanks for taking the questions. Given the strong results you certainly have lots of cash. I guess given the higher share price, how are you viewing allocation at this point in terms of share repurchases versus M&A. I guess how are you trying to balance those?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

Good question. We still value M&A and internal investment as a priority. As the share price dips and goes up and down, we'll be opportunistic. As you can see, the share price went up in Q3, we were less aggressive in the market around buybacks. But Tim and I view this as a huge opportunity to invest in the business. And then of course M&A being core here at Central and a huge priority for us. So, I would I would look at it in those terms.

William Michael Reuter

Analyst, Bank of America

Q

I know, historically you've been pretty disciplined, but I imagine valuations for both Pet and Garden are relatively elevated right now given the strength. Would you consider acquisitions outside of those areas if there were synergies in terms of distribution or manufacturing customers et cetera?

Timothy P. Cofer

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

A

Absolutely. We're evaluating a number of them now. And you hit the nail on the head. We look for synergies around delivering to the same customers, same channels, things of that nature. And again, we just continue to evaluate everything and anything right now.

William Michael Reuter

Analyst, Bank of America

Q

Great. Thanks for taking the questions. I'll pass to others.

Operator: Thank you. Our next question comes from the line of Bill Chappell with SunTrust Securities. Please proceed with your question.

Grant O'Brien

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Hi. This is actually Grant on for Bill. Thanks for taking the questions. Good afternoon, everyone.

Timothy P. Cofer

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

A

Hey Grant.

Grant O'Brien

Analyst, SunTrust Robinson Humphrey, Inc.

Q

I had one – afternoon. Had one to start. Just on the e-commerce growth, trying to get a sense of the margin mix implications as both Garden and Pet e-commerce seem to be growing faster than the brick-and-mortar business. I would imagine a lot of the Garden is click-and-collect, – correct me if I'm wrong – the Pet side maybe more DTC, but any margin impacts going forward as that business continues to grow?

Timothy P. Cofer

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

A

Sure. I'll start. I mean, first of all on e-commerce, there's no doubt – as I said earlier, we're seeing that dramatic increase and really that consumer shift in terms of channel choice. This last quarter I think we had maybe 10 consecutive weeks of growth kind of in that 80% to a 100% range. So, truly explosive growth on e-commerce on the Pet side, also the Garden side. Clearly, in Garden on a smaller base. The – it's a significantly underdeveloped set of categories. And so you're looking at kind of low-single-digit as a percent of total sales on the Garden side, whereas on the Pet side, as I mentioned earlier, for Pet, if you look at our Pet branded consumer business, you're looking at more like 20% of the entire business. So, to your point, it's becoming increasingly meaningful and we are investing in it accordingly.

In terms of margins, at present we've got a margin structure that is more or less parity to our brick-and-mortar and it differs by delivery mode and obviously it differs by product line. To your question, it's something we're very much paying very close attention to, because as you play this out over the next many years, we do want to be sure that that is not presenting an unnecessary headwind to our overall objective to grow margins.

Grant O'Brien

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thanks. That's helpful. And actually just one on the Garden side. The question, kind of going to the fall here with the consumer engagement or the category, would you think there would still be some strong demand for the grass seed business? I want to get your thoughts on that. And then, how our inventory levels are coming out of the main season looking to that business. Thank you.

J.D. Walker

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

A

Sure. This is J.D. Thanks for the question. I'll take that. I would say going into Q4 and into the fall season we are – we feel very optimistic. The trends that we've seen – the strong trends that we've seen in grass seed as referenced a couple of times continue to be strong going into the fall. The retailer inventory levels are at an acceptable level, they're not out of balance. And Tim's talked about new users in the category. So we feel good about that.

Our customers are bullish on the category and we are investing in demand creation for the fall. So all of those are reasons for us to feel confident and bullish on the fall season. I will say, as always, weather is a critical factor. So, non-damage during the summer will certainly lead to stronger fall demand, and if we see the excessive heat during the fall that we saw last year, that could have a dampening effect on our retail takeaway. But overall, I'd say we're cautiously optimistic as we move forward.

Grant O'Brien

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thank you. I'll pass it on.

Operator: Thank you. [Operator Instructions] The next question comes from the line of Karru Martinson with Jefferies. Please proceed with your question.

Karru Martinson

Managing Director - HY Retail, Consumer Products & Food, Jefferies

Q

Good afternoon. It's been a while since we've heard weather was very good and that was a driver of the business, I'm happy to hear that. Just when you guys talk about the supply chain being stressed, I mean are we – but inventories at retail you said are within the normal bounds. So what is the stress that's being created? Are we missing orders? Are there sales that are falling through or being delayed? What are we seeing there and what investment needs to be made to ease that stress on the supply chain?

Timothy P. Cofer

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

A

Sure. First, to your point on whether indeed weather was favorable this year – and it hasn't been for the last two years. So both in 2018 and especially 2019 it was a headwind. Sadly that's the nature of weather. It can be cyclical and unpredictable and obviously it is a corollary to the strength of the Garden season. This year, it happens to be a beneficial one.

To your question on supply chain, it is stressed. That's a word I chose carefully, and it's stressed in a number of ways. First, there are increased costs to running our supply chain and those costs are driven by the incremental safety precautions we have taken to address our number one priority, which is obviously the health and safety of our employees. So, it's increased PPE, it's increased sanitation, and that does manifest in higher costs in supply chain. Second, there are select raw material supply challenges. There are some import restrictions we work through. Obviously you're well aware of some continuing macro challenges with China. As Niko referenced earlier, particularly in live animals, there's been some supply challenge particularly I'll say in areas like fish – tropical fish especially.

There are even some product lines we make that has sources of raw materials or packaging equipment that compete with other categories that are in great demand given the current pandemic. Think spray bottles, think waste management pads et cetera vis-à-vis face masks. In select cases, I would tell you, there are some labor availability challenges and while I'm pleased to report that as of today all of our facilities, manufacturing plants and distribution centers are up and operational, throughout the last quarter, there were days where a given facility needed temporary shutdown.

And then finally it is, given the strength of the demand in both of our core categories, we are finding that that demand is occasionally outstripping our near-end capacity. And to your question, yes, that has resulted in compromised service levels on certain lines at certain times with certain customers below our ideal promise to our retail partner. So, the stress is real. I think on the positive side, despite everything I've just shared for your question, we were still able to execute very well and deliver a historic quarter.

Karru Martinson

Managing Director - HY Retail, Consumer Products & Food, Jefferies

Q

Absolutely.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

And Tim, if I could, I'd just like to add a comment too for clarification. When I talked about the retail inventories being not out of balance, I was specifically speaking to grants that are going into the fall season. Some of the other categories are much more stressed, much more challenged and there's no question we left some money on the table during the quarter.

Karru Martinson

Managing Director - HY Retail, Consumer Products & Food, Jefferies

Q

Okay. Thank you for that clarification. And just lastly, in terms of the tariff aspect, when you talked about certainly not getting some of the raw materials out of China, you know is there a tariff headwind still that we need to be factoring into our models or is that just now anniversaried as we go forward from here?

Timothy P. Cofer

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

A

I would say the tariff situation is going to continue for us, but I'll remind everyone that we really only have about 10% of our cost of goods exposure to China. And we continue to look for remedies around the tariffs and that – things like sourcing from different countries. We also work with the vendors to lower the cost. We look to insource things that were previously outsourced. And then when all else fails, we will take price where needed. So, we think it will be a continuing issue going forward, but so far we've dealt with it quite well and we expect to do the same in the future.

Karru Martinson

Managing Director - HY Retail, Consumer Products & Food, Jefferies

Q

Thank you very much guys. Appreciate it.

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

James Andrew Chartier

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

Q

[Technical Difficulty] (00:46:57) ones. First, did you guys quantify the amount of the special bonus [indiscernible] (00:47:04)...

Operator: [indiscernible] (00:47:04) back with you. I apologize for that. Give me one moment.

Timothy P. Cofer

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

A

Devon, I think we heard Jim – Jim's question of the bonus. Jim?

James Andrew Chartier

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

Q

Yes. Did you quantify the amount of the special bonus during the quarter? And then just looking at your gross margin for fourth quarter, last year it was down I think about 180 basis points. Could you just remind us what the drivers of that decline were last year and how we think about gross margin this year? Thanks.

Timothy P. Cofer

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

A

So we typically don't give margin guidance. So I'll speak more qualitatively. Last year, if you recall, we had quite a bit of bad weather and our animal health business was really affected by that. And we had some write-downs in that area in Q4. As far as the one-time bonus, we have not quantified that. And then, again, as far as the margins go into Q4 this year, we again don't guide on that. Really it comes down to mix, being such a big deal for us, and

it's very difficult for us to guide on that. And obviously the mix is really heavily dictated by weather. So, we're always very cautious around that.

James Andrew Chartier

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

Q

Great. And then just looking at the press release, I think it says that grass seed for you is down year-to-date. Can you just kind of talk about that given what seems to be a pretty strong season for the grass seed business. Thanks.

J.D. Walker

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

A

Yes. So to be clear, the grass seed business is – from a POS standpoint, from a consumption standpoint, is up versus prior year. It was late in coming though, and during the spring season we had a number of substantial promotions that we had planned on that retailers at the time of the onset of the pandemic canceled a lot of the promotional support. That impacted our business. But we've seen strength in the grass seed business over the last couple of months. And given what I said earlier, retail inventory has been in good shape, strong promotional support moving into the fall. We believe that we've worked through any inventory issues [ph] to be down (00:49:32). We believe that the future looks bright for that business.

James Andrew Chartier

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

Q

Great. Thanks and best of luck for the fourth quarter.

Timothy P. Cofer

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

A

Thank you.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

Thank you

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

Carla Casella

Analyst, JPMorgan Securities LLC

Q

I'm wondering if you could give us a little more color on the Pet segment. How much of your sales today are coming from that Specialty channel versus mass versus online only and how that's changed and how you expect it to change post-COVID-19?

John Hanson

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

A

For our organic growth, as we look at it in Q3, about two-thirds of it came from brick-and-mortar and about a third of it came from e-com. So, as we look at our brick-and-mortar business – we get Nielsen and syndicated data for top 25 customers and then we get POS for many of the others – it's really clear in brick-and-mortar that we gain share. And that's a good place to be. And then when we look at e-com, clearly with our largest customer we gain

share as well. So, we're feeling pretty good from a Pet consumer product standpoint that we gained share in the market in Q3. If you look at our Pet distribution business, we had very strong volume in that and it was really driven by service reliability versus competition. So we feel good relative to our competitors in that channel as well and believe we gained share there as well.

Carla Casella

Analyst, JPMorgan Securities LLC

Q

That's great. Thank you very much.

Howard Machek

Chief Accounting Officer, Central Garden & Pet Co.

A

With that, we have time for one more question, operator.

Operator: We actually have no further questions in the queue at this time.

Howard Machek

Chief Accounting Officer, Central Garden & Pet Co.

Perfect. I thank everyone for joining today's call and we look forward to speaking with you again for our fourth quarter earnings release as well as our first Investor Day. Have a good day.

Operator: This does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.

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