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Lancaster Colony Corp. (LANC)

Q2 2020 Earnings Call

CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Jason, and I will be your conference call facilitator today. At this time, I would like to welcome everyone to the Lancaster Colony Corporation Fiscal Year 2020 Second Quarter Conference Call. Conducting today's call will be Dave Ciesinski, President and CEO; and Tom Pigott, CFO.

All lines have been placed on mute to prevent any background noise. After the speakers have completed their prepared remarks, there will be a question-and-answer period. [Operator Instructions] Thank you.

And now, to begin the conference call, here is Dale Ganobsik, Vice President of Investor Relations and Treasurer for Lancaster Colony Corporation.

Dale N. Ganobsik
Vice President-Investor Relations & Treasurer, Lancaster Colony Corp.

Thank you, Jason. Good morning, everyone and thank you for joining us today for Lancaster Colony's fiscal year 2020 second quarter conference call. Our discussion this morning may include forward-looking statements which are subject to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially, and the company undertakes no obligation to update these statements based upon subsequent events. A detailed discussion of these risks and uncertainties is contained in the company's filings with the SEC. Also note that the audio replay of this call will be archived and available at our company's website, lancastercolony.com, later this afternoon.

For today's call, Dave Ciesinski, our President and CEO will begin with an update on our strategic initiatives and highlights for the quarter. Tom Pigott, our CFO will then provide an overview of the financial results. Dave will then share some comments regarding our outlook for the remainder of our fiscal year. At the conclusion of our prepared remarks, we'll be happy to respond to any of your questions Once again, we appreciate your participation this morning.

I'll now turn the call over to Lancaster Colony's President and CEO, Dave Ciesinski. Dave?

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.

Thanks, Dale, and good morning, everyone. It's a pleasure to be here with you today as we review our second quarter results for fiscal year 2020. I'd like to start off by sharing the progress we've made against our growth plan this quarter. As you may recall, our Better Food Company growth plan consists of three simple pillars; accelerate our base business growth, simplify our supply chain to reduce our cost and grow our margins, and identify and execute complementary M&A to grow our core. During the last several years, we have focused on strengthening our team, implementing our growth plan, and harvesting the results.

During this past quarter, our consolidated net sales grew by 1.6%. Our Retail segment net sales were flat, while our Foodservice segment net sales grew 3.4%. Retail net sales benefited from favorable net price realization, increased sales of frozen garlic bread and continued gains for shelf-stable dressings and sauces sold under license agreements.

Our New York Bakery frozen bread products delivered another quarter of sales growth as we took share from other branded players. New York Bakery also benefited from the successful launch of 3-Cheese Cheese Sticks and targeted consumer support. In addition, our licensing business continues to grow nicely as our Olive Garden line increased share and remains the top selling Italian dressing in the shelf-stable dressing category.

Offsets to Retail growth in the quarter were primarily timing related. First, we saw seasonal orders of our Marzetti caramel apple dips skew more towards Q1. In produce dressing, our bottle conversion project which is providing a nice net price realization benefit resulted in a higher level of shipments in Q1 versus Q2. Overall, we are making good progress in this segment and have a strong pipeline of new products planned for launch during Q3, which I will discuss later in the call.

In our Foodservice segment, excluding sales attributed to Omni Baking, which closed on November 16, 2018, net sales increased 2%, led by higher sales of branded products sold through distributors and solid top-line growth for Bantam Bagels. The 2% increase in Foodservice net sales compares to a strong second quarter last year when the segment reported net sales growth of over 12%.

Turning our attention to product supply, we continue to make significant progress on our second pillar, simplifying our supply chain to produce cost and grow our margins. During Q2, our consolidated gross profit increased $8.5 million or 9.3% to $999.9 million. And gross margin improved 200 basis points to 28.1%. This improvement was driven by a handful of key initiatives including strategic procurement, transportation management along with some favorability and commodity costs, [ph] since these eggs (00:05:31) and soybean oil.

We also continue to invest in our supply chain to support growth and reduce cost. I'm happy to report that construction for the expansion of our Sister Schubert frozen dinner roll plant in Horse Cave, Kentucky was completed on schedule last month, and the new production line there is expected to be up and running as planned later this month. We are also in the midst of a capital project for our Bantam Bagel (sic) [Bantam Bagels] (00:05:57) business to expand production capacity and increase automation that we expect to be complete and operational early in fiscal year 2021. Overall, we were pleased with the progress made during our fiscal second quarter in growing our base business, reducing costs through supply chain initiatives and investing to support continued growth.

I'll now turn it over to Tom Pigott, our CFO for his commentary on our Q2 results.

Thomas K. Pigott

Vice President, Chief Financial Officer & Assistant Secretary, Lancaster Colony Corp.

Thanks, Dave. Overall, we are pleased with the results of the quarter. Consolidated net sales increased 1.6% to a second quarter record of $355.1 million. Excluding Omni Baking sales of $6.3 million in the current year quarter and $3.8 million in the prior year quarter, consolidated net sales increased by 90 basis points. As you'll recall, Omni Baking sales are attributed to a temporary supply agreement. These sales will decline from the current level in the coming quarters with the expectation that the supply agreement will end by December 2020. Consolidated gross profit increased $8.5 million or 9.3% to $99.9 million. This increase was driven by our cost savings programs, lower commodity costs, improved net price realization and a favorable Foodservice sales mix.

Selling, general and administrative expenses increased $5.9 million or 14.8%. The largest driver of this increase was our ERP program which accounted for $4.9 million in SG&A for the quarter. We also capitalized an additional $900,000 of ERP related expenditures for application development stage activities.

Reported consolidated operating income declined $7.1 million due in part to the ERP investment in the current year quarter and the prior years' favorable non-cash reduction to contingent consideration for Angelic Bakehouse of $9.7 million. Key drivers of the operating income growth excluding these items include the 200 basis point gross margin expansion the company achieved as well as the top line growth. Our effective tax rate decreased to 21% this quarter from 23% in the second quarter of fiscal 2019. The decrease primarily reflected a higher tax benefit on stock-based compensation activity.

Our tax rate for the remainder of the fiscal year 2020 is forecasted to be 23%. Second quarter diluted earnings per share decreased $0.15 to a $1.58. The investment in the ERP reduced earnings per share by $0.14 and the non-cash adjustment to contingent consideration increased EPS by $0.27 in the prior-year period.

With regard to capital expenditures, we continue to project our fiscal year 2020 expenditures to be in the range of $80 million to $100 million. Our year-to-date spending of $57.7 million includes investment for the capacity expansion project at our frozen dinner roll facility in Horse Cave, Kentucky that we recently completed and the purchase of the Omni Baking facility that was previously leased.

In addition to investing back into the business, we also returned funds to shareholders. Our board of directors approved a $0.05 or 8% increase to our quarterly dividend that was paid in December. Lancaster Colony is proud to be one of only 13 US companies with 57 consecutive years of regular cash dividend increase. Even with the higher level of investments and increased dividend payouts, we finished the quarter debt free with over $200 million of cash on the balance sheet.

So, to wrap up my commentary, this quarter featured strong gross profit and margin improvement, driven by cost savings programs, pricing discipline, commodity favorability and top-line growth that help fund our investments for future growth.

Now, I'll turn it back over to Dave for his closing remarks. Thank you.

David A. Ciesinski

President, Chief Executive Officer & Director, Lancaster Colony Corp.

Thanks, Tom. Looking ahead to the second half of our fiscal year, we expect consolidated top-line growth to be in the low-single digits excluding Omni Baking sales. For the Retail segment, we expect improved base business growth in the low- to mid-single digits, driven by a strong pipeline of innovation that will be hitting the store shelves starting in Q3.

In licensed products, we're excited to announce that last month, we began shipping Olive Garden Italian dressing into the retail drug channel, and we will be expanding into the dollar channel later this month. Both the drug and dollar channels are new to Lancaster Colony's distribution network and represent a significant growth opportunity for our business. We look forward to bringing additional products including some from our own family of brands to these channels in the future.

Starting later in February, we will be introducing and shipping Asian sauces under a license agreement with BIBIBOP Asian Grill. BIBIBOP is a very fast growing, on-trend, fast casual chain and this new license agreement will encompass their delicious yum-yum sauce and other great tasting flavors.

In March, we will be extending the license agreement with our Foodservice partner Buffalo Wild Wings and began selling individual bottles of their [ph] Panama (00:11:08) sauces in six different flavors; traditional buffalo, Asian zing, honey barbecue, parmesan garlic, mango habanero, and Caribbean jerk. This expanded license and single-bottle offering provides us with an opportunity to significantly increase distribution and grow the brand with retailers that we were not able to reach with our current multi-pack offering. We will continue to selectively pursue licensed product opportunities as a source of growth for our Retail segment.

Finally, I'm thrilled to announce that later this month, we will begin shipping an entirely new line of shelf-stable dressings under the Marzetti brand called [ph] Tastefully Dressed (00:11:50). These salad dressings will consist of cleaner ingredients, a package that protects them and will be offered in eight great tasting flavors, including Blackberry Poppyseed, Buttermilk, Romano Ranch and [ph] Sun Dried Tomato Italian (00:12:05). Suffice it to say our increased focus on innovation and growth for our Retail segment is translating into an expanding pipeline of new product introductions and growth opportunities. We will look forward to updating you on our progress in the months ahead.

In the Foodservice segment, excluding Omni Baking sales, we anticipate low-single-digit sales growth in the back half of our fiscal year, driven by select national chain restaurant accounts and increased sales of our branded products. Offsets to Foodservice sales growth are expected to include the impact of a second sourcing initiative by one of our national accounts and slowing traffic trends for the sector as a whole. Regarding our margin outlook for the second half, we're projecting commodity costs will turn inflationary most notably in our fiscal fourth quarter and we expect to finish the full fiscal year with commodity costs modestly inflationary compared to fiscal year 2019. Our cost savings initiatives combined with our net price realization programs will help offset the impact of commodity cost increases.

Before I wrap up my comments, I would like to update you on two very important initiatives that are tied to our long-term growth. First, I'd like to provide you with an update on our ERP initiative, Project Ascent. As you may recall, Project Ascent will enable us to replace our current 20-year-old ERP system. The new ERP system will provide us with a long-term scalable system infrastructure well into the future to facilitate organic growth and scale acquisitions, all the while also helping us to drive cost savings. We're making good progress with the design phase of the project and deployment remains on schedule for the first half of fiscal year 2021.

We will continue to disclose ERP project cost separately in our quarterly earnings releases and SEC filings to provide the investment community and all of our stakeholders with a clear understanding of the cost associated with this important project. We expect to have an estimate of the total ERP project cost to share with you in future earnings calls.

Finally in January, our board of directors approved the capital expenditure for a major capacity expansion at one of our dressings facilities. This project is slated to cost roughly $95 million and will significantly increase the production capacity of our dressing and sauce business. We anticipate it will take roughly 18 months to complete. And importantly, it will enable us to keep up with the long-term growth requirements of our strategic Foodservice partners and our own Retail business. We expect roughly $10 million of this project cost to hit fiscal year 2020, and this number is included in the $80 million to $100 million CapEx forecast that Tom mentioned earlier in the call.

This concludes our prepared remarks for today. And we'd be happy to answer any questions that you may have. Jason?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Brian Holland from D.A. Davidson. Your line is open.

Q

This is [ph] James Michael (00:15:25) on for Brian Holland. Good morning, everyone.

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.

A

Good morning, James.

Thomas K. Pigott
Vice President, Chief Financial Officer & Assistant Secretary, Lancaster Colony Corp.

A

Good morning.

Q

Thanks. Just a few questions for me. In the context of those upcoming Retail license products, and then looking historically, your Buffalo Wild Wings and Olive Garden lines, can you speak at a high level on how single item SKUs could maybe be a key unlock for enabling broader distribution?

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.

A

Yeah. Absolutely. It's a great question. As you're aware, up until recently, we were limited to a multi-pack offering that was principally in Costco, Sam's and then in Walmart. We've been able to work out an expanded license agreement with Buffalo Wild Wings, which gives us the ability to move into all of Retail. The way I would probably think about this is that the total addressable opportunity is well in excess of a $1 billion dollars. If you include barbecue sauces, wings sauces, marinades and the other space where this line can play, there is a lot of room for the brand to run. Up until just recently, we were limited though to principally just the club channel and Walmart where they could handle a three pack. So, we think this will provide a major unlock and it'll give us the potential to create something that may be able to approach what we've been able to do with Olive Garden.

Q

Yeah. That's very helpful. And then, changing subjects, you've talked in the past few quarters about how your Foodservice customers have nicely outperformed broader Foodservice. As we're seeing some sequential deceleration in your growth, any change in that dynamic? It looks like Foodservice restaurant traffic was slowing and pick back up in November, December, have you seen a trend in the past few months? And then, can you comment on any wider QSR trends that may be having an impact on your business?

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.

A

Yeah. Another great question. Historically, we've said that our business probably performs 150 basis points to 200 basis points above the sector average and what we're seeing here that caused us to sort of guide down marginally are a couple of drivers. One is, one of our strategic customers, as I mentioned earlier in my transcript, is implementing the second sourcing initiative. So, we've absorbed one quarter of that. We expect to have three more quarters of that to take on. So, we obviously didn't lose the customer, but just I think to create supply chain redundancy like many of them do, they've decided to add a second supplier.

The other thing that we are seeing though is we continue to see general softness. What we're seeing is that traffic generally is trending down. It's been marginally offset by increased ring, but generally as we go deeper into the data and we go account by account, we're seeing things that are leading us to believe that we're going to see a – not a pullback, but a slight slowdown.

Q

Understood. Thank you for your time, everyone.

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.

A

Thank you.

Thomas K. Pigott
Vice President, Chief Financial Officer & Assistant Secretary, Lancaster Colony Corp.

A

[ph] Thank you, James (00:18:18).

Operator: Your next question comes from the line of Todd Brooks from C.L. King. Your line is open.

Todd M. Brooks
Analyst, C.L. King & Associates, Inc.

Q

Hey. Good morning, everybody. Congratulations on the quarter.

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.

A

Good morning, Todd. Thank you.

Thomas K. Pigott
Vice President, Chief Financial Officer & Assistant Secretary, Lancaster Colony Corp.

A

Thank you, Todd. Good morning.

Todd M. Brooks
Analyst, C.L. King & Associates, Inc.

Q

If we could maybe parse the gross margin improvement to 200 basis points that we saw in fiscal Q2, can we talk about maybe what's attributable to the process improvements both supply chain and transportation management. And then, I think in Q1, you did quantify what the benefit from better commodities was and then the net price realization as well. If we could just get some color within the 200 basis points.

Thomas K. Pigott
Vice President, Chief Financial Officer & Assistant Secretary, Lancaster Colony Corp.

A

Sure. So, this is Tom. So, the cost savings program was the largest contributor of the margin growth. There, we were tracking to about $20 million annually. So, we're approximately in the $5 million range. Commodities contributed another $2 million of costs of favorability of savings, and as Dave mentioned, we do expect that to turn inflationary going forward. We also got the favorability from the price realization and the higher volumes in the Foodservice segment. So, those were some of the key drivers of the margin accretion that we achieved in the quarter.

Todd M. Brooks
Analyst, C.L. King & Associates, Inc.

Q

And the back half commodity outlook, has it changed? I know you've talked about things getting inflationary on the Q1 call. As you're looking out, are you expecting as much inflation, more inflation, what's inflecting within the individual line items?

Thomas K. Pigott
Vice President, Chief Financial Officer & Assistant Secretary, Lancaster Colony Corp.

A

Yeah. So it turns from being favorable in this quarter to neutral and then more unfavorable in the fourth quarter based on our current projections.

Todd M. Brooks
Analyst, C.L. King & Associates, Inc.

Q

Okay.

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.

A

The commodities that are driving that for us, if you just want a little bit more texture, our eggs where we've seen a pretty significant pullback over the last three quarters on eggs, that's driven some of the deflation in our portfolio overall. So, we're going to see begin to reverse itself. And the other is soybeans. I think as everybody who sort of watch the sector knows, due to the trade disputes, soybeans and soybean oil both pulled back. And we're starting to see the outlook on soybeans tighten up marginally as well.

Todd M. Brooks
Analyst, C.L. King & Associates, Inc.
Q

Okay. Great. And then, my second question is, if we look at not the license partner products at Retail, but as you look at new product development in the pipeline whether it's the cheese sticks or maybe the sweet rolls, can you talk about expected new product performance from a revenue standpoint or what you task the new product development side of the house with from a revenue creation standpoint?

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.
A

Well. It's a great question, Todd. Historically, we haven't broken out those numbers. I can tell you anecdotally some of the things that we have going on. In the last quarter, we talked about 3-Cheese Cheese Sticks which continued to do well. We talked about the sweet items, the Pumpkin Spice rolls continues to perform well. And there's some other items in Sister Schubert's that I didn't get into in this call, because we didn't want it to turn into a laundry list. But there's a lot of activity that's going on there on our own brand, the [ph] Tastefully Dressed (00:21:43) product is one that we're very, very excited about. It gives us a chance to – and besides our license with Garden, which has become a real leader for us to use our own brand as a means by which to reach more broadly outside of Italian in that that categories in excess of about $1.8 billion in shelf-stable salad dressing.

So, I don't really want to go into a number, but if you were to ask the team here internally, it usually sounds something like this; a lot more and a lot faster and we're not satisfied until we start to get towards that. So, you're going to see just us maintain focus on continuing to – make sure that our existing brands like Sister Schubert and New York and others in our portfolio are healthy and we're renovating those and that we're pushing innovation to bring new and exciting and relevant items there.

Todd M. Brooks
Analyst, C.L. King & Associates, Inc.
Q

Okay, great. And then, just a final one on the Horse Cave facility being completed at the end of January. What does that unlock for you guys going forward? Is it capacity to fulfill demand? Is it new product capabilities? Or is it more on the product cost side of production?

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.
A

Great question. And really what it did and this is the Sister Schubert Horse Cave project. They're sort of addressing that same need. If you look at over the recent past, our business has continued to grow and we are running out of roll capacity. So, first and foremost, what it enabled us to do both in Retail and Foodservice to keep up with our growing Sister Schubert business. When we built that facility though, we also built it with the optionality where we could look at potentially simplifying our overall network structure. As you know by going through our material, we have 16 factories many of which are subscale and one of the things that we're looking at long-term is how do we continue to find ways that are prudent to simplify and streamline our overall supply chain structure.

As you sort of pivot now, and we talk about the dressing expansion that we talked about, I'll give you a case in point on this one. About four years ago, five years ago or so, we were doing about 200 million pounds a year through our Horse Cave facility down there. That facility now, believe it or not, it's up to almost 300 million pounds. Just to give you the idea of the sort of dressing that we're running through the pipes, so to speak, and we've done that all the while without increasing capacity. We've done a lot of kaizen events and we've leveraged Six Sigma as a means by which to wring more capacity out of the existing facility. We've increased things like kettle sizes and stuff like that, but we've hit a point where given the growth of both our Foodservice customers and our own Retail business, we don't have room to expand without expanding the size of the box and that was a big part of the driver for this one. It's the first new box that we've built or an extension on a box rather and our dressing business and probably about 12 years, maybe a little bit more than that.

Todd M. Brooks
Analyst, C.L. King & Associates, Inc.
Q

Okay. Great. Thank you.

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.
A

You're welcome.

Operator: If there are no further questions, we will now turn the call back to Mr. Ciesinski for his concluding comments.

David A. Ciesinski
President, Chief Executive Officer & Director, Lancaster Colony Corp.

Jason, thank you. And thank you, everyone, for participating this morning. We look forward to sharing our third quarter results with you in early May. Good morning.

Operator: That concludes today's conference call. You may now disconnect.