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# Central Garden & Pet Co. (CENT)

Q1 2022 Earnings Call

## CORPORATE PARTICIPANTS

**Friederike Edelmann**

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

**Timothy P. Cofer**

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

**Nicholas Lahanas**

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

**J.D. Walker**

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

**John Hanson**

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

## OTHER PARTICIPANTS

**William B. Chappell**

*Analyst, Truist Securities, Inc.*

**Bradley Thomas**

*Analyst, KeyBanc Capital Markets, Inc.*

**Kojo Achiampong**

*Analyst, JPMorgan Securities LLC*

**James Andrew Chartier**

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

**William Michael Reuter**

*Analyst, BofA Securities, Inc.*

**Hale Holden**

*Analyst, Barclays Capital, Inc.*

**Karru Martinson**

*Analyst, Jefferies LLC*

## MANAGEMENT DISCUSSION SECTION

**Operator:** Ladies and gentlemen, thank you for standing by. Welcome to Central Garden & Pet's Fiscal 2022 First Quarter Earnings Call. My name is Kyle, and I will be your conference operator for today. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to turn the call over to Friederike Edelmann, Vice President-Investor Relations. Please go ahead.

**Friederike Edelmann**

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

Thank you, Kyle. Good afternoon, everyone. Thank you for joining us. With me on the call today are Tim Cofer, Chief Executive Officer; Niko Lahanas, Chief Financial Officer; J.D. Walker, President, Garden Consumer Products; and John Hanson, President, Pet Consumer Products. As usual, Tim will provide a business update, and Niko will discuss our Q1 results and our outlook in more detail. After the prepared remarks, J.D. and John will join us for the Q&A.

Our press release providing results for our first quarter ended December 25, 2021 and related materials are available at [ir.central.com](http://ir.central.com), and contains the GAAP to non-GAAP reconciliation for the non-GAAP measures discussed on this call. Lastly, unless otherwise stated, all growth comparisons made during this call are against the same period in the prior year.

Before I turn the call over to Tim, I would like to remind you that statements made during this call which are not historical facts, including the potential impact of COVID-19 on our business, earnings per share and other guidance for fiscal 2022, expectations for new capital investment, product launches, and future acquisitions are forward-looking statements subject to risk and uncertainties that could cause actual results to differ materially from those implied by forward-looking statements. These risks and others are described in Central filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K filed on November 23, 2021. Central undertakes no obligation to publicly update these forward-looking statements to reflect new information, subsequent events, or otherwise.

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

### Timothy P. Cofer

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

Thanks, Friederike, and good afternoon, everyone. Thank you for joining our Q1 earnings call. With the recent rise of the Omicron variant, we hope you and your loved ones are staying healthy and safe. Central is not immune to the developments of this pandemic, and we do our very best to keep our employees safe by maintaining strict health and safety standards. Thankfully, all of our manufacturing facilities and distribution centers remain open and operational. I cannot thank Team Central enough for their perseverance and execution in yet another challenging quarter.

As we enter the third year of the pandemic, we're pleased to report that Central has delivered another quarter of solid financial results. While this is an encouraging way to start our fiscal 2022 year, it's important to keep in mind that the first quarter is one of our smallest quarters, particularly on the Garden side, and we still have most of the year ahead of us. Net sales increased 12%, driven by recent acquisitions. In particular, our new Green Garden seed business and our Hopewell live plants business performed well above our expectations for the quarter.

In addition, we saw some pull forward in a couple of our Garden businesses. Organic sales were in line with prior year, which is notable given double-digit growth in the prior-year quarter. The rapid inflation is certainly putting cost pressures on our business, and yet I'm pleased we were able to expand gross margin, thanks principally to the improved pricing and favorable mix. Our operating income declined slightly, about 3%, versus prior year as we made purposeful investments in our business to drive long-term growth. Finally, our GAAP EPS grew \$0.06 compared to prior year.

Now, let me give you some color on our two segments, especially as it relates to our sales growth and the trends across our consumers and customers. Tailwinds such as millennial household formation, de-urbanization, remote working, as well as less frequent travel continue to have a positive impact on both the pet and the lawn and garden industries. Millennials, who are at the forefront of many important industry trends, are currently the largest home buying group in the country, and together with Gen Z they account for the majority of dog and cat owners.

Throughout the pandemic, we have seen new and existing pet owners increase their focus on the health and wellness of their furry companions, leading to a surge in a wide variety of pet health products and services. Our Pet segment enjoyed continued strong consumer demand across most categories, with contributions from animal health, dog and cat and our distribution business offsetting some softness in pet beds, small animal and aquatic supplies.

Our point of sale or POS has returned to pre-pandemic single-digit growth rates, lapping strong double-digit growth in the prior-year quarter. We gained market share in dog toys, rawhide, equine, reptile and health and

wellness. Despite the convenience that online shopping provides, consumers are eager to get back to in-person shopping. And more and more now routinely shop both in-store and digitally. Our eCommerce now represents approximately 22% of our Pet branded sales, and we continue to invest in our digital capabilities.

Turning now to our Garden segment. Even before COVID, gardening was increasing in popularity as millennials discovered the joy of gardening. They're transforming the suburbs with purpose-driven planting and gardening, and they're proud to post about their plants, lawns and gardens on social media. The surge in interest in lawn and gardening over the past 18 months has been remarkable.

Compared to 2019, household penetration increased 3 percentage points to 93%, with the largest gains in live plants and wild bird. The number of households buying more than just once is growing across the majority of our categories. And buying rates overall are at higher levels than in 2019, another indication of the stickiness of the recent rise in consumer engagement in lawn and garden activities.

As I previously mentioned, growth in the Garden segment was driven by our acquisitions. Organic sales were modestly lower than in the prior-year quarter, lapping a 34% growth rate. Organic strength in wild bird, chemicals and fertilizer, as well as live plants, was offset by softness in our distribution and grass seed businesses. Our POS grew mid-single digits, better than anticipated, on top of the strong growth rate in the prior year as consumers remain engaged in the category.

Retailers were working through a fair amount of inventory over the past couple of quarters, and we now see our inventory at healthy levels going into the critical Spring Garden season. In particular, we're pleased with our share gains in wild bird and the continued distribution share gains in live plants and packaged seeds. With consumers returning to physical stores, our Garden eCommerce grew in the single digits, comping triple-digit growth rates in the prior year.

We continue to make progress against our Central to Home strategy, and I'd like to share some noteworthy examples. First, on our cost pillar, which aims to improve our cost structure, better leverage our scale and generate fuel for growth, and the consumer pillar where we seek to build distinctive brands and drive disruptive innovation.

The strong consumer demand in both our segments continues to challenge our supply chain. For example, this quarter, certain types of packaging, as well as some raw materials, were difficult to procure. Coupled with delays in ocean freight and labor shortages in manufacturing and trucking, these factors impacted our service levels. And while we're pleased with the progress our teams have made to increase our fill rates quarter-on-quarter, we're not yet back to where we need to be.

To further bolster our capacity for long-term growth, we continue to invest in incremental manufacturing lines and automation across a wide variety of our key businesses, including dog and cat, small animal and pet bird controls, chemicals and fertilizer, live goods, grass seed, and bird feed. We expect that these investments will improve our customer fill rates, and our teams are working hard to get back to historic service levels later this year.

The COVID pandemic has also manifested in higher input costs across commodities, freight and labor. To offset these inflationary pressures, our Pet and Garden teams have partnered well with retailers to get our pricing accepted. So far, price implementation and realization are going smoothly for most of our categories and customers, and we are encouraged by the consumer resilience in the face of higher prices. Where necessary, we will seek additional pricing to address increasing inflation.

Now, let's take a look at the consumer pillar. Our organic growth agenda is one area where I have signaled increased investment and management focus. Here, we are investing in consumer insights, sharper and more distinctive brand marketing, and enhanced product innovation to attract new consumers. Let me give you three examples of recent innovation.

On the Pet side, we're expanding our Aqueon PURE water care line with Betta Beads. Betta Beads deliver a healthy environment for the fish with a decorative element for the fish owner to enjoy. The soft biodegradable balls contain beneficial bacteria that provide enzymes to help break down organic sludge for better water quality, while encouraging natural foraging behavior in the fish. Driven by Betta Beads, the Aqueon PURE line grew by more than 50% in the first quarter.

Next, applying decades of expertise, Nylabone has crafted an innovative new line of gourmet-style chew toys with a unique mouth feel for dogs. The long-lasting chews feature deeply embedded and enticing gourmet flavors, including chicken, bacon and peanut butter with flavor bits roasted throughout the product. The launch is being accompanied with extensive digital support, including e-mail, influencer and social media campaigns on Instagram and Facebook.

On the Garden side, we recently introduced Pennington Smart Patch. This innovative product is a ready-to-use combination of mulch, grass seed, and fertilizer, specifically designed for bare spot lawn repair, and provides consumers with surprisingly fast results. Using 30% less water than ordinary grass seed, it has a nice sustainability benefit, increasingly important for our millennial and Gen Z consumers. Moreover, it employs a proprietary tackifier that protects the seed and prevents it from washing away following rain. In addition to the in-store launch at our key customers, we also improved our e-commerce presence with enhanced content. And while still early, we're encouraged by the planned customer promotion and display support.

Now, before handing the call over to Niko, let me say a few words about our outlook for the remainder of the year. While we had a solid start to our fiscal 2022, it's still early. The garden season is still ahead of us and there remains a lot of variability at the macro level. We expect challenges from higher input costs across commodities, freight, and labor and a degree of uncertainty related to the consumer behavior and spending patterns given both the evolving pandemic landscape and the significant pricing agenda across much of our portfolio.

Nevertheless, our management team is clearly focused on our top priorities: first, successfully adding capacity and automation to improve our service levels; next, managing through this high inflation period with a focus on pricing actions and cost control efforts; third, making meaningful progress against our long-term strategy by investing behind our brands and driving innovation; and finally, continuing to recruit and develop the top talent in our industries. While these are certainly challenging times, I remain confident in the team's ability to navigate and deliver.

With that, let me turn it over to Niko, who will share more details of our Q1 financial results. Niko?

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## Nicholas Lahanas

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

Thank you, Tim. Good afternoon, everyone. We are once again pleased with the performance of our business, especially in light of the extraordinary results in the prior-year quarter. First quarter net sales reached \$661 million. The increase of 12% was driven by the \$70 million contribution from our four recent acquisitions. In addition, we saw some pull forward in a couple of our Garden businesses, which we expect to impact our second quarter. Organic net sales were in-line with prior year. However, looking at that growth over a two-year period, organic sales grew at an 11% CAGR in the first quarter. Consolidated gross profit increased \$33 million to \$198

million, and gross margin improved 210 basis points to 30% despite significant cost inflation in commodities such as tallow, milo, millet, and sunflower, as well as freight and labor.

SG&A expense rose 24% to \$172 million, driven by inorganic increases related to our recent acquisitions. Higher logistics costs purposefully heightened investment spending, and our capacity expansion and automation, consumer insights, brand building, innovation, and e-commerce. SG&A as a percentage of net sales increased 260 basis points to 26%.

Operating income declined \$1 million to \$26 million and operating margin decreased 60 basis points to 4% as the improvement in gross margin was more than offset by the increases in SG&A. Net interest expense was \$14 million, compared to \$21 million a year ago. The decrease was primarily driven by incremental interest expense related to recognizing the impacts of the call premium, unamortized debt issuance costs, and double interest on the debt retired during the first quarter a year ago, partially offset by higher debt outstanding. Remember, we issued \$400 million of senior notes last April.

Net income grew 61% to \$9 million from \$6 million a year ago. Diluted GAAP earnings per share was \$0.16, an increase of \$0.06 compared to the prior-year quarter, and adjusted EBITDA grew \$7 million or 16% to \$52 million. Our tax rate was 20.7% compared to 19.7% in the prior-year quarter.

Now I'll provide some insights into the segment, starting with Garden. Garden segment sales grew 45% or \$70 million to \$225 million. Excluding the contribution from acquisitions, Garden sales decreased 0.3% as growth in the wild bird, chemicals and fertilizer, as well as live plants, was more than offset by declines in our distribution business and grass seed. Keep in mind that our Garden segment is comping extraordinary growth in the prior year. And when looking at the growth over a two-year period, organic garden sales increased at a 15% CAGR in the first quarter.

Garden segment operating income was \$6 million, an increase of 30% while Garden segment operating margin decreased 30 basis points to 2.7%. The margin decline was mainly driven by inflationary headwinds and heightened investment spending that exceeded the benefits of our pricing actions and the contribution from acquisitions. Garden segment adjusted EBITDA increased \$8 million or 115% to \$16 million.

Turning now to Pet. Pet segment sales of \$436 million were in-line with prior year, a strength in animal health, dog and cat, as well as distribution, were offset by shortfall in dog beds, small animal and aquatics, largely related to capacity constraints and limited product availability.

Similar to our Garden segment, Pet is up against strong comparables from the first quarter a year ago. And when looking at the growth over a two-year period, organic pet sales increased at a 10% CAGR in the first quarter. Pet segment operating income grew by 4% to \$45 million and operating margin improved 40 basis points to 10.4%. Thanks to our pricing actions and favorable product mix despite inflationary headwinds in commodities, freight and labor, as well as investments in our growth initiatives. Pet segment adjusted EBITDA increased \$2 million or 4% to \$55 million.

Now moving to the balance sheet and cash flows. Cash and cash equivalents at the end of the first quarter were \$296 million compared to \$608 million a year ago. The decrease is mainly driven by cash payments for acquisitions as well as inventory build. Thanks to our strong cash position and the amount remaining on our credit facility, we remain on the lookout for great growth and margin accretive companies in both Pet and Garden. Net cash used by operations was \$92 million for the quarter, compared to \$36 million a year ago. The increase was

mainly driven by working capital requirements. CapEx grew 65% to \$24 million as we continue to lean on capacity expansion and automation.

As Tim mentioned during the quarter, we invested in our dog and cat, avian and small animal, as well as our animal health businesses on the Pet side and in our wild bird food, grass seed controls and fertilizer and live plant businesses on the Garden side. Total debt was \$1.2 billion, up from \$800 million at the same time last year. Our leverage ratio was 2.9 times at the end of the quarter, compared to 2.3 times a year ago, well within our target range. In December, we extended our existing \$400 million credit facility with a \$200 million accordion feature to a \$750 million credit facility with a \$400 million accordion feature. We had no borrowings under our credit facility at the end of the first quarter.

Depreciation and amortization for the quarter was \$20 million, compared to \$13 million the prior year quarter, primarily driven by amortization related to our recent acquisitions. During the quarter, we repurchased approximately 153,000 shares or \$6.7 million of our stock. There remains \$100 million under the board's previously authorized share repurchase program as well as additional shares under the board's equity dilution authorization.

And finally, turning to our 2022 outlook, while we are certainly pleased with our solid start into the third year of the pandemic and anticipate our business momentum to carry on, the first quarter is typically one of our smaller quarters with most of the year still in front of us. Moreover, we are now lapping two years of extraordinary growth. Our supply chain remains stressed with outstripped capacity. We're seeing labor shortages across many of our business units on the rise, and we expect cost for raw materials and freight to increase further.

While we have taken and plan to seek additional pricing where necessary, we do not expect to be able to offset all of this impact this fiscal year. And we're monitoring customer dynamics and consumer spending as they adapt to this inflationary environment. Despite this, we continue to execute against our long-term strategy and lean in with increased investment spending to drive profitable, sustainable growth.

Taking all of this into consideration, we are maintaining our guidance of full year 2022 GAAP EPS of \$3.10 or better. Please note that this outlook excludes any impact from potential acquisitions undertaken during the year.

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



## QUESTION AND ANSWER SECTION

**Operator:** At this time, we will be conducting a question-and-answer session. [Operator Instructions] Our first question is from Bill Chappell with Truist Securities. Please proceed with your question.

**William B. Chappell**

*Analyst, Truist Securities, Inc.*

Q

Hey, just first question on the Pet business, I mean, looking at -- I understand it's tough comps from a year ago, but up 10% on kind of a two-year basis. How much of that is the company, what you're doing, marketing, merchandising and how much of that is do you think the category post-pandemic or mid-pandemic, however you want to call it, is that much heightened with pet ownership and consumer spending more permanently on their pets?

**Timothy P. Cofer**

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

A

Hey, Bill, this is Tim. Thanks for the question. Yeah, I think it is some of both. I mean, no doubt at a category level, we continue to see favorable trends in the in the pet supplies industry and the categories in which we compete. And I think may have shared on the call, from a POS standpoint, what we saw in the first quarter was, kind of low to mid-single digit growth lapping extraordinary strong double-digit growth in the prior year on the Pet side.

So I think that's a good indication that even as we're lapping the two years of strong growth, you're seeing that, kind of mid-single-digit. Like you saw pre-pandemic, the pet supplies category grow. The further good news is we grew in-line with that category. And I think in the prepared remarks I shared with you a number of categories where we grew share, obviously we didn't grow share in every category, but there were a number of them where we grew share like rawhide, like dog toys, like equine, et cetera.

And so overall feeling good about our competitiveness, continuing to invest in capacity, which is still constrained more on the Pet side than the Garden side, should see that play through by year-end and continuing to invest in brand marketing and in innovation. So overall net category continues to hold up well, mid-singles and we're performing in line.

**William B. Chappell**

*Analyst, Truist Securities, Inc.*

Q

Okay. And then switching to Garden, just any thoughts on Scotts Miracle-Gro's commentary about the upcoming season. They seem to be a little more bullish, seem very comfortable at some aggressive pricing that they haven't taken three prices in quite some time. I know you don't compete in every category, but I guess the question we all have is how many of the consumers that came into the category over the past two years can be retained? And just any -- up to date, I understand it's still February, so it's early, but any further thoughts on that would be great?

**Timothy P. Cofer**

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

A

I'll give a few seconds and hand it over to J.D. if he wants to build. Feeling good about garden and the stickiness of it, again POS in the first quarter was in that low to mid-single digit growth, lapping extraordinary growth, as you recall in Q1 of prior year, organic sales in-line with prior year. We're seeing, and I think I said it in the earlier



remarks, we're seeing household penetration rates 300 basis points higher than pre-COVID period, and we're seeing buying rates staying elevated. So overall, feeling good, and I think feeling good about inventory levels going into the season, J.D. Any builds?

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**J.D. Walker**

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

**A**

Sure. I'll just add to that. Just building off of what Tim said, the mid-single-digit growth was on top of 30% comps the prior year. So that says a lot of the consumers are staying engaged in the categories, and we do still have some concerns about headwinds going into Q2 and beyond. We're up against tough comps for the first seven months or so of this year, so I expect that to continue through April. And we're still seeing inflation. We've taken pricing to offset some of that inflation. But we haven't decided yet if we've taken enough, if we have to take more, I'm not signaling we are, but that could be the case if it continues like it is.

Bill, there's still plenty of reasons to believe. So without getting into Scott's commentary, I'll say that we feel bullish as well. Really, there's – our inventories are back in line at the retail level, and we went into Q1 with some heavier inventories. They work through those destocked somewhat. Our service levels are in much better shape now. Fill rates and so on, much better shape than we were a year ago.

So going into season, we're sitting on a fair amount of inventory as well. So we feel like those service issues that we encountered last year, we won't have those at near the magnitude that we had a year ago. I think the only unpredictable aspect as it always is, is weather. But if we get any favorable weather whatsoever, I think we're well positioned for the year and feeling very good about it. So cautiously optimistic, I'd say.

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**William B. Chappell**

*Analyst, Truist Securities, Inc.*

**Q**

Got it. Thanks so much for the color.

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

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**Bradley Thomas**

*Analyst, KeyBanc Capital Markets, Inc.*

**Q**

Hey, good afternoon, everybody, and congratulations on a nice start to the fiscal year here. The first thing I wanted to ask about was gross margin. And when I look back at well over 10 years of data, I mean, this looks like a record first quarter here for you, for the gross margin rate. And so I was hoping maybe, Niko, you could unpack this for us a little bit and help us understand maybe how much is mix and some of the acquisitions you've made versus the pricing starting to flow through and normalize margins after some pressure you have been seeing last year, maybe, first of all. And then as a follow-up, just if you could help us think about what this maybe implies for how you're thinking about gross margin going forward here.

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**Nicholas Lahanas**

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

**A**

Sure, Brad. Yeah. As we look at gross margin, that's one of the real highlights of the quarter. We were really pleased to see it expand. As we break it down, the biggest component is the pricing piece that helped expand margin. I think second would be mix. The acquisitions have certainly helped. I think Tim and I messaged that we were really keen to go after businesses that were margin accretive. And I think you're now seeing that play out,

helping to expand the margin and then really some gross productivity in there as well. And that will probably be the smallest component to offset, obviously, these massive inflationary headwinds that we're seeing.

And then I think as we look forward, we're going to continue to do what we're doing. We want to continue to expand those margins. We want to take cost out of the business, continue to look for M&A prospects that will be margin-accretive. So we feel really good about things. And then also within the organic business, I might add, we had a favorable mix in the quarter, so some of our higher-margin businesses tended to outperform. And then that also helped expand our margin.

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**Timothy P. Cofer**

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

A

And, Brad, my build on Niko, agree obviously with everything Niko said, he nailed it. Towards the end of your question, you talked about what this means for the year. I would say and I think you heard both Niko and I say at that last quarter's call and again today. We are experiencing significant inflation, and I think in last quarter's call, I dimensionalized that of about a couple of hundred million bucks.

This quarter our pricing agenda was starting to really kick in and we have more to come on the year. I think even in Niko's remarks a few minutes ago, we don't anticipate that pricing will be able to fully offset the inflation on the year. But we're going to try to pull every lever we've got – favorable mix, pricing productivity to get real close to that significant inflation envelope. As Niko said, improve – pleased with Q1. Acquisitions favorability was a big part of it, but also the good organic work by the team.

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**Bradley Thomas**

*Analyst, KeyBanc Capital Markets, Inc.*

Q

That's really helpful, Tim. And if I could ask a follow-up to you, Tim, about acquisitions, these are kind of standard questions we ask you regularly. But for one, could you just talk about how you feel the management and the company's bandwidth is to do another acquisition now if it comes up? And then maybe for two, any color or details around what that landscape seems like and what the deal flow potential looks like for you. Thanks.

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**Timothy P. Cofer**

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

A

Yeah. We're extremely pleased with our recent acquisitions. We've done four in the last year and change and touchwood, feeling good about all four and their performance in this quarter. And you heard this from Niko and me, two of them in particular delivered above the expectations, Green Garden and Hopewell, and that was part of the strong performance in the first quarter. All four are going well. They're on or above our investment thesis a year into the burn.

The integration is going well. As you know all four on the Garden side over with J.D. and the Garden leadership team, I think that that group is doing a wonderful job of integrating those business. Importantly, having them continue to deliver on the strong results that we saw prior to acquisition and then finding smart ways to make one plus one equals three as they joined the Central family.

In terms of future acquisitions, we remain on the on the lookout. Niko, myself, our corp dev team, are continuing to be very engaged in the M&A landscape, done a nice job I think on the cash side, extending our ABL, some of the work that Niko and team did, last year in Treasury to make sure we've got the flexibility and the firepower for future acquisitions, and we continue to be active both on the Pet and the Garden side. And I think you use the

term management bandwidth, we feel good about the management bandwidth here and the ability on both the Garden and Pet side at the right price for the right asset to continue to bring in new elements to our portfolio.

**Bradley Thomas**

*Analyst, KeyBanc Capital Markets, Inc.*

Very helpful. Thanks so much, Tim.

Q

**Operator:** Our next question is from Andrea Teixeira with JPMorgan. Please proceed with your question.

**Kojo Achiampong**

*Analyst, JPMorgan Securities LLC*

Hey, good afternoon, everyone. This is actually Kojo on for Andrea.

Q

**Timothy P. Cofer**

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

Hey, Kojo.

A

**Kojo Achiampong**

*Analyst, JPMorgan Securities LLC*

Hey there. And I understand this is probably a bit hard to quantify at this point, but just any estimate or perhaps any color around how much your service levels -- they were a drag on shipments in the quarter? And then just if we could add a quick one on price elasticity, obviously, probably still a bit early given your pricing is still being implemented and you still have more to come. But just any observations around unit volume performance and any private label pickup that you've seen just from a category perspective? Thank you.

Q

**Timothy P. Cofer**

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

Sure. Yeah. Maybe three parts to your question there. Starting with service level, I'd say -- I'll start with the glass half full. The good news is we have seen improvements in service levels quarter-on-quarter. So, our Q1 was better than our Q4, and we like our trend line here. In particular on the Garden side, our service level is now in the mid-1990s, which we feel good about, that's still not at its historic level, which is in the upper 90s, but mid-1990s is a hell of a lot better than where we were this time last year. And so Garden team's done a real nice job.

A

On the Pet side, we still lag that. We're not yet at that level and plan to be later this year. That's one where demand is more outstripped our supply capacity, our available capacity. And that's where you see a significant influx of CapEx in fiscal 2021 and again in fiscal 2022. I think last year we said we spent around \$80 million and this year we guided will spend \$80 million or more, maybe a little bit more. So that's a big part of that. So service level summary is definitely seeing improvement, notably on the Garden side and getting better on the Pet side. How much do we leave on the table, low tens of millions would be a revenue estimate for you on that front.

On pricing, yeah, look, we're pricing kind of mid mid-single digits on aggregate. We're depending on the category in the customer, it may be no pricing and it may be high-double-digit pricing. So the portfolio as broad and varied as ours. Obviously, your mileage varies by product line by category, by customer. But in aggregate, you're talking mid-single-digit pricing. And so you're seeing that, if you just do the math, Kojo, overall kind of organic revenue was in-line with prior year. So with a mid-single digit pricing, you're looking at probably a mid-single-digit impact to

unit volume. And so we're seeing that elasticity begin to kick in overall. But in a way that's consistent with our expectations and consistent with the full year guidance that we gave you.

And was there a third element to your question?

A

Private label.

**Timothy P. Cofer**

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

A

Oh, yeah, private label. Yeah, I tell you, on private label, just a couple of quick comments for you. I mean, we looked at this just recently and I think as you look over the last really couple of years, we looked at 2021 and early in fiscal 2022. The good news is in our business on both Garden and Pet, we are not seeing any significant shift, or at least not yet, away from branded to private label. And in fact, within a couple of points, we're seeing actual strength in branded versus private label. I'd also remind you and others that our portfolio is actually really well-diversified.

The majority of our portfolio here at Central Garden & Pet are iconic brands like Pennington and Nylabone and Kaytee and others. But we also play in private label. And I think we've shared with the market, our private label is around 20% of the portfolio in the past. So, that's good news for us as well, 15% to 20% of the portfolio. That's good news as well because if there is any sort of shift, we also participate in that private label side with many of our customers. But overall, we continue to see good strength in our branded business.

**Kojo Achiampong**

*Analyst, JPMorgan Securities LLC*

Q

Very helpful color. Thank you so much.

**Operator:** Our next question is from Jim Chartier with Monness, Crespi & Hardt. Please proceed with your question.

**James Andrew Chartier**

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

Q

Hi. Thanks for taking my questions. Tim, you mentioned about \$200 million of cost inflation you're expecting this year. How much of that did you see in first quarter and how was that relative to your expectation?

**Timothy P. Cofer**

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

A

Sure. First of all, Jim, I would say in general versus when we met 90 days ago and guided for the year, inflation is more or less coming in as we expected both for Q1 and kind of the outlook. They're different. There are always moving components. Some things are getting more favorable, some things less favorable. When you look at the first quarter, maybe about 20% of that has hit. That's a rounded number for you already in the first quarter, which means the balance is yet to come.

The good news is when you think about pricing as the primary lever to offset that, it would kind of mirror that. So, you look at J.D.'s team and John's team, they had some pricing carryover, they had some pricing that impacted

Q1, but there was a wave of pricing that just is starting to hit at the end of our fiscal Q1 and early in our fiscal Q2. So, that's now kicking in. And obviously, we've got the next three quarters where we're going to benefit from that offset to that inflation.

**James Andrew Chartier**

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

Q

Okay. And then just in terms of the gross margin performance, I mean, should we expect similar improvement for the rest of the year or was first quarter more of an anomaly and it shouldn't be as meaningful next two quarters?

**Nicholas Lahanas**

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

A

I mean, I – it's hard to call because when you look at the margin, our product mix did play a pretty critical role. So, we did get a benefit organically from favorable mix, and then the acquisitions kicked in. So, hard to call for the entire year, so we're a little remiss to kind of guide on that. But we feel like we're in a good position with the portfolio, as well as with our pricing, to offset some of these inflationary pressures. So, we feel good about the year, but we're not in a position to really guide on margin going forward.

**James Andrew Chartier**

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

Q

Okay. And then you mentioned the pull forward of some sales in the Garden business. Can you give a sense of how much that impacted first quarter and what the impact in the second quarter is going to be?

**Nicholas Lahanas**

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

A

Well, we're not going to quantify it, but what I – what we will tell you is it's going to affect the second quarter, and we do feel like that second quarter will probably come below – come in below last year. So, we feel like that's sort of the offset there with that pull forward.

**Timothy P. Cofer**

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

A

Yeah. And Jim, agree exactly with what Niko said. I'll remind you, our second quarter last year was a monster quarter. We saw sales growth 33%. We saw operating income grow 58%. We saw EPS grow almost 70%. That was Q2 last year. So, we're lapping that quarter. And so I would agree with Niko, at this point, given the pull forward, the overall dynamics, et cetera, we'll – there's a chance where that's going to be a number below year ago, given just the strength in the prior-year quarter. Now, having said all that, you heard both Niko and I retain our full year outlook, and that that full year outlook at \$3.10 or better, on a tax adjusted basis, that's a 10% increase in EPS. So, feeling good about the year, but Q2 will be a challenge. We know that. We're in it right now.

**James Andrew Chartier**

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

Q

Great. Thank you.

**Operator:** Our next question is from William Reuter with Bank of America. Please proceed with your question.

**William Michael Reuter**

*Analyst, BofA Securities, Inc.*

Q

Hi. So, I was going to – a follow-up question on M&A. The large pet industry conference was just a couple of weeks ago, and a lot of times there's discussions that take place there. I guess, was there anything that you gleaned about where valuations are? Historically, you guys have been pretty disciplined. And I guess, whether you think those valuations are going to impede the ability to find targets in that sector this year?

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

A

I mean, not necessarily. We look at each deal based on its own merit, and look at the management team, the synergies, all the things that we can bring to the table, that that business can bring to the table, and we evaluate it on that level. The other thing to think about, too, is it also depends on the category you're in. So, we've seen a lot of supplement transactions happen recently, and those are going for really high multiples.

They have quite healthy margins and high growth rates. So, you're always going to pay extra for that. But we evaluate it on a deal-by-deal basis, so it all depends. We kind of feel that we're value buyers of growth businesses. So, we're going to be always on the lookout for that sort of value equation of that nice intersection of growth at a reasonable price. So, we're still going to look, and we continue to look and still be aggressive.

**William Michael Reuter***Analyst, BofA Securities, Inc.*

Q

Okay. And then I guess as a follow-up, do you think you could ever see pet food being a part of the portfolio? It's obviously a very different business, and a lot of the companies are relatively large and some trade at big multiples, but obviously you have strong relationships with a lot of the customers, so there would be some synergies there.

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

A

Yeah, I can comment on that. We certainly divested a pet food business. And as you mentioned, there are large players in that category with very intense capability and is highly competitive. So, we have other categories that, I'd say, are higher priority for us. We are aware of what's going on on M&A in those categories, and we'll continue to be aware of that. But we do have higher priority categories that we're looking at.

**William Michael Reuter***Analyst, BofA Securities, Inc.*

Q

Makes sense. All right. That's all for me. Thank you.

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

A

Thank you.

**Operator:** Our next question is from Hale Holden with Barclays. Please proceed with your question.

**Hale Holden***Analyst, Barclays Capital, Inc.*

Q

Thank you. I was curious on the mid-single-digit pricing which were taken across the portfolio. I heard this a little bit in your intro comments, but where do you think that elasticity point is for consumers? It sounded like a little bit



[ph] unsurely (46:01) on where consumers would push back on pricing and which categories they would push back on pricing. But from a high level, we'd just be interested in your thoughts.

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**Nicholas Lahanas**

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

**A**

Yeah. I mean, as Tim mentioned, we were mid-single digit on the pricing. I think if you look at the mix we had, which was favorable, back of the envelope tells me that actually elasticity was probably below 1, which we feel pretty good about. Going forward, because the commodities are running quite hard, we may have to take subsequent price increases. And so, kind of TBD, we have to see and evaluate how that plays out and how the consumer reacts to that.

I think, as you look at the categories, just kind of rule of thumb would be the more discretionary the category, I think probably the higher the elasticity. So, categories we're going to keep a sharp eye on would be wild bird food, we're very, very discretionary, whereas pet flea and tick maybe a little bit less so, maybe dog treats a little bit less so. And then also it depends on the price point, throw that in there as well. But that's really how we look at it, small animal bedding, small animal food. If you've got a hamster or a guinea pig, you're probably going to continue to purchase those items even as they go up a little bit. So, I think that's really how we think about it.

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**Hale Holden**

*Analyst, Barclays Capital, Inc.*

**Q**

Great. Thank you.

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**Operator:** Our next question is from Karru Martinson with Jefferies. Please proceed with your question.

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**Karru Martinson**

*Analyst, Jefferies LLC*

**Q**

Good afternoon. With 22% eCommerce sales in pets, what additionally do you need to do in terms of that investment? What capabilities are you lacking? And kind of what's the time horizon and where do you want to get that number to?

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**Timothy P. Cofer**

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

**A**

Yeah. Well, I'd start by saying feel good about our eCommerce business today. I mean, 22% of our Pet business is not a small number, but there is upside here and it's definitely an area of significant strategic focus and investment. And I'd tell you that investment is in three areas. The first is incremental capacity.

I would say our eCommerce business, even more than our brick-and-mortar business, took the brunt of our service shortfalls over the last few quarters. And obviously, that ends up hurting certainly in the near term when you think about search results and page ranks and so on. So, that's the first, and again that's well underway and feel like, by the end of 2022, we're going to be back to where we need to be.

Second area of investment, you mentioned, is really around talent and capability. This is a place where we've been very active in hiring. I can tell you, I feel great in the last 12 months. We have a new Head of Pet eCommerce that joins us from a competitive firm in the pet industry, big brand you would know. We have a new Head of Garden eCommerce. We've got new account leads on big pure play desks like Chewy and Amazon.



So, we're really staffing up in this area in terms of talent acquisition, and in terms of capability build. We've invested in some pretty powerful and bespoke training and capability build, as well as third-party partners in the area. I think we've announced publicly a couple of the partnerships that we've signed in the eCommerce space. And then the third and final is obviously investing more in the marketing support, in the content and in the brand building, in digital marketing, in support of our eCommerce business.

So, all three of those big investment envelopes are really important to eCommerce, and there's real upside here. I mean, while eCommerce in this last quarter has slowed on the Pet side, we're lapping massive growth the prior year, mid, double digits type number on the Garden side, triple digits is what we're lapping in the prior-year quarter. We're still seeing kind of a mid-single-digit growth, but there's more upside, particularly on the Pet. And that's a big part of our long-term strategic investment, as I said, in capacity, talent capability, partnership, and marketing spend.

**Karru Martinson**

*Analyst, Jefferies LLC*

Q

Okay. And then, when you guys talk to service levels now being sequentially better, but not quite where you want them to be, where are you at inventory at stores right now and where will that kind of trend over the course of the year?

**Timothy P. Cofer**

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

A

J.D. and John?

**J.D. Walker**

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

A

Sure. I'll speak to Garden. So, right now, our inventories at retail are higher than they were a year ago, but not significantly higher. We're talking low double-digit increase. And you think about that, well, that's – is that significant? A year ago, we were still shipping to largely empty shelves, a lot of holes on the shelf. So, we were – the retailers had – didn't have the inventory levels that they wanted. They were still building inventory at that point in time.

Also, we've had a few price increases over the course of the past year, so that would be factored into the inventory levels now. So, it would be pricing at a higher rate. So, I'd say that, where inventories are right now, we feel good about where they are. They're not going to be a real challenge, even though we did have pull forward in a couple of businesses. Overall, our inventory is in very good shape.

**John Hanson**

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

A

Yeah. And on the Pet side, I'd say pretty similar to J.D., inventories are higher. Our service is challenged. As Tim mentioned, we have made capacity investments in many of our categories. Much of this capacity is still coming online, and with the global supply chain challenges, especially freight and labor, service has remained challenged. It is improving in Q2, and it will continue to improve in the balance of the year.

**Karru Martinson**

*Analyst, Jefferies LLC*

Q

Thank you very much, guys. Appreciate it.

**Operator:** We have reached the end of the question-and-answer session. And I will now turn the call over to Tim Cofer for closing remarks.

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**Timothy P. Cofer**

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

Thank you, everyone, for joining our Q1 earnings call. Appreciate your interest in Central Garden & Pet, and Friederike and our IR team are here to answer any of your further questions. Have a good week.

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**Operator:** This concludes today's conference, and you may disconnect your lines at this time. Thank you for your participation.

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