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Central Garden & Pet Co. (CENT)

Q1 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 First Quarter Fiscal 2020 Financial Results Conference Call. My name is Diego and I will be your conference operator for today. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. [Operator Instructions] As a reminder, this conference call is being recorded.

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

Howard Machek

Chief Accounting Officer, Central Garden & Pet Co.

Thank you, Diego. 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. A press release providing results for our first quarter ended December 28, 2019 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 adjusted EPS guidance for 2020, 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 new CEO, Tim Cofer. Tim?

Timothy P. Cofer

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

Thank you, Howard, and thanks to all of you on the phone for joining today. As you know, this was my first quarter here as Central's CEO. My time with colleagues, customers and consumers over the last four months has only strengthened my conviction about the value creation opportunities ahead. These include sustained and attractive organic top line growth, margin expansion and continued smart M&A activity. We have the platform, the people and the resources required to unlock our potential. And I look forward to providing as promised on the last call a more robust view when we share our strategy later this year.

As you have seen from our press release, first quarter performance was generally in line with the guidance we gave on our last earnings call. Total sales rose 4.5%, with the increase driven principally by the Arden and C&S acquisitions. Organic sales were flat. Our loss per share was \$0.08 close to our November guidance of a loss of \$0.10 to \$0.15. This compares to income of \$0.03 per share in the first quarter of 2019. You'll recall that the key factors that made for a tough comparison with last year's first quarter include, our strategic exit of the fashion-oriented pottery product line in mid-2019, a major retailer's decision in 2019 to exit the live fish business, a fire in one of our pet bedding facilities, and the inclusion of Arden in our Garden segment.

Arden typically has a loss or little to no profit in it's out of season quarters. Importantly, Q1 is typically our smallest in terms of revenues and earnings because of the seasonality of our Garden segment. Back in November, I spoke to you about my view that Central needed to invest more in growth initiatives and consumer-oriented capabilities to drive success in the years ahead. To that end, I challenged each of our businesses to identify areas where they believe significant opportunity exists to increase sales and profits if resources were made available for them to help spur growth. The response from the businesses was encouraging with numerous areas identified for smart investments. Examples include incremental marketing and promotion activities, enhanced digital and e-commerce initiatives, increased capital expenditures, and select additional personnel in targeted functions.

We plan to begin executing on these initiatives very soon with many of them being funded during 2020. The early top line benefits of these actions will likely begin to show up later this year, and we expect to see a nice overall return on these investments over the next 18 months to 36 months. So while there may be a negative income impact as we invest in the short-term, including in our second quarter, this is the right path to enable sustainable growth and strong shareholder returns in the years ahead. Importantly our planned investments are embedded in the fiscal 2020 EPS guidance we gave last quarter. We are not changing that guidance today. We continue to expect 2020 EPS to be at or modestly above fiscal 2019 EPS of \$1.61.

Last quarter I also discussed Central's efforts in the months ahead to evaluate and fortify our long-term strategy. We've kicked off these efforts to identify and prioritize the initiatives we believe will be most important in driving our success in the years ahead. Internally, we're calling it Vision 2025, and we currently have leaders across our business units and functions engaged in this important effort. We expect to share further information of this plan with investors this summer, and we'll tell you more about the specific date and format as we get closer. Finally, I want to reinforce my confidence in the long-term potential of Central Garden & Pet. We've got work to do, but I'm confident that we can deliver.

And with that let me turn it over to our CFO, Niko, to share more of the Q1 details for the company and across our Garden and Pet segments.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Thank you, Tim. Good afternoon, everyone. First quarter total company sales increased 4.5% or \$21 million to \$483 million from \$462 million in the first quarter of last year. Our recent acquisitions were the main drivers of the sales gain. Organic sales came in relatively flat, negatively impacted by the factors Tim mentioned earlier. Consolidated gross profit for the quarter increased \$1 million and our gross margin decreased 100 basis points to 27.2%, negatively impacted by an unfavorable mix of sales and the impact of the lower volumes in decor and live fish businesses.

SG&A expense for the quarter rose 8% or \$9 million versus a year ago due to the recent transaction acquisitions. Our corporate expense increased versus the first quarter of last year due primarily to higher variable compensation expense and increased third-party expenses. As a percent of sales, SG&A increased 80 basis points to 26.8%. Central operating income for the quarter decreased to \$2 million and operating margin decreased 180 basis points to 0.4%, due in part to the Arden acquisition, the lower gross margin and the higher SG&A expenses. EBITDA for the quarter decreased 33% to \$15 million.

Turning now to the Pet segment, Pet segment sales for the quarter increased 4% or \$14 million to \$354 million, and grew 1% on an organic basis, despite the live fish and pet vetting declines mentioned earlier. Most of the other pet categories had positive organic growth. Pet segment operating income for the quarter increased by approximately \$0.5 million or 2% compared to the prior year to \$30 million, aided by the C&S acquisition. Pet operating margin decreased 20 basis points and remained at 9%. Our aquatics business was the main factor in the decline as supply constraints that carried over from the prior quarter impacted the period. We would expect those challenges to now be behind us. Pet EBITDA for the quarter increased 2% to \$39 million.

Turning now to Garden. For the quarter, Garden segment sales increased 6% or \$7 million to \$129 million due to the Arden acquisition. Organic sales decreased 4% despite a 4% increase in POS for the quarter. Sales were negatively impacted by our exit from the fashion-oriented decor business. Lower grass seed and control sales due in part to timing factors and much higher than normal temperatures in the eastern third of the country in early fall were also factors in the decline. Offsetting some of the weakness was stronger sales in our Bell Nursery business, which benefited from new distribution. And just to remind you, the first quarter is typically the smallest for our Garden segment.

Garden's operating loss increased to \$8 million in the quarter compared to \$5 million in the first quarter of last year. Garden operating margin decreased 270 basis points to negative 6.5%. Almost two-thirds of the decline was due to the inclusion of Arden, which was not in last year's Garden results, and the decor category, which was impacted by lower volumes and the disposition of obsolete inventory of the exited businesses. Garden EBITDA was a loss of \$5 million versus the loss of \$2 million a year ago.

Now getting back to our consolidated results. In the first quarter, we had other income of \$300,000 compared to other expense of \$200,000 a year ago. Net interest expense increased \$0.5 million to \$8.6 million due primarily to lower interest earned on our cash balances this year versus a year ago. Our tax rate for the quarter was 27.6% as compared to 14.3% in the first quarter a year ago.

Turning to our balance sheet and cash flow statements. Cash at the end of the first quarter was \$446 million, down from \$479 million at the end of the first quarter last year. For the quarter, cash used by operations was \$18

million versus cash generated of \$7 million in the first quarter a year ago due primarily to the loss for the period and higher inventories. CapEx was \$10 million, an increase of \$2 million from \$8 million in the first quarter of 2019. Total debt was \$693 million, relatively unchanged from last year. Our gross leverage ratio at the end of the quarter decreased to 3.0 times, well within our target range. We had no borrowings under our \$400 million of credit line at the end of the quarter.

Depreciation and amortization for the quarter was \$13 million, up from \$12 million a year ago. During the quarter, we repurchased approximately 829,000 shares or \$22 million of our stock. There remains \$100 million under the board's previously authorized share repurchase program, an additional 600,000 shares under the board's equity dilution authorization. It is worth noting a substantial change to our balance sheet this quarter. We adopted the new GAAP lease accounting standard and have now added leases to our balance sheet. The effect was to gross up our balance sheet by about \$105 million. At quarter end, we had a right-of-use asset of \$105 million and a related liability of \$110 million.

As Tim mentioned earlier, we're maintaining the 2020 earnings guidance we gave last quarter at or slightly above last year's diluted EPS of \$1.61. It is still very early in the year and our first quarter is typically the smallest of the year in terms of sales and profitability. As we see how the Garden season plays out, we will be in a better position to update our guidance if needed on the next earnings call.

Now operator, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, at this time, we will conduct our question-and-answer session. [Operator Instructions] Our first question comes from Chris Carey with Bank of America. Please state your question.

Christopher M. Carey

Analyst, Bank of America Merrill Lynch

Hi. Good evening.

Q

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Hi, Chris.

A

Timothy P. Cofer

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

Hey Chris.

A

Howard Machek

Chief Accounting Officer, Central Garden & Pet Co.

Hi, Chris.

A

Christopher M. Carey

Analyst, Bank of America Merrill Lynch

Q

How are you? Hi.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

Good.

A

Christopher M. Carey

Analyst, Bank of America Merrill Lynch

Niko, just – I wanted to just ask quickly on your last comment there around you'll see how the lawn and garden season shapes up before thinking about adjusting the guidance. And I ask this in the context of clearly more of a weighted year to the next three quarters than what is typical given the Q1 earnings which you had expected. So were you referring to the fact that that weather is always a bit of a wildcard or were there other comments embedded into that view on the potential to change earnings guidance only after seeing how the lawn and garden season shaped out?

Q

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

No. As we have said, there is just that the largest part of the year still remains out in front of us. And like every year after Q1, it's really too early for us to call and it would be not wise for us to change or adjust guidance at the stage because really the season hasn't played out.

A

Christopher M. Carey

Analyst, Bank of America Merrill Lynch

Okay. That makes sense.

Q

Timothy P. Cofer

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

And Chris – Tim. And the other thing to build on what Niko said is just what you said which is the good news is the quarter result was within our expectations, I'm talking Q1. And so, so far we're on track with our plan and that puts us in a position of confirming that full year guidance.

A

Christopher M. Carey

Analyst, Bank of America Merrill Lynch

Yeah. Okay. Make sense. And then just given that the Pet segment has been one that has required a bit more attention recently, are you able to kind of frame the impact of the live fish retailer exit and the fire in the Pet betting business to get a sense of what the underlying trend of the business might be and how you might see that playing out over the remainder of the year with some of these headwinds behind you?

Q

John Hanson

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

Yeah. This is John. As we mentioned, live fish as well as the fire did have an impact on our Q1. We would say that it was less than 3% of total Pet sales combined. The fire impact is something that's fully covered by insurance. I mean there may be quarterly [ph] bids (00:17:06) and when we see the insurance payments come in, there may be some quarterly ups and downs on it, but we feel very good that it's fully cover. In addition, we are currently filling all orders, doing all customers and in a very good position going forward.

A

Christopher M. Carey

Analyst, Bank of America Merrill Lynch

Q

Okay. But it – okay. So, relatively small impact and perhaps the trend that we've seen this quarter in that business is reasonable to assume that that's indicative of the underlying trend of the business more or less?

John Hanson

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

A

Yes.

Christopher M. Carey

Analyst, Bank of America Merrill Lynch

Q

Okay. And then I suppose just last one, right, in the context of the outlook for this year and the investment spending that you're going to be putting into the business, hence the earnings outlook. And you had mentioned expecting some of these investments to come to fruition over the next 18 to 36 months and starting to feel the impact of the P&L. I wonder if you're expecting any of the investments that [ph] you're beginning (00:18:09) in this fiscal year to have any upside in the back half of the year, said another way whether you're embedding some positive impact from these investments over the course of this year in order to hit your numbers.

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

Yeah. Chris, as I said in the prepared remarks, the investment envelope broadly was part of the overall plan and, therefore, embedded in the guidance that we provided down at the EPS line. So, no new news for really favorability or unfavorability on that. I would say since we're beginning to green light those investments now, there is the opportunity to see maybe a little pickup on the organic top line if we go into the back half versus what we see here in Q1. But of course, we're in investment mode, so not so much on the bottom line. Over time, over the next couple of years, obviously, we're investing on these based on good ROI credentials and so we feel good about the ROI on it over a broader timeframe. But again I would tell you the important takeaways I'd encourage you to take is, one, that investment is built into the guidance that we've already shared and, two, we're doing the right thing for the long term of the business. I mean, I – it's been an area of focus for the last couple of years in this company, but my view is, we needed a little bit more in a few areas that I've highlighted. There are some certain brand positions where we have an opportunity to smartly step up the investment to fortify if not expand our share positions. There's some places especially in digital marketing and e-commerce where I think we're still at a point of the investment curve where there's some really nice returns to step up, and there's some few capabilities and a couple of areas that we need to build, all towards setting up this company for long-term sustainable returns.

Christopher M. Carey

Analyst, Bank of America Merrill Lynch

Q

Okay. Makes sense. Thanks very much.

Operator: Thank you. Our next question comes from Bill Chappell with SunTrust Robinson Humphrey. Please state your question.

William B. Chappell

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thanks. Good afternoon.

Timothy P. Cofer

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

Hey Bill.

A

William B. Chappell

Analyst, SunTrust Robinson Humphrey, Inc.

From the last release to this one, I guess, we've moved the financial update from the spring to the summer. And then, I think, the guidance was slightly better than last year to now slightly better inclusive of some of the changes that you're making. So can you give us, I guess, why it's been pushed out a little bit further? And then also maybe quantify if there's some difference or maybe some color there of, are you not going to spend that much this year anyway, so it's not that big of a difference, or is there a \$0.05 to \$0.10 cushion to your guidance?

Q

Timothy P. Cofer

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

Sure. I'll start. Bill, this is Tim. Look, I mean, spring and summer are adjacent seasons. So I think we're still, as I said in my comments Bill, we're looking for a date, a date that's going to work for us and where we're going to get an appropriate participation rate from folks like you. So we'll be back shortly on that. It'll be somewhere in that late spring, early summer season, and so I don't think a big change there. On your second point, Bill, no, I guess, I don't see it that way. We guided at the end of last year to be at or modestly above 2019 EPS. That included our investment plans, and we're reconfirming that today. So I don't see a change, Bill.

A

William B. Chappell

Analyst, SunTrust Robinson Humphrey, Inc.

I guess, to ask another way, is there a way to quantify what the investment changes are doing to this year's EPS?

Q

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

We don't know that yet because we have to still see how the ROI plays out on a lot of those investments. So it's a little bit hard for us to predict. And some of them obviously are going to dribble over into next year and the year after, which is why we're a little reluctant to give an exact number.

A

Timothy P. Cofer

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

Yeah. I mean, Bill, if nothing else, little bit on competitive reasons, we're not willing at this stage to share what that incremental investment number is. But I think you'll see as the quarters play out, I think, you'll see that show up in our numbers in terms of incremental commercial investment. And again, all contemplated within the guidance shared last quarter and reaffirmed this quarter.

A

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

And keep in mind too, Bill, that on the Garden side, those investments we still have to see how the weather plays out. If it's a horrific weather year, we're not going to lean into that spend incrementally. So we're going to be pretty disciplined in the approach and we still have to see how things play out.

A

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

Q

Okay. Switching gears just actually into the Garden segment, Scotts implied on their call and in their numbers that they're kind of, I guess, reaccelerating some growth at Walmart, which has been both your core customer and your core kind of place where you've gained some share over the past four years or five years. Didn't know if that impacts your outlook, if you're seeing that, how we should read that for your upcoming Garden season?

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

A

Bill, it's J.D. I'll take that question. I'd say, it's difficult to tell and we wouldn't comment on a specific retailer on the impact on a specific retailer. But as you know, their portfolio is different than ours. So it's possible they could have some gains in some categories in which we don't compete. They are big in mulch and rodenticides, and much bigger in soils, and we're bigger in things like wild bird food and we're in live goods, and we're still in pottery and the terracotta segment of pottery. But no, we don't feel – first of all, we feel like we're going to have a very bullish and optimistic on the upcoming year, we feel good about our plans at that specific retailer and others. So they may have called that out, but I don't see that deterring us from achieving our plans for the year.

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

Q

Okay. Great. Thanks so much.

Operator: Our next question comes from William Reuter with Bank of America Merrill Lynch. Please state your question.

William Michael Reuter*Analyst, Bank of America Merrill Lynch*

Q

Good afternoon. My first is a channel question in the Pet segment. I guess, if you could provide any color, and how the growth of brick-and-mortar is trending versus the growth that you're seeing in your e-commerce customers.

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

A

Yeah. This is John. First of all, we see e-com growing much faster than brick-and-mortar both in the categories in our business. We're happy with our growth, but we think we've got a long runway ahead of us. We continue to build capability and investment in that growth, both on the marketing side and the capability side. And we're very excited about the future of e-com. Relative to brick-and-mortar we continue to partner with our major customers, and we continue to make progress. We don't speak to individual customers, but we also feel very good about the relationships we have in the future there as well.

William Michael Reuter*Analyst, Bank of America Merrill Lynch*

Q

That's helpful. You continue to have a large cash balance. You did some share repurchases during the quarter. Does the pace of share repurchases in the quarter reflect maybe what we should expect going forward, or do you expect that the pipeline for M&A may pick up and that will be where you allocate more of the cash?

Timothy P. Cofer

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

A

Yeah, we look at that obviously every day, and we're going to buy back shares where it makes sense. We have different levels at which we purchase, where we think there's tremendous value. And I think, again, we play that off of what's going on in M&A. My preference right now would be to do more M&A, and then also invest in the business organically with CapEx or low cost producer type of initiatives and then have the stock repurchase program be in third place.

William Michael Reuter

Analyst, Bank of America Merrill Lynch

Q

All right. And then lastly from me, I think last call you mentioned the CapEx is going to be up this year. I don't remember hearing a number. Do you have a target now that we're one quarter in, and I guess maybe one or two of the larger increases or items contributing to the increase are this year?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

Yeah, I think we gave a range of \$40 million to \$45 million in terms of what we expect this year. Last year, some of that is carryover from last year, and if you recall last year's CapEx was little bit on the low side. So that's why you're seeing a little bit, a little higher CapEx here in 2020, and also the renewed willingness to invest in the business with Tim stepping on board. So I think that's really the way to look at it. There's really not any one or two projects that I would call out. I think there's good breadth across Pet and Garden. So we're pretty pleased with those projects. And the other part is, we evaluate them all on their merits. So we look at the ROI of each project before it gets done, and we have a whole process and the CapEx committee around that.

William Michael Reuter

Analyst, Bank of America Merrill Lynch

Q

Great. That's all from me. I'll pass it to others. Thank you.

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

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

Hi, good afternoon. Thanks for taking my questions. J.D., just wanted to follow up a little bit more about trends that you're seeing. I just want to make sure I understood if there had been any timing shift between 4Q and 1Q, and any further quantification of that. And then just thoughts on how selling had been, and how your door count and shelf space were shaping up for this year.

J.D. Walker

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

A

Sure. Thanks, Brad. First of all, with regard to timing, there were some minor timing differences between some volume that had shifted into Q4 versus Q1 that had a minor impact on Q1, I wouldn't call it significant. The two big drivers there were called out in the script. One was the addition of Arden and the other was our intentional exit of the fashion pottery business. So those were the big drivers there. In terms of timing, that would be about it. In terms of how retailers are staffing up for the year or stocking up for the year, we're seeing opening orders that are a little bit smaller than they were a year ago. And I think that's intentional on their part. Things are being a little bit

more surgical, and the way they're [ph] flooring the goods to the stores and not buy the way (00:29:57) I think that that's probably smart. We have one major retailer last year that put awful lot of inventory in the stores early on. I think they did that to prove a point, and then we're seeing their opening orders this year be a little bit smaller or it will be closer to consumption.

Having said that it will continue to build throughout Q2, and they will be ready for the season. We feel good about the engagement level of the retailers going into season, and we feel good about our listing. So I'd say, from the controllable standpoint, things like inventory levels, inventory levels at retail were in great shape coming into this year. We weren't heavy on inventory, the retailers weren't heavy on inventory. The customers are engaged, and we have the level of support we need. And in terms of our distribution for this year, if you factor out our intentional exit of some of the pottery SKUs, if you factor that out, our points of distribution are up mid single-digits year-over-year. So we feel very good about that.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

Very helpful. Thank you J.D. And Tim, I was hoping to just ask you a question about the opportunity for acquisitions and how you're thinking about if there is any brands that are maybe worth pruning. Just could you give us a sense of your state of mind on the portfolio today and your aptitude to take on maybe a medium or bigger acquisition if it presented itself?

Timothy P. Cofer

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

A

Sure. Look, I think, as you well know, I mean, M&A has been just a real critical part of the playbook of building this company at Central Garden & Pet, and it was one of the many points of attraction for me in joining this company, and I expect that to continue. So when I look at our positions across Garden & Pet, we've got a number of strong businesses, good brands in a number of niches and segments, but there's so much more to play. And there are both in terms of the categories and segments in which we compete to-date to strengthen leadership positions and fortify ourselves, and then in other places, I think there's some what I call more adjacencies that are very, very attractive. So it's fair to say that in the last number of months, there's no proof in that pudding yet. But as Niko has shared in the past, I mean, don't mistake that for lack of appetite and lack of activity. You've got to swing the bat a few times, and we are swinging the bat, but have nothing yet to report on. But I can assure you that as Niko said from a capital allocation strategy standpoint, for me it's about reinvesting in the business and smart growth opportunities. Then, it's about M&A and adding to our platform. And then if we feel it makes sense based on price, some buybacks.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Q

Very helpful, Tim. If I could squeeze one more in here for Niko perhaps on modeling for the second quarter, I don't think there's real explicit commentary on how to think about 2Q, but I think there was a reference to there being investments, it's a little bit of a headwind. It looks like maybe the Street is modeling earnings up a little bit year-over-year. Does that seem reasonable to you or are there any other considerations we should take as we think about 2Q?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

No, I think, where the Street is, is reasonable, assuming we have a relatively normal weather, it doesn't have to be a great weather quarter, but a fairly normalized one, and I think the numbers right now are fairly reasonable.

Bradley Thomas

Analyst, KeyBanc Capital Markets, Inc.

Very helpful. Thank you all so much.

Q

Timothy P. Cofer

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

Thanks, Brad.

A

Operator: Our next question comes from Hale Holden with Barclays. Please state your question.

Hale Holden

Analyst, Barclays Capital, Inc.

Hi. Good afternoon. Thanks for taking my question. I had one or two quick ones here. The increased investment that's baked into your guidance for this year, it sounded like it was more on marketing muscle and SG&A. So I was wondering, do you feel like you also have the right product set, or would there also be increased investment in product innovation for new SKUs?

Q

Timothy P. Cofer

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

Very much innovation is part of the consideration set. We do have some pretty exciting initiatives in a couple of different business units that are either hitting the shelves today or will in the balance of the year. And part of that growth investment is against supporting that innovation. I think, on top of that, in general, there's a recognition right now with me and the leadership team at Central Garden & Pet that we can still build further capability in innovation, and increase our consumer orientation to improve the success rate of our innovation. So part of the investment envelope is also building some of those capabilities, and that is including things like some – as I said earlier, some select additional personnel in key areas. But innovation, back to the core of your question, is definitely part of the [indiscernible] (00:35:45) set of investments.

A

Hale Holden

Analyst, Barclays Capital, Inc.

And then when you get this flywheel moving, do you have a sense of what the capture rate would be in terms of how much more growth versus the category you could achieve or maybe what you're currently missing out on in either one of your two core categories?

Q

Timothy P. Cofer

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

Sure. Yeah. First part of the answer is, I do expect to be able to share more later this year when we have the chance to come out and give you a perspective on our [indiscernible] (00:36:21) strategy. And I think that that will be part of what we share. But I would tell you, if you look at the organic growth of Central Garden & Pet the last couple of years, it's been more in the flat territory, and the majority of the growth has been through M&A. I think collectively we have an ambition that we could do better than that. But there's a few things we're going to need to do to assure that on a sustainable basis and make sure of course that we do it in a profitable way. So if I have to give you a little bit of a preview, I think there'll be an ambition to see that sets up. But more to come a little later.

A

Hale Holden

Analyst, Barclays Capital, Inc.

Q

Great. Thank you. And then just very quickly, do you guys have any supply issues from China related to factories that maybe on extended shutdowns because of the virus?

Timothy P. Cofer

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

A

Well, we're monitoring that situation as is everybody. And interestingly, this virus broke out right around Chinese New Year. So we typically order quite a bit in advance of Chinese New Year. So I think in the short term, we feel really good about our position from an inventory standpoint. But again, more to come. We don't really have a sense of how long this is going to go on, and so more to come. We're going to continue to monitor that. Obviously, the longer this goes on, the tougher it will get. But I think that's going to affect a lot of people, not just our company.

Hale Holden

Analyst, Barclays Capital, Inc.

Q

Right. Thank you so much.

Operator: Thank you. [Operator Instructions] Our next question comes from Jim Chartier with Monness, Crespi & Hardt. Please state your question.

James Chartier

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

Q

Hi. Thanks for taking my questions. First, I just want to clarify on the impact of the live fish and pet bedding. So excluding those two items, organic sales for Pet would be closer to 4%. Is that correct?

John Hanson

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

A

No, I think, so on the pet bedding business, as I mentioned, we did have some shortages in the quarter, and we focused very heavily on making sure that we serve us all customers. And the impact on that in the short term is less than 1% of our sales, about \$1 million in total. Live fish as we continue to lap Walmart, we're seeing a decline year-over-year, a bit of that and we'll see it through June of the year. But the majority of it will be out of our base in April-May time period. So hopefully that helps.

James Chartier

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

Q

Great. And you'd been talking last year about the animal health business was a meaningful headwind [indiscernible] (00:39:32) inventories in the channel for that business and what are your thoughts on that for the upcoming year?

Nicholas Lahanas

Chief Financial Officer, Central Garden & Pet Co.

A

Well, we feel pretty good about inventory levels. We don't think that they're crazy, but that said, we still have to see about really the health of the farmer and what their P&L looks like and are they going to lean in and spend a little extra on the products that we provide. So that remains to be seen. The weather will play a role there. What I

can tell you about this last quarter, the volume was down in animal health, but we really like the mix, and we had some nice margin expansion but again, the volumes were down. So we have to see how that really recovers over the long haul, and again, that one really mirrors Garden – really the Garden controls business because most of these products control [ph] tests (00:40:34) and so we'll know more as Q2 winds down and into Q3.

James Chartier

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

Q

Okay. And then on the pottery, decor business that you guys exited, can you give us a sense of how big that business was? And just I guess given the seasonality of the Garden business, is it fair to say the first quarter would be the most impacted from a percentage standpoint from the exit of that business?

J.D. Walker

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

A

So, Jim, it's J.D. We haven't disclosed the size of that business. Having said that, it would be fair to assume that the largest percentage would be Qs 2 and 3.

James Chartier

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

Q

Is the seasonality similar to the rest of the Garden business?

A

Yes.

J.D. Walker

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

A

It is. I'd say that's – typically for pottery, the peak would be in the month of May. So Q2 and Q3, I'd say, tracks very closely to the rest of this – to the seasonality of the rest of the business.

James Chartier

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

Q

Okay. And then, finally, in terms of the investment spending, was there any investment spending increase in the first quarter related to your plans for the year?

J.D. Walker

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

A

Yeah, I think.

Timothy P. Cofer

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

A

I think what – in the first quarter, there was limited incremental investment over prior year. Q2, you'll see it go up higher and then the material increases in the back half.

James Chartier

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

Q

Great. That's all I had. Thanks for the time.

Operator: Ladies and gentlemen, there are no further questions at this time. I'll turn it back to Tim Cofer for closing remarks. Thank you.

Timothy P. Cofer

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

Thanks everyone for joining the call today and look forward to talking to you again soon. Have a good day.

Operator: Thank you. This concludes today's call. All parties may disconnect. Have a great day.

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