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Lancaster Colony Corp. (LANC)

Q2 2022 Earnings Call

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Todd M. Brooks

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Analyst, Consumer Edge Research LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Carmen 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 2022 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 Corporate Finance and Investor Relations for Lancaster Colony Corporation.

Dale N. Ganobsik

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

Thank you. Good morning, everyone, and thank you for joining us today for Lancaster Colony's fiscal year 2022 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 the business update 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 current strategy and outlook. At the conclusion of our prepared remarks, we'll be happy to respond to any questions you may have.

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 and 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 2022. In our fiscal second quarter, which ended December 31, consolidated net sales grew 14.2% to a record \$428 million, with Retail net sales up 10.1% and Foodservice net sales up 20.3%.

Retail net sales growth of 10% was driven by pricing across the portfolio and volume, led by the expansion of our licensing program and strong performance on Sister Schubert's frozen dinner rolls. This compares to very strong retail sales growth of 19.5% during the same period last year. Retail sales volumes measured in pounds advanced 4% on top of the 12% volume growth last year.

Notably, our licensing program continued to perform well in the period, led by distribution gains for Buffalo Wild Wings sauces and increased household penetration and strong repeat rates for Chick-fil-A sauces. In the aggregate, these two licensed sauces combined for over 10% of our net sales growth in the quarter.

For the quarter versus prior year, IRI data showed strong share gains for our frozen breads with Sister Schubert (sic) [Schubert's] dinner rolls, up 150 basis points to 54.1%, and New York Bakery garlic bread up 230 basis points to 42.5%. With sales of \$61.6 million, Q2 was Sister Schubert's strongest holiday performance ever, thanks to great retail execution in a difficult environment.

On a two-year stack basis for the quarter, IRI retail scanner data shows strong sales growth and share gains for several of our branded products, including Marzetti produce dressings, Sister Schubert (sic) [Schubert's] frozen dinner rolls, New York Bakery garlic bread, and Reames frozen noodles. Of particular note, during the same two-year stack period, our licensed sauce platform has grown from \$22 million in sales to \$78 million in sales, an increase of 250%.

Based on the aforementioned growth, I'm pleased to share that in January, IRI named Lancaster Colony Marzetti one of a handful of CPG growth leaders for calendar year 2021, credit to our retail and R&D teams for all their efforts in this achievement. In summary, our retail top line performance in the quarter was driven by pass-through pricing and volume growth driven by consumer-relevant brands and great store level execution.

In our Foodservice segment, net sales growth of 20% was driven by inflationary pricing, volume growth with our quick service restaurant or QSR customers and a rebound in demand for our branded products. Foodservice volumes measured in pounds advanced 7%. Per NPD CREST, our sales to the QSR channel continued to pace well ahead of the industry, driven by our strong relationships with national account customers and our outstanding culinary team.

Turning to our margin performance, our gross margin decline in the second quarter reflects unprecedented inflation, cost incurred to support the shifting and growing demands of our business, and a wide array of supply chain disruptions. During the period, we made significant investments in labor and warehousing to improve customer service levels. And while pricing actions serve to offset significant commodity cost inflation and higher freight rates, we were not able to fully recover the other industry-wide cost pressures such as elevated wage rates in the period.

Finally, our margins were also adversely impacted by our decision to significantly increase our utilization of co-manufacturers in the period to help satisfy the growing demand of our bottled sauces business. While costly in the short-term, the decision to outsource production has not only enabled the strong retail growth we delivered, but also eliminated the immediate need for us to look at acquiring a dressing and sauce manufacturer to support this rapid growth.

In response to these operating and cost pressures, we're implementing discrete actions that should help us improve our margin profile: first, leveraging our recently completed sauce capacity expansion project at one of our Columbus-based facilities to better optimize throughput and reduce cost; second, adding a new Columbus-based warehouse location and pursuing other initiatives to reduce material handling costs, decrease transportation costs, minimize third-party warehouse needs and improve inventory management throughout our distribution network; third, leveraging productivity improvements to enable us to increase the utilization of our own facilities while moderating our reliance on co-manufacturing; and finally, implementing the next phase of our revenue growth management strategy to recover increased labor cost.

I'll now turn the call over to Tom Pigott, our CFO, for his commentary on our second quarter financial results.

Thomas K. Pigott

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

Thanks, Dave. Overall, the results for the quarter reflected strong top line performance, offset by higher costs resulting from significant inflationary impacts, several supply chain challenges and investments made to facilitate growth. Second quarter consolidated net sales increased by 14.2% to \$428.4 million. This growth was driven by consolidated volume growth of approximately 6% and pricing actions taken in both segments. Consolidated gross profit decreased by \$10.2 million to \$96.6 million. Gross margins declined by 600 basis points. The key drivers of the gross profit decline were the high commodity inflation and increased supply chain costs.

Inflation for commodities and packaging materials was approximately 23%, consistent with our expectations. The majority of the commodities we utilized were priced at or near 10-year highs. Our significant exposure to soybean oil, which was up notably, drove our inflationary impact higher than many of our peers.

The increase in supply chain cost resulted from a number of factors. First, we experienced a high level of inflation on our factory labor and other manufacturing costs. The labor inflation was driven by our decision to raise wages to ensure we had adequate staffing to serve our customers in this tight labor market. Other indirect input costs on things like pallets and supplies were also highly inflationary. Second, our manufacturing costs were also up due to operational challenges in this environment, including supply disruptions at our facilities, lower overhead absorption at some facilities, additional personnel and other costs we incurred to support growth. Third, we had higher freight and warehousing costs due to wage and fuel inflation and higher levels of inventory we built to improve service. Last, our co-manufacturing costs were up as we outsource production to meet our growing demand. As Dave highlighted, we are taking several actions to address these increases and improve our operations.

As a result to pricing, we continue to execute against our revenue growth management program. We benefited from a second round of pricing in our Foodservice segment that was effective at the beginning of the quarter and our first Retail pricing action that was effective at the end of the first quarter. Those actions to serve – to offset the vast majority of the commodity inflate – cost inflation we experienced during the quarter on a dollar basis.

Additional actions are planned or have been implemented in an effort to recover the remainder of the commodity and freight cost increases, as well as the higher labor inflation. We also benefited from strong volume growth in

both segments, with retail shipments growing 4% and food service growing 7% behind the programs Dave discussed.

Selling, general and administrative expenses increased 6.8% or \$3.3 million. This increase was driven by a higher level of investments to support the continued growth of our business. These investments included a supply chain optimization study, higher brokerage costs attributed to the increased sales, a modest resumption of consumer spending and IT infrastructure improvements. Expenditures for Project Ascent, our European initiative, totaled \$8.6 million in the current year quarter versus \$8.5 million in the prior year quarter.

The company recorded two special items this quarter related to the Bantam Bagels business. First, we revalued the contingent consideration liability to the sellers using fair value accounting. Based on that analysis, we reduced the current value of the projected payout by \$2.2 million, creating the income you see on the contingent consideration line of the P&L. We recorded \$1.3 million of this adjustment in our Foodservice segment and \$0.9 million of this adjustment in our Retail segment. Second, we revalued the intangible assets on the balance sheet for this business, which resulted in an impairment charge of \$0.9 million. This item was recorded in our Retail segment.

In addition, the company announced its plans to close our frozen garlic bread facility in Baldwin Park, California. Production at the facility ceased in January of 2022, and the Mamma Bella brand frozen garlic bread product line was discontinued based on its small size and low profitability. We recorded restructuring and impairment charges of \$1 million related to this closure. This adjustment was not allocated to the two reportable segments.

Consolidated operating income declined \$13.3 million or 22.7% versus the prior year to \$45.3 million. Operating income declined primarily due to inflationary impacts and supply chain challenges I described. These items were partially offset by the pricing actions taken and the volume growth the company achieved.

Our effective tax rate was 24.3% this quarter versus the tax rate of 23.8% in the second quarter of fiscal 2021. We estimate that the tax rate for fiscal 2022 will be 24%. Second quarter diluted earnings per share decreased \$0.37 to \$1.25. The decrease was primarily driven by the operating income decline. The EPS benefit for the change in contingent consideration of \$0.06 per share was nearly offset by the restructuring and impairment charge of \$0.05 per share. Costs related to Project Ascent reduced EPS by \$0.24 per share this quarter and \$0.23 in the prior year quarter.

With regard to capital expenditures, second quarter payments for property additions totaled \$36.5 million. For our fiscal year 2022, we are forecasting total capital expenditures between \$170 million and \$190 million. This forecasting includes approximately \$105 million for the Horse Cave expansion project that will help meet the growing – increasing demand for our dressing and sauce products.

In addition to investing in our business, we also returned funds to shareholders. Our quarterly cash dividend of \$0.80 per share paid on December 31 represented a 7% increase from the prior year amount. Our enduring streak of annual dividend increases currently stands at 59 years. Our financial position remains very strong as we finished the quarter debt free with \$114 million of cash on the balance sheet.

So to wrap up my commentary, this quarter featured strong top line growth, as well as the unfavorable impacts from significant inflation, supply chain challenges and investments. We are addressing the inflationary cost increases with our revenue growth management program. And as Dave has shared, we have other discrete action plans in place to address the supply chain issues. In addition, we're continuing to invest in the long-term potential of the business.

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

David A. Ciesinski

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

Thanks, Tom. As we look ahead, Lancaster Colony will continue to leverage the combined strength of our team, our operating strategy and our balance sheet in support of the three simple pillars of our growth plan to, number one, accelerate our core business growth; to, number two, simplify our supply chain to reduce our cost and grow our margins; and number three, to expand the core of focused M&A and strategic licensing.

Looking ahead to our fiscal third quarter, sales volume drivers are expected to remain our licensing program in Retail and our QSR customers and branded products in Foodservice. Pricing actions will continue to add to total net sales in the face of commodity and packaging cost inflation and higher freight cost. We also expect cost pressures attributed to higher warehousing costs, supply chain disruptions, increased labor costs, and higher manufacturing costs to remain a headwind to our fiscal third quarter results.

As a reminder, our future financial results and expectations remain subject to the impacts of COVID-19, including shifts in consumer demand between Retail and Foodservice, ongoing supply chain challenges and disruptions, and increased costs to produce our products and service our customers. Beyond the discrete actions I shared with you earlier that are underway to improve operations, we also made the decision to engage an outside consultant to assist us with planning for our supply chain network. While it's too early to share any of the preliminary findings of this study, we are very encouraged about the potential opportunities that have been identified. These opportunities are fully aligned with the first and second pillars of our growth plan.

I'd also like to update you on two important initiatives currently in progress. First, our significant investment in production capacity at our dressing and sauce facility in Horse Cave is going well, with the target completion timeframe in the first half of fiscal 2023. Second, the implementation phase of our ERP initiative, Project Ascent, remains on track to begin in the first quarter of fiscal year 2023.

Turning to growth, I'm excited to announce that we will be adding barbecue sauce to the exciting and consumer-relevant Chick-fil-A platform. As with other Chick-fil-A sauces, we will plan by executing a small regional pilot in the March and April timeframe that will inform our broader rollout plans.

Taking a step back, while our second quarter financial performance fell short of our expectations, actions are underway to help us overcome the many challenges of the current supply chain environment. Longer term, I'm confident that our business remains very well-positioned for the future with category leading retail brands, a rapidly growing and consumer-centric retail licensing program, and a foodservice business that supplies many of the leading and fastest growing national chain restaurants across the country. When combined with the investments in capacity and infrastructure, we have a strong and unique platform to deliver profitable growth for years to come.

In closing, I'd like to express my sincere thanks for the ongoing efforts of the entire Lancaster Colony team as we've navigated through unprecedented cost inflation, demand fluctuations, and supply disruptions. Our focus remains on the health, safety and welfare of our employees, continuing to play our role in the country's vital food supply chain and preparing our business for the future.

This concludes our prepared remarks for today, and we'd be happy to answer any of your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question is from Tom (sic) [Todd] Brooks with The Benchmark Company. Your line is open.

Todd M. Brooks

Analyst, The Benchmark Co. LLC

Q

Hey. Good morning, gentlemen. How are you doing?

David A. Ciesinski

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

A

Good morning, Todd.

Thomas K. Pigott

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

A

Good morning, Todd.

Todd M. Brooks

Analyst, The Benchmark Co. LLC

Q

Few questions, if I may. Leading off, just with the top line strength that we saw in the quarter, can we talk through where the strength was in Foodservice to see that type of increase in pounds? You talked about maybe some of the branded products coming back, but also strength in – with your QSR and pizza customers, and I know that plays into your customer mix. So if we could talk through the strength there, that'd be great.

David A. Ciesinski

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

A

Yeah. Absolutely, Todd. First of all, again, good morning. On the branded side, as you remember same time ago last year, we were pretty deeply in the throes of COVID and that part of the business was soft. And as we rolled through Q1 and Q2, that segment of the business, which supports concepts up and down the street, but also, to a lesser degree, K-12 education and higher education, started to post sequential strength. So, that was a material contributor to that growth.

The other side, though, was really we continue to see our QSR customers, some of them, by name, Chick-fil-A, Domino's and others, really continued to perform well all the way through the majority of that December timeframe. Once we got to the very last week of December, we did start to see a pullback because of Omicron that we've seen really continue through the remainder of January, and we can talk about that in a separate context. But really to summarize, we were winning with winners on the Foodservice side in terms of concepts and then the brands.

Todd M. Brooks

Analyst, The Benchmark Co. LLC

Q

That's great. Why don't we tackle Omicron now and I want to do it from a higher level. If you look at kind of what the margin pressures were running on the business kind of through that, let's say, even middle of December before we really saw the spike in Omicron, how much did the inflation reality change for you with the onset of the

variant, and any way you can size what margin pressures were running versus what they – what you saw once the variant really took hold?

David A. Ciesinski

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

A

Sure. Well, I would tell you, Todd, in Q2, I don't think that we could really point to Omicron as a contributor to our margins, per se. When we go in and we look at NPD CREST data, for example, what I can tell you is that QSR as a whole, when we look at transaction data, was probably run – and this is all QSR – was running depending on the week to up a point to down a point or so. I can tell you once we got into the January timeframe, though, that started to slow down where these concepts and transactions. Now, this isn't sales. This is transactions. We're down in the mid-single digits. When you look at all Foodservice in the aggregate, that same thing is true, obviously, because of the size of QSR, where the concepts across the board were, let's say, up a point on the aggregate to down a point sort of vacillating there. We've seen a pullback of about 600 basis points in January. So really, I can't point to Omicron as a contributor on the margin side as we look at our Q2 results.

Todd M. Brooks

Analyst, The Benchmark Co. LLC

Q

Yeah, Dave. Let me follow-up because I might not have been clear when I asked the question. I was talking more on an overall Lancaster level. If you looked at the cost of doing business in the latter parts of December, how did that change with Omicron, whether it was employee callouts, friction in your distribution...

David A. Ciesinski

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

A

Got it. Got it.

Todd M. Brooks

Analyst, The Benchmark Co. LLC

Q

...and just additional costs there that...

David A. Ciesinski

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

A

Yeah.

Todd M. Brooks

Analyst, The Benchmark Co. LLC

Q

Thanks.

David A. Ciesinski

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

A

So, we did – really was the week ending December 28 is probably where we started to see the biggest spike. And I can tell you, it, like every place else in the country, it took off. By the first week or so of January, we were seeing case rates that were as high as we had seen at any other point in time during the course of the pandemic. We were seeing call-offs, but I can tell you, we continued to operate without really a lot of disruptions because of either leaning into overtime, or by virtue of the fact that the pressure that you've seen in our margins, we were carrying a little bit heavier labor going into the fall because of not only an anticipation of a spike in COVID, but the fact that we were seeing a fair – a higher level of resignations on the hourly side. So as far as our ability to

produce, not a lot of pressure, maybe a small uptick that we're going to see in overtime cost. And then, other – December had some other noise in it. For example, we didn't get into it, but there was the tragic tornado that struck across all of Kentucky. Fortunately, it didn't impact our facility in a material way but it did impact a number of our employees, and it resulted in a bit of a slowdown in December but not enough for us to call out and mention by name.

Thomas K. Pigott

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

A

Yeah. Todd, some of the other impacts beyond Omicron, we did see a number of supply disruptions in our start supply packaging material disruptions, and some of our suppliers had difficulty staffing in this environment to provide us with the raw materials. So there was a number of disruptions, not necessarily specific to Omicron, that did impact...

David A. Ciesinski

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

A

Correct.

Thomas K. Pigott

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

A

...our margins in the quarter.

David A. Ciesinski

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

A

Yeah. If you want to talk more broadly about interruptions, Tom, exactly right. Starches and gums, as a particular category of supply, were a challenge for us. [ph] Leading (24:56) for Foodservice was a particular challenge for us. Transportation inbound from our suppliers with truckers calling off continued to be a problem for us. I mean, it's really the usual suspects that you're seeing at a range of our other partners. I think the ones that were unique pressure points to us were probably more a function of the products that we make. So starches and gums that go into sauces and dressings, probably highest among the list, and then, some of the packaging items that are unique.

Todd M. Brooks

Analyst, The Benchmark Co. LLC

Q

Okay. Great. And then, one more and I'll jump back in the queue. If you look at the realities that you just talked about dealing with kind of Q4 and then some of the Omicron realities into Q1, but you did highlight revenue management actions that you're taking, we are seeing favorable trends with Omicron and kind of the speed of this normalizing seems to be encouraging, knock wood. Just can we look at this gross margin performance in this quarter and think of this as a kind of a basing of where gross margins should kind of settle out from these pressures in the near term because we do have these positive levers that you're pulling against going forward.

David A. Ciesinski

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

A

So, maybe I'll comment on Omicron first. I'm pleased to report that even I looked at the data today, we're seeing things return back to normal in terms of our cases in our plants. They're down substantially and the number of call-offs that we're seeing are down substantially as well. So Omicron itself, I think, should begin to normalize across the country.

As far as the other pressures of concern on margins, maybe Tom, I'll turn it over to you to give us an outlook.

Thomas K. Pigott

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

A

Yeah. So – yeah, and Todd, I'll start by saying it's difficult to give specific guidance given some of the disruptive impacts we experienced in the quarter. As you look at some of the headwinds, we do – we had over 200 basis points of dilution due to the commodity impacts on our raw materials. And certainly, we priced to cover a lot of that, but naturally, as you raise prices and have higher costs, you have natural dilution that's going to hit your P&L, and that we expect to continue, but 200 – a little over 200 basis points going forward. Some of the other headwinds we're expecting is continued labor and other inflation. We do expect some of these disruptions to continue.

Now, in terms of tailwinds, the Retail segment took another pricing action on the dough-based products recently, and the Foodservice segment took another pricing. And the goal from a dollar basis is to offset the inflationary impacts. And then, in terms of the supply chain challenges we experienced, as Dave highlighted, we have some discrete actions in place. So a lot of headwinds and some tailwinds, difficult to give you a specific kind of ongoing impact, but certainly, that commodity inflation piece we expect to stay with us, that 200 to 250 basis points of dilution, given the natural higher prices and higher costs that will flow through the P&L.

Todd M. Brooks

Analyst, The Benchmark Co. LLC

Q

Okay. Great. I'll pass it along and jump back into the queue. Thanks.

David A. Ciesinski

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

A

Thanks, Todd.

Operator: Thank you. Our next question comes from Ryan Bell with Consumer Edge Research. Your line is open.

Ryan Blaze Bell

Analyst, Consumer Edge Research LLC

Q

Good morning, everyone.

David A. Ciesinski

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

A

Good morning, Ryan.

Thomas K. Pigott

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

A

Good morning, Ryan.

Ryan Blaze Bell

Analyst, Consumer Edge Research LLC

Q

So just trying to touch a little bit more on the foodservice industry trends, it seems like from your commentary was that you're gaining share growing ahead of the category overall. Maybe could you touch a little bit more on the category growth and then sort of your relative performance? It seems – some of the drivers are what your mix is. But outside of that, I just wanted to see if maybe if you could provide any additional context.

David A. Ciesinski

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

A

Sure. So if we were maybe to take a real-wide angle look at this, if you go back to the summer through the middle of January, when you looked at all foodservice, all concepts, I mean, what we would see is that the industry overall in transactions is just down modestly. If you then click in and you look at the QSR space, what you would have seen on transactions again is that the QSR space would have been, let's say, up 50 basis points, so modest growth in transactions, with their sales growth supported more by pricing overall, right, but in transactions they would have been up modestly.

If you look at our business then and you click into that, Ryan, what you're going to find is that within that mix, there are a handful of customers that are outperforming the rest. Some of the QSRs, Chick-fil-A is one that we mentioned by name, and then pizza QSR is another area subset that's performed well. So when you look at our performance versus the industry as a whole, typically, we're performing to the tune of – historically, it was a couple hundred basis points better than the industry. We're performing even better than that just because of the strength of the concepts that we're aligned with. Now, what I wouldn't tell you is that we're gaining share with the concepts that we're working with. But we're positioned with the concepts that are growing in the market, that when you compare our business versus the market, it's going to show that we're growing faster.

Ryan Blaze Bell

Analyst, Consumer Edge Research LLC

Q

Thanks. That's helpful. Could you also touch a little bit more on the details behind the capacity expansion efforts and what sort of the impact would be from the increase in co-manufacturing usage? And I'm not sure if I picked up on this correctly, but in terms of the co-manufacturing increase and uptick, the duration of that, and when can some of that be brought in-house and sort of the margin implications.

David A. Ciesinski

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

A

Sure. No, I think this is – you take all of the challenges associated with COVID, and if it's possible, you move them aside for a second, one of the things that's happened in the last two years is that we've grown our business by almost 25% when you look at consolidated net sales. When you look at our retail business, it's grown by almost a third over that same period of time. And then really, you kind of screw in two clicks deeper, as I mentioned in my transcript. When you look at our licensed sauces, in Q2 of fiscal year 2020, we did \$22 million in sales roughly. In Q2 of this year, we did almost \$80 million of sales, right? So if you think, this is during COVID, we've taken a business that might have been operating at a run rate of about \$90 million or so, and we've taken it up to a run rate now that's closer to \$320 million, right? So – and that's the sort of order of magnitude of growth that we're talking on a run rate with these licensed sauces.

And we've done it with continued growth on Olive Garden, but with the growth now of Chick-fil-A, which on a run rate, and this is scanner data, this is all the stuff that's publicly available, Chick-fil-A is bigger than Olive Garden already, and it hasn't been in the market in a year yet, right? And then, we've also been working to expand up Buffalo Wild Wings. So, part of what's happening here is that we've had to make some moves, pretty aggressive moves, in order to bring online the capacity fast enough to facilitate this growth, and there's a strategic reason

why we had to do it. When we go out and we talk to key partners like a Kroger or like a Walmart and we say, hey, look, we want you to cut in 8 phasings or 12 phasings on a shelf for the product. If we're not there to deliver on the promise, the next time we come back with an opportunity to expand, they're going to say talk to us next time, right? So, we have one chance to get it on the shelf and demonstrate that it works. And we wanted to make sure, for the purposes of our long-term growth algorithm, that we didn't miss that opportunity.

Now, to capitalize on that growth is coming at a cost, not a price. We're not buying down the price in order to get it to turn on the shelf, quite the contrary. But what we are having to do is pay a material upcharge based on the strength of the items to get co-packers to bring – to allow us to rework our mix of business. And what I would tell you is we're pushing our – a range of products out, a lot of own products, like Simply Dressed, et cetera, to make room within our own capacity to meet the needs of the business.

Now, flipping over to that capacity expansion, our biggest facility in our dressing network is our Horse Cave facility. It's about 250,000 square feet. And this expansion that we're bringing online is about another 200,000 square feet. So from a production perspective, it's going to be a material increase in the size of the facility with a couple of bottling lines and then also capacity to meet the needs of our Foodservice business. As I pointed out, that project is slated to be done in the first half of fiscal year 2023. So within the next year, we expect that project to come online, and then sequentially, we're going to be starting up kitchens and lines to allow us to gradually rework the balance of what we have out in co-packers.

Now, maybe with a footnote, you heard one of the things that I mentioned in my comments today is that we were excited to announce that we're expanding our partnership with Chick-fil-A now to also include barbecue sauce. And so, part of our decision to pull back versus leave out is going to be predicated on our ability to drive this growth, right? If we find that we continue to have more and faster opportunities, we will continue at least at some level to lean on these great co-pack partners. And they are great partners. They're helping us accommodate this growth in this environment.

To the degree in which our growth rate starts to, let's say, moderate at some point in the future, obviously, we start to think about a different algorithm and, well, let's say, a strategy for using our co-manufacturers. But really, what we're focusing on here is what we feel like is a really unique opportunity by virtue of our strategy around Foodservice to Retail licensing and the speed of these things that's forced us to go out and lean hard into co-packers to capture the opportunity.

Ryan Blaze Bell

Analyst, Consumer Edge Research LLC

Q

Thanks. I appreciate the context on that and then some of the details about sort of the push-out for Chick-Fil-A barbecue product. And then, just from a general sense, I understand it's a tough environment to try to predict what's going to happen in terms of pricing, but [ph] in state of (35:58) pricing environment overall or cost side overall sort of stabilized, what do you think about the cadence or the movement sequentially of your gross margins over the balance of the year? Is the pricing that's currently in effect and plan to go into effect enough to tip the scales so that it might move upward on a year-over-year basis or at least the decrease starts to ameliorate somewhat?

David A. Ciesinski

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

A

So, maybe I'll hit it sequentially and then I'll turn it over to Tom to cover the points that I don't make. Really, for the last handful of years, we've talked about our PNOC strategy, which is pricing net of commodities. And historically, when we launched it, we were just looking at commodities. Within about a year or so, we started to also include

freight in our net PNOG conversation. And then, most recently now with the labor changes, we started to track wages in that PNOG conversation. So what I would tell you, Ryan, to date, when we look at our PNOG, with the pricing actions we've taken, we've largely recovered the commodity component and the freight component. Where we're lagging is in the way trade adjustments that we've made and we're in conversations on the Foodservice side to recover those and we're – we have pricing actions that are in flight in Retail to cover those. So, I would expect from a PNOG perspective that as we go through Q3 and Q4, PNOG should become net neutral again, right? So, that's how I would view that.

And then, what I would tell you is that there were other, let's just call them temporary points of dislocation in supply chains that we're all facing, things like truck drivers and inbound supplier issues because of their own issues, that I think we're just going to have to wait and see how they work their way through. What I would tell you is that what, as Tom and I had pointed out, we're taking a range of actions to creep into our suppliers where we have to make sure that we can assure more stable supply so we can make our factories run more predictably.

And Tom, I don't know if there's anything else you want to add in that.

Thomas K. Pigott

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

A

Yeah. No, I think you hit on it, Dave. And I think there's one additional point to add and that our pricing has been well received by the retailers. I think the strength of our brands that we're seeing good reflection and the elasticity impacts are in line or lower than what we had originally projected. So, we feel good about overall our ability to price to recover these costs...

David A. Ciesinski

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

A

Yeah.

Thomas K. Pigott

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

A

...but it will take some time, as Dave outlined.

Ryan Blaze Bell

Analyst, Consumer Edge Research LLC

Q

Thanks. One last one for me, could you touch on some of the potential unlocks once you implement the Project Ascent program in the beginning of 2023 just in terms of general productivity? And then, obviously, your balance sheet is quite [ph] flush (38:55). What that would mean in terms of your ability to digest the larger acquisition? Thanks.

David A. Ciesinski

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

A

Yeah. So, we're on the forefront of some exciting times. If you remember, we did a pilot implementation of one of our factories that went into effect about a year ago now, and it's proven to be very, very helpful. And a lot of what we're seeing is just the speed to information that we wouldn't have had access to in the past. That's helped us with things like staffing. We're – within the next couple of months, it's going to be taking the trade promotion management component live on the system. And then finally, when we go live earlier in the next fiscal year with order to cash, procure to pay and the other components, I think that's where we would likely to see an even larger benefit.

The benefits are likely to come in the usual places. Procurement is going to offer an opportunity. But the bigger area is just going to be the speed of information in our factories to make sure that we're staffing right and that we're sourcing right and we're running right. And it's a little bit hard for us to estimate exactly what that's going to look like in a COVID environment. And then, longer term, Ryan, what this is going to give us is the ability to do much more seamless acquisitions with cost synergies than we haven't been able to do in the past.

If you go back to the underlying reason why we did this, our current ERP system was installed in 1995. The vendor went out of business. When we installed it, we didn't really cascade it through the supply chain in areas like MRP, which had resulted in a business today that's run pretty manually. And when we look at acquisitions, it really precludes us from looking at cost synergies and we focus more on growth. Not only is this going to give us a stable platform, but I think it's going to give us a scalable platform for us to look at acquisitions or, for example, bringing online licensing and other stuff where we can ramp up very quickly and very seamlessly in a way we couldn't – we can't today.

Ryan Blaze Bell*Analyst, Consumer Edge Research LLC*

Thank you.

Q

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

Thanks, Ryan.

A

Operator: And we have a follow-up from the line of Todd Brooks from The Benchmark (sic) [Benchmark] Company. Please go ahead.

Todd M. Brooks*Analyst, The Benchmark Co. LLC*

Hey. Thanks for the second crack here. Can we talk about Chick-fil-A barbecue? And I guess it seems like that probably hits on more categories at Retail competitively than Polynesian does. Just any commentary that can give us out of the Foodservice side about barbecue popularity versus Polynesian popularity and kind of size where this falls between Chick-fil-A sauce and Polynesian from a revenue opportunity.

Q

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

Yeah. So, Chick-fil-A barbecue sauce is a category. It's about a, if I remember right, \$500 million category, maybe a little bit bigger than that. As you pointed out, there are a range of competitors that are playing the space. If you look at it within Chick-fil-A's lineup, it's probably one of their – it's probably their number three sauce. So, it's a material contributor to what they do. And part of what this gives us, Todd, as we think about our longer-term brand, what we're looking to do ultimately is to create a bigger and more substantial brand block on the shelf.

A

So if we were to sort of say leaping forward, what does the future look like here? I would say, obviously, Chick-fil-A original, Polynesian sauce, barbecue and then some players to be named later that are in the works. But the other thing that we're going to be focusing on is launching larger sizes that allow us to drive greater holding power on the shelf, greater holding power in the pantry, and it really creates a roadmap for, for example, the way we grew ketchup when I was at Heinz and the way we thought about mac and cheese when Tom and I were at Kraft together. It all becomes part of how you grow up, a really meaningful brand.

Encouragingly, when we look at the brand today, we continue to have extremely high velocities. Our trial is high, our repeat is high. I believe even as of right now, that's our number two brand or so in household penetration, really only trailing New York. But in due course, we expect to see that quite possibly pass New York as well. So, it continues to be a very, very exciting platform. All of our retailers are excited about it.

And maybe bringing you around to the last point is, as you recall, when we were trying to bracket this, we said that we thought it had the potential to be the same size as Olive Garden. And right now, what we have essentially is two SKUs. We have a retail 16-ounce in original and a retail 16-ounce that's in Polynesian, and those two SKUs are already generating sales, net sales in – or excuse me, retail sales that are in excess of what we're doing out there with Olive Garden with a lot of room to run.

Todd M. Brooks

Analyst, The Benchmark Co. LLC

Q

So Dave, I'm trying this kind of picture in my head of what Chick-fil-A will eventually look like as far as placement and breadth on the shelves at grocery. To kind of level set us, how long after a Horse Cave opening does it take to fully realize the potential of Chick-fil-A at grocery retail, so not unlocking club or anything but maximize that grocery potential?

David A. Ciesinski

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

A

Well, maybe going back to – if you're thinking about how do we line this up sequentially, the factory is going to come online in the second half of the next fiscal year. So, it's going to be coming online, really, let's call, it in the fall time period with kitchens in line starting up thereafter. That's going to allow us to really start to expand more aggressively.

There are two bottom lines there with the number of kitchens that we're going to be able to grow into. But based on the modeling, we have a base case and we have an upside case that we're looking at here. We think that factory gives us capacity for a handful of years. In the upside case, it's quite possible that we're going to be looking for another facility either to buy or build. And if you go back to the comments that were in the script, that was one of the things that we pointed out. We actually engaged a top tier consultancy to look at our growth algorithm and overlay our capacity footprint, and then also, begin to give thoughts to regionality and transportation in this and to start to think about, okay, what – not only do the next two years look like but what are the next four and six years look like, and how do we make sure that we grow but we're also growing margin as we push our way through this.

So hopefully, that gives you some to think about. And then, I would tell you, we continue conversations with other partners about other licenses that fit into this mix. So, [ph] I would say anything (46:27)...

Todd M. Brooks

Analyst, The Benchmark Co. LLC

Q

Yeah. And that...

David A. Ciesinski

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

A

...that continues to give us a measure of optimism in a complicated COVID environment is that our strategy around these licenses continues to hold and our own brands continue to perform well in the environment. We just need to make sure that it's translating to profit.

Todd M. Brooks*Analyst, The Benchmark Co. LLC*

Q

Yeah. That's helpful. And then, it dovetails into the next question. I think last call, you may have talked about the license branding strategy and it's kind of evolved from a – go deeper with the three existing partners at Retail or look at other partners who want to work with us that we may have Foodservice relationships with and we could help them get to Retail as well. I think the last call, you kind of debunked that a little bit and it sounds much of an either/or as a both. So if you can talk about maybe depth of that pipeline, opportunities that might be outside of – are there opportunities that are outside of bottled dressings and sauces where capacity may exist to unlock some more momentum on the licensed branded products? And I'll leave it there. Thanks.

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

A

So another good question, Todd, and per earlier conversation, we don't view it as an either/or. We view it ultimately as an and. We are looking at adding other license partners against dressings and sauces. We'd be very interested. And we are exploring opportunities around dips, for example, and then also selectively in big categories where we have the capabilities. So really, we're looking at anywhere where we have capabilities and the opportunity to move into licenses. And that's where we think this thing has literally a number of years of legs.

And if you look at the broader landscape, you look at the shelf and you look at the world that our consumers live in today, I think about when I started in marketing and consumer packaged goods at Heinz, I mean, typically, you would generate an idea, you would test the idea, you would go out, you would put advertising behind the idea to try to break through to consumers and drive awareness and trial and get it on the shelf. If you think about that world then, it seems quaint now in a world that's loaded with social media and in all sorts of distractions that consumers have. And our ability to penetrate that and to reach consumers' minds is increasingly difficult, and I think that's part of the reason why once you're starting to see our brands that have a different sort of a hook. So take BODYARMOR, for example. Who could have ever thought that somebody could have got on the other side of Gatorade, right? Well, BODYARMOR, with the backing of Kobe Bryant back in the day was strong enough obviously to penetrate that. You've seen the same thing play out with brands like Honest with Jessica Alba's backing in. And you've seen it play out in the spirits industry with 3 Amigos and with Aviation Gin.

And so, our view is rather than tying up with a particular partner, we would prefer to use really what we view as a core competency, culinary skills and relationships with top tier and relevant foodservice partners to take their products onto the shelf. And in so doing it, it allows us to leverage their marketing muscle and their awareness in order to penetrate the consumer noise. And so, I think that strategy seems to continue to hold at sort of a really high level. And when you bring it down to our little company here and the brands that we work at – we work with, we continue to believe that it's highly relevant and a great pathway to – great value for us and our licensing partners.

Todd M. Brooks*Analyst, The Benchmark Co. LLC*

Q

Okay. Great. That was helpful. Thanks, Dave.

Operator: Thank you. And there are no further questions. I will turn the call back to Mr. Ciesinski for his concluding comments.

David A. Ciesinski

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

Thank you, everyone, for your participation this morning. We look forward to joining with you for our third quarter results early in May. And in the meantime, stay safe and we look forward to talking with you then.

Operator: Thank you, ladies and gentlemen. This concludes today's conference. You may now disconnect. Have a wonderful day.

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