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Lancaster Colony Corp. (LANC)

Q4 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Denise, and I'll be your conference call facilitator today. At this time, I'd like to welcome everyone to the Lancaster Colony Corporation Fiscal Year 2018 Fourth Quarter Conference Call. Conducting today's call will be Dave Ciesinski, President and CEO; and Doug Fell, Vice President and CFO. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer period. [Operator Instructions]

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

Director-Investor Relations, Lancaster Colony Corp.

Thank you, Denise. Good morning, everyone, and thank you for joining us today for Lancaster Colony's fiscal year 2018 fourth quarter conference call.

Let me remind everyone before we begin that 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.

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

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

Thanks, Dale, and good morning everyone. It's a pleasure to be here with you today as we review our fourth quarter results for FY 2018. Doug and I will provide comments on the quarter, the year and the fiscal year 2019 outlook. Following that, we'll be happy to respond to any of your questions.

For the fourth quarter, consolidated net sales increased 6.3% to \$308.2 million versus \$289.9 million last year. Retail net sales increased 1.7% to \$156.8 million, driven by refrigerated dressings and dips, along with shelf-stable dressings and sauces sold under licenses. Frozen bread was down for the quarter as influenced by the impact of the shift in the Easter holiday from our fiscal fourth quarter last year to our fiscal third quarter this year.

On the pricing front, we continue to make progress, implementing price increases with our retail customers to help offset higher commodity cost and freight cost. We also reduced the level of trade spending in coupon expenses as we continue to better optimize those cost through our investment in category management tools.

Foodservice net sales grew a strong 11.6% to \$151.4 million, driven by segment-wide sales volume increases including sales attributed to limited-time-offer programs with our national chain customers. Pricing actions also helped to offset higher freight and commodity cost.

Consolidated gross profit improved \$3.7 million to \$76.2 million as the favorable influences from the increased sales volumes, pricing actions, lower trade spending, reduced coupon expenses, and cost savings realized from our Lean Six Sigma program overcame the impact of higher freight and [ph] commodity costs (03:38).

SG&A expenses increased \$3.5 million as the prior-year quarter included a one-time pre-tax benefit of \$1.4 million from the full settlement of a class-action lawsuit. The higher level of SG&A cost also reflected higher expenditures to retail consumer promotions.

Consolidated operating income was essentially flat at \$42.9 million, while consolidated operating margin declined 80 basis points due to the factors referenced above including a less favorable sales mix as sales growth in the Foodservice segment outpaced that of Retail.

Retail segment operating margin declined from 20.5% to 19.1%, most notably influenced by the \$1.4 million one-time benefit in last year's fiscal fourth quarter from the lawsuit. Other factors resulting in the reduced Retail segment operating margin were the higher costs in the quarter for freight and commodities in addition to the increased spend in retail consumer promotions.

The Foodservice segment operating margin improved from 9.9% to 10.6% largely due to price recovery from our national accounts and pricing implemented in branded foodservice. Net income was \$32.4 million or \$1.18 per diluted share compared to \$28.5 million or \$1.04 per diluted share last year. The regular quarterly cash dividend paid [ph] on (05:18) June 29, 2018, was maintained at the higher amount of \$0.60 per share set in November of 2017.

Turning our attention to Retail sell-through data from IRI, for the 13 weeks ending July 1, 2018, we maintained our share leadership position in all of our six categories. During the quarter, we were able to increase our share in two out of the six categories while we saw a modest pullback in the remainder due to our targeted pricing and trade reduction activities.

For the full year, consolidated net sales increased 1.8% to a record \$1.2 billion. The Retail segment net sales increased 1.4% to \$650.2 million, driven by increased sales volume for shelf-stable dressings and sauces, the incremental sales from Angelic Bakehouse, pricing actions, reduced trade spending, and lower coupon expenses.

The Foodservice segment net sales grew 2.2% to \$572 million. After a very challenging first half of the fiscal year, segment sales improved significantly in the second half, both with inflationary pricing and volume gains contributing to this growth. Consolidated operating income decreased \$2.6 million to \$172 million from \$174.7 million last year, excluding the pre-tax charge of \$17.6 million in the prior year resulting from the company's withdrawal from an underfunded multiemployer pension plan. Operating income declined \$20.2 million or 10.5%.

Increased commodity costs, particularly eggs, and higher freight costs were the primary causes for the drop in operating income. These were partially offset by cost savings realized from the company's Lean Six Sigma program and pricing action.

At the segment level, driven by the same factors that I just mentioned, Retail operating margin declined from 21.6% to 19.4% while the Foodservice operating margin declined from 11.8% to 10.2%. Net income totaled \$135.3 million, or \$4.92 per diluted share versus the prior year amounts of \$115.3 million or \$4.20 per diluted share.

In addition to the favorable impact of the lower federal income tax rate, Tax Act also resulted in a one-time deferred tax benefit to this fiscal year's net income of \$9.5 million or \$.35 per diluted share. Conversely, last year's net income amount was unfavorably impacted by the cost resulting from the company's withdrawal from the underfunded multiemployer pension plan of approximately \$11.5 million or \$0.42 per share. The regular cash dividend was also increased during the year for the 55th consecutive time.

With that, I'd now like to turn it over to Doug to make some comments on the balance sheet and related items.

Douglas A. Fell

Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

Thank you, Dave. Overall, our balance sheet remained strong. I will make a few brief comments on the more meaningful changes in our balance sheet since last year. From a high level perspective, nearly all of the increase in our cash balances of \$63 million last year can be summarized as follows. Cash provided by operating activities of \$161 million offset by regular dividends of \$65 million and property additions of \$31 million. Accounts receivable balances remained in line with sales volumes and our expectations.

Consistent with past quarters, our agings remain solid. While in line with our expectations, the noticeable increase in inventory reflects the impact of several items including increased sales volumes, higher input cost from commodities, balancing of production within our plants for seasonal inventory builds, and some adjustments to our days of forward coverage to maintain high levels of customer service.

As I mentioned, fiscal year-to-date cash expenditures for property additions totaled \$31 million. This is in line with expectations. Consistent with our past communications, in addition to the expansion project for our Angelic Bakehouse facility this year, the largest amount were spent on new processing and automation equipment to accommodate growth and enhanced productivity.

Looking ahead, at the present time, we anticipate capital expenditures to be in the range of \$60 million to \$80 million for fiscal 2019 and in general, will focus on projects to increase capacity and productivity. A most significant project planned for fiscal 2019 is to expand production capacity to meet increased demand for our

Sister Schubert's products. This project is expected to start this fall with a projected completion date in fiscal 2020. Other notable projects to be completed in fiscal 2019 involve a dedicated innovation center and packaging capacity for our retail dressings.

Depreciation and amortization expense totaled \$27 million for fiscal 2018 at this point we expect a level of about \$30 million for fiscal 2019. As we conveyed last quarter, the increase in our accounts payable since June largely reflects an emphasis by our procurement team to extend payment terms with our vendors in conjunction with our ongoing Lean Six Sigma efforts.

With respect to our balance sheet capitalization, not much has changed since our last commentary. We continue to have no debt, over \$650 million in total shareholder's equity and nearly \$206 million in cash and equivalents. Borrowing capacity under our credit facility remains at nearly \$150 million.

Finally and broadly speaking, as reported in our past quarter earnings release, our income tax provision for fiscal 2018 was favorably impacted by the Tax Cuts and Jobs Act. Our blended effective tax rate for our fourth quarter was estimated to be 28.5%, yet our actual tax rate was 26%.

The favorable difference of 250 basis points is largely due to two discrete items of roughly equal size. First, the continued refinement of the estimated impact of the Tax Act on our deferred taxes; and second, the impact of the new accounting guidance on the tax treatment of employees' stock option exercises. Looking forward, at this time, we continue to estimate our effective tax rate for fiscal 2019 to be approximately 24%.

Thanks for your participation with us this morning. I will now turn the call back over to Dave for our concluding comments. Dave?

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

Thanks, Doug. Looking ahead to fiscal year 2019, Retail sales will benefit from new product introductions, including Marzetti Simple Harvest plant-based dips, a fresh lineup of 60-calorie Flatout wraps, and new Angelic Bakehouse sprouted grain wraps that are made with superfoods such as Kale & Spinach, Beets and Sweet Potatoes.

In addition, our Retail segment expects to build upon the recent rollout of the new Olive Garden Parmesan Ranch dressing flavor and implement a follow-on program to our recent successful retail test of Buffalo Wild Wings.

In the Foodservice segment, we expect to continue to strengthen our existing customer base and pursue new opportunities for profitable growth through our culinary expertise and noted reputation for custom formulated products.

Based on our current assessment, commodity costs are projected to remain unfavorable in fiscal year 2019, although to a lesser extent than we experienced in fiscal year 2018. Freight costs are expected to persist as a headwind through the first half of 2019.

Higher pricing in both Retail and Foodservice segments will help offset these increased costs. In addition, our supply chain team will remain focused on cost savings initiatives and opportunities throughout the coming year.

Finally, I'd like to expand upon Doug's reference to our forecasted FY 2019 capital expenditures of \$60 million to \$80 million. This past May, our board of directors approved three significant strategic projects that will drive long-

term benefits to our business, but elevate our short-term capital spending. The first project has a material capacity expansion for our Sister Schubert's business. This project will not only help the continued growth of our Retail business, but also position us to meet the increasing demand from one of our key Foodservice customers.

The second strategic project is a new high-speed bottling line that will be installed at our dressing and sauce facility in Columbus, Ohio. This project will enable us to insource some retail dressing volume that's currently co-packed, and also provide us with added capacity for future growth.

The third strategic project is a new innovation center that's planned for construction in the Columbus area. This facility will enable us to bring Retail and Foodservice R&D teams and our quality team all together in one central location to more effectively collaborate within our organization, but also with our Retail and Foodservice partners. We believe that innovation is the key to our success.

We expect the innovation center and the bottling line projects to be completed in fiscal year 2019. And as Doug mentioned, we anticipate the Sister Schubert's expansion project to be completed in fiscal year 2020, most likely the back half. Excluding these three strategic projects, we expect our fiscal year 2019's capital spending to be essentially in line with that of fiscal year 2018.

That concludes our prepared remarks for today. And we'd be happy to take any of your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Michael Gallo of C.L. King. Your line is open.

Michael W. Gallo
Analyst, C.L. King & Associates, Inc.

Q

Hi. Good morning.

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

A

Good morning, Mike.

Douglas A. Fell
Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

A

Good morning, Mike.

Michael W. Gallo
Analyst, C.L. King & Associates, Inc.

Q

Just a couple of questions. I guess just to delve in a little bit on your margin commentary, obviously fiscal 2018 was a difficult year from a margin perspective. You had higher commodity and labor as well as logistics costs. You had obviously the issues related to the fire which impacted some of your retail volumes as you went through the year.

It would seem that at least the commentary you have here suggests that there's going to be some continued headwinds in fiscal 2020. You do have better – I think you'll have better price realization it would seem. So I guess as sort of boiling it down, do you expect that you'll be able to materially improve your gross margins in

2020, or will it be just a continued transition where you'll continue to have to take cost out and get pricing just to kind of hold the line or slightly improve margin? Thanks.

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Sure. So, Mike, great question and why don't I dive in for you. So if you think about it, we in the industry have been talking about two forms of inflation coming in. First, the raw material and packaging and freight. As we think about the sequencing of fiscal year 2018 which we just ended in fiscal year 2019, the first thing we're seeing is a bit of a step down in commodity inflation as context. We expect to see one more quarter of just pure commodity inflation principally driven by eggs. And then we think that it will continue to be inflationary, but at a more modest pace through the remainder of the year.

Freight, we expect to be a headwind for the entire first half. If you remember, the hurricanes hit at the very end of Q1, beginning of Q2, and then we saw a subsequent and significant step-up in those costs due to the new Department of Transportation rules. So we're going to see freight as a headwind through the first half and then plateau thereafter.

So, if you then take maybe three big steps back, I'll frame it into another context, probably about three quarters ago, we began aggressively tracking what we call PNOC, pricing net of commodities, and this is the first quarter where we're seeing positive PNOC in both segments. What we're doing is we're offsetting the cost in the absolute sense, but we haven't been able to get enough yet to necessarily hold margins.

So how do we think about this then, on a go-forward basis? The first thing that I would share with you is that we're going to see probably a tougher first half principally because of freight. Remember, the freight for us is up in the gross margin category, and one quarter that's tougher, the first quarter also driven by commodities, and then we're going to see – what we expect to see is more improvement thereafter. If you look at the entire fiscal year, we would expect to see flat to modest improvement based on what we currently see today.

Michael W. Gallo

Analyst, C.L. King & Associates, Inc.

Q

In terms of the year overall, though, would you expect to be able to improve gross profit?

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Yeah. Yeah.

Michael W. Gallo

Analyst, C.L. King & Associates, Inc.

Q

Okay.

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

And that's what I meant, Mike. I'm sorry if I wasn't clear. We would expect for the full year to see modest improvement based on what we see today.

Michael W. Gallo

Analyst, C.L. King & Associates, Inc.

Q

Okay. Great. And then just to follow up in terms of just the step-up in capital expenditures, I think I heard you say that Sister Schubert's [ph] plant (19:34) wouldn't be complete till sometime in 2020. So, should we expect this kind of stepped-up level of capital expenditures to go for the next two fiscal years or would you expect this to kind of level off next year or perhaps not as high as 2019, let's say, somewhat elevated? Thanks.

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

You know what, Mike, what I would tell is right now, what we have clear line of sight here, was what we've outlined, what we're continuing to evaluate projects. We went through the three that we're focused on. The most material of which is the capacity expansion for Sister Schubert's. That project is going to be probably more heavily weighted towards fiscal year 2019 with some cost incurred in 2020. The other two are more modest and they're going to be completed in this upcoming fiscal year, fiscal year 2019.

So, the best we can tell you now is this is what we have clear line of sight to. As we continue to evaluate other opportunities with the board, especially when it takes our spending at an elevated level, you can count on us to come back to you and sort of take you through what we're thinking.

Michael W. Gallo

Analyst, C.L. King & Associates, Inc.

Q

Okay. Thank you.

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Absolutely.

Operator: Your next question comes from Jason Rodgers of Great Lakes Review. Your line is open.

Jason A. Rodgers

Analyst, Great Lakes Review

Q

Yes. Hello, guys.

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Hi, Jason. Good morning.

Douglas A. Fell

Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

A

Hey, Jason.

Jason A. Rodgers

Analyst, Great Lakes Review

Q

Good morning. Just wanted to follow up with the whole commodity cost question, and just looking at soybean oil, it's come down dramatically, and I was just wondering why you wouldn't see some type of tailwind in fiscal 2019 from that?

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

That's a great question. So, we are seeing soybean come down. That's been a class that's been favorably impacted. And what we're seeing on the flip side, though, is for us eggs are a really large commodity category. We buy both whole eggs and yolks, and they remain elevated versus prior year. So, that would be one. Packaging cost, linerboard, corrugate and resin all remain elevated. And honestly, for us, transportation cost is also included in that, and that's a big number.

If you think about our total business this past year, all-in, we probably looked at somewhere in the range of 5% of gross inflation across the business. And what we're seeing is that inflation is going to remain elevated, albeit at a more modest rate into fiscal year 2019. The trade stuff that's going on externally has helped us with soybean, but it hasn't seemed to give us any relief in the other classes.

Dale N. Ganobsik

Director-Investor Relations, Lancaster Colony Corp.

A

Yeah. And one thing I'll add to that, Jason – this is Dale – is that the basis cost and, to Dave's point, the transportation cost of soybean oil is really cutting into what you would see just on the spot market for that. So I just want to make you mindful of that.

Jason A. Rodgers

Analyst, Great Lakes Review

Q

All right. And very nice increase in the Foodservice segment for the quarter, how much of that was due to one-time programs versus just a general better environment for the restaurant chains?

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

A fair amount of that was just from a couple of things. It was just a better overall restaurant environment, and we've been able to pick up some new accounts. We did benefit from an elevated level of LTOs, but that wasn't a big [indiscernible] (23:02) if we sort of have to rank them for you, I would say, first and foremost would have been the improved external environment and improvements within our business that were volume-driven. The second would have been pricing related associated with commodity inflation that we're finally getting through. And then the third component would have been driven by LTO activity.

Jason A. Rodgers

Analyst, Great Lakes Review

Q

All right. And if I could just squeeze one more in, would you happen to have what the volume increases were for the quarter in total and by segment?

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Yeah. We don't necessarily break it out by segment, but I can tell you that the overall volume increase was about 2 points. Yeah.

Jason A. Rodgers
Analyst, Great Lakes Review

Q

All right. Thanks very much.

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

A

Thanks, Jason.

Operator: Your next question comes from Brian Holland with Consumer Edge Research. Your line is open.

Brian P. Holland
Analyst, Consumer Edge Research LLC

Q

Thanks. Good morning.

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

A

Hi, Brian.

Douglas A. Fell
Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

A

Good morning, Brian.

Brian P. Holland
Analyst, Consumer Edge Research LLC

Q

Good morning. Thanks. If I could ask first about maybe the reconciliation between the consumption trends that we're seeing in IRI versus the reported in Retail segment, not the first time this has happened, but there's a pretty meaningful gap between reported and track sales. Should we attribute that to Blue Buffalo selling or the extent to which Blue Buffalo sales are occurring in non-tracked channels? I'm just wondering if you're seeing that disconnect and if that's what you would attribute it to.

And then maybe just as a follow on to that, if you could give us some sense about the scope of where that Blue Buffalo rollout is today and how we think about what that looks like over the next 12 months.

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

A

Got it. Brian, I think you're saying Blue Buffalo. But knowing you like I do, I think what you mean is Buffalo Wild within our case. Correct?

Brian P. Holland
Analyst, Consumer Edge Research LLC

Q

Pardon me. Yeah. Sorry.

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

A

You and I were on the same frequency. I just want to make sure everybody else was as well. So going right to it, that was in fact one component of it. Why don't I talk about what we've done, to-date, what we've run has been a test within Costco that went extremely well. What we have planned to do is expand that into all the club channel and into retail on a limited basis as well and it's going to extend across the year. You can expect to see the product really start to hit in the fall, sort of I think the latter part of football season and go hard football season into basketball season in March Madness. And then we'll sit down with our partners at Buffalo Wild Wings and really evaluate things from that point forward.

So, it was a contributor to the quarter albeit a bit of a modest one. The other contributor that we had that was material was the continued sell-in of our Olive Garden Parmesan Ranch. You had a specific question about how do we reconcile against what you see in the measured channels and what you're seeing otherwise. I think probably what I would point to is if you think about that 1.7%, that was partially also driven – or more than partially, it was driven by pricing and some of the other net price realization tools.

In our case, what we are doing given that the fight that we in the industry have had against inflation is we are going back looking at category by category and say where do we have rented share and where do we have share that we own, where does it make sense for us to pull back on trade spending where we think we can get justifiable price realization and work our way out of a profit curve and where does it not. So in this case on Retail, it was not a volume-led story as much as it was a pricing-led story.

Brian P. Holland

Analyst, Consumer Edge Research LLC

Q

Thanks. That's helpful context. Maybe just a quick follow-on on the pricing side. So I think the reported results and maybe a little bit with respect to your outlook to 2019, it paints a more favorable or optimistic view of pricing than maybe your commentary in Q3, which was quite candidly sounded like there was still some concern about whether you would get that. So I'm just curious if you could maybe walk us through...

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Sure.

Brian P. Holland

Analyst, Consumer Edge Research LLC

Q

...what you're seeing – what sort of happened here over the last quarter that sort of – I mean, again this is my interpretation that it looks like this is coming in more of the high-end of your expectations. So maybe what sort of transpired to get there?

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Yeah. Absolutely. So we'll break it into two segments. First of all, I think we probably started mentioning in late Q2 and Q3 that we were seeing progress on the Foodservice side, and that continued and it was manifest. You guys can follow the way the numbers tumbled. On the Retail side, as far as the external environment, it honestly remains very, very contentious. They're contentious discussions. In some cases, we're seeing list price realization; in other cases, we're getting it through pulling back on trade and things like that. So I would say that the environment remains more or less consistent with what I outlined in Q3, the way we're getting there. In some cases, it's list; in other cases, it ends up being by pulling back in trade. Like you, I keep track of sort of

commentary from peers in this space, and I think what we're experiencing is quite consistent with what they're experiencing.

Brian P. Holland

Analyst, Consumer Edge Research LLC

Q

Okay. Thanks. That's helpful. Last one from me, just quick – following on from the prior question, the last question you asked about Foodservice and the magnitude of growth there. So if we wouldn't ascribe too much of that growth or not a significant portion of your Foodservice growth to LTOs in Q4 and we think about kind of a setup that you have going into 2019. I mean, should we – can we take from this that sort of something, at least in the mid- to high-single-digit top line growth range for Foodservice is realistic for 2019? Is that a fair characterization of sort of how you're set up?

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

I wouldn't be that bold at this point. I think I would back off that sum, honestly. Things fell into place nicely this time around. If I step back and sort of look at what we are, I'll give you maybe the way we view the business internally. First of all, the overall economy seems to be coming along at a much stronger pace. I think consumers are seeing the benefit of more money in their pocket and higher consumer confidence, and it seems to be benefiting the traffic at our restaurants.

So we looked at Technomic data recently and we could see if you look at the 200 largest national accounts, all of them seem to be seeing a measure of benefit in traffic and in terms of a little bit higher range from what's happening. We're also seeing this as it pertains to our mix of customers. All that being said, it's hard to say that we continue to grow in this segment at the rate of which we do because in some respects, we're lapping some easier comps. I would expect to see something. I'd probably say in the low single-digit range on a normalized basis across the entire segment today.

It's just where I am. Now that's coming off of, really, if you looked at this segment where it's probably running, let's call it, down 50 basis points to – in some cases, down 100 basis points. So I think you've seen an inflection point, but I would be reticent to say that I expect to see it in the entire industry and in our business run in the mid-to-high single-digits. I just don't. I don't see the fundamentals there to support that, Brian.

Brian P. Holland

Analyst, Consumer Edge Research LLC

Q

Okay. Thanks. That's helpful. Appreciate it.

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Sure thing.

Douglas A. Fell

Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

A

Thanks, Brian.

Operator: Your next question comes from Brett Hundley with The Vertical Group. Your line is open.

Brett Hundley

Analyst, The Vertical Trading Group LLC

Hey. Good morning, guys.

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

Hey, Brett. Good morning.

A

Douglas A. Fell

Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

Good morning, Brett.

A

Brett Hundley

Analyst, The Vertical Trading Group LLC

Congratulations on a good quarter here. A tough environment.

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

Thank you.

A

Brett Hundley

Analyst, The Vertical Trading Group LLC

I wanted to ask you – I want to go back to the margin outlook and try and get a better handle on gross margin. So if I heard everything correctly, you guys finally got PNOC into positive territory during Q4. Correct?

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

Yes.

A

Brett Hundley

Analyst, The Vertical Trading Group LLC

Okay. And the reason I want to confirm that is because your gross margin performance was pretty solid. It was close to last year when you consider that for much of the year you've been trending 150 basis points to 200 basis points below the prior year and then you guys finally got close to even during the quarter.

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

Yes.

A

Brett Hundley

Analyst, The Vertical Trading Group LLC

And I guess what I'm trying to understand is, when I think about the impacts that have weighed on you during fiscal 2018 and I try and think about how to put my model together for fiscal 2020 and – or excuse me, fiscal 2019 and fiscal 2020, the way I've always kind of lined things up is, look, as you guys went through fiscal 2018, you had this commodity drag that was upwards of a 100 basis points by my math. You had a freight drag that I think was

Q

close to a 100 basis points if I'm not mistaken. And then you had a garlic bread issue that weighed on you that that you've now gotten around.

All along, you've been lagging with pricing and trying to recover a good portion of that or pricing-related efforts and you've also had your Lean Six Sigma efforts and if I'm not mistaken, I think a lot of the cost saving efficiency work that you've been trying to drive is potentially upwards of a 200 basis point impact to margins if not more over time.

So you can correct me if I'm wrong in any of these, but the point I'm trying to make is, if you guys are able to get PNOC-positive and let's say there comes a point during fiscal 2019 where you recover freight, you recover commodities and you are even again, those Lean Six Sigma efforts, all else equal, should really flow in and give you guys some really nice margin improvement potentially as you exit fiscal 2019 and fiscal 2020. But I just want to make sure that I'm on the right track there because if your PNOC was positive in Q4 2018, I would have maybe expected better gross margin performance. So maybe you can just help me tie all this together. [ph] I hope (00:33:50) that make sense?

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

So I'll take you through a couple of things, maybe starting first with kind of an update on our Lean Six Sigma program. It continues to be up and running; with every passing quarter, we graduate another class of green belts and the program gets more completely seeded into the organization. I think I mentioned in a prior call, we were achieving somewhere in the mid-seven figures of savings every single quarter and that seems to be where we sort of got the organization up to a gallop and we continue to run at that pace.

So you're exactly right on that piece, Brett. Maybe it might be helpful to sort of help you true-up sort of PNOC versus margin. When we think about pricing, really there is two things; the first thing you want to do is you want to cover the cost in the absolute sense and that's sort of what PNOC gives you. And then you want to make sure that you're getting enough pricing to not only recover your input costs, but to continue to protect your margins, right? So pricing to go in excess of PNOC and get margin protection.

What we've done this time through is, we're getting the PNOC. And PNOC by the way includes both pricing and the cost savings, both components of that. Has exceeded the amounts that we're seeing in the input cost. The reason why you are not seeing necessarily flow all the way into holding margins or expanding margins is there's still an increment that we haven't completely covered that we're working against, which is that difference between covering the inflation to cover the input cost and also expanding it beyond that to hold on to our margins. That's the piece that's happening, just as a little context for why there was a little further unwinding in this period.

Now, fast-forward, how do we think about fiscal year 2019? Overall, sort of in reference to Mike's question earlier in the – or commentary here, we expect to see us – based on what we're seeing today in the commodity environment a sequential improvement for the year overall. We do expect to see that the first half is going to be way down because of the continued elevation of freight cost. For us in the industry, it's a big number and we have two more full quarters of that to hit and one more quarter of egg.

So, I think that's why we're saying we're going to see a bit of a drag. I think you would expect to see that the story continues to improve. But as far as more significant building, it's probably going to be back half just honestly because of the factors that I described. Egg inflation in Q1 – all of inflation, but egg inflation predominantly and then trans inflation for the first half.

Brett Hundley

Analyst, The Vertical Trading Group LLC

Q

That's really helpful. So, as we get through H1 of 2019, would it be your hope that by the end of that time periods or heading into H2 that that final increment of pricing is through for you guys – I mean, all else equal?

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Yeah, I'd like to think so based on what we're seeing right now, and I think it also – as we think about 2020 and the period thereafter, we're sort of assuming that we're going to see sort of a low grade of inflation on a going basis, hopefully not to the degree to which we saw in fiscal year 2018.

But as we think about sort of inflation versus deflation, we're expecting a continued inflationary environment probably somewhere in the half of the range that we were seeing in the most recent year. And I think it's because of the strength of the economy; it's because of things like linerboard and corrugate where the owners are almost an oligopoly of resin suppliers that tend to operate the same way, where – those are areas where it continues to be tough. So, we're expecting that the combination of our Lean Six Sigma program and good careful pricing is going to allow us to continue to improve our margins and offset inflation.

Brett Hundley

Analyst, The Vertical Trading Group LLC

Q

Is labor included in that? Has labor cost popped up for you in any meaningful way?

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

It has. If you think about our business, roughly two-thirds of our absolute costs come from raw material and packaging and about a third of the costs are in conversion, of which labor would be a component. We are seeing labor. The most significant place where labor [indiscernible] (00:38:14) is in freight because it's really – we don't have a truck shortage, we have a trucker shortage and that's where you're seeing that inflation.

Parenthetically, some of the things that we're doing in this space of Lean Six Sigma, things like automating the end of lines with palletizers and stuff like that are helping take the edge off of some of the labor pinch that we're seeing in our factories.

And that's part of our long-term plan, honestly is to figure out where can we invest in automation to take out unskilled labor so we're relying more predominantly on true skilled labor. That helps us today. And as we think into the future about things like healthcare cost, workers' comp cost and everything else, it'll help us as well.

Brett Hundley

Analyst, The Vertical Trading Group LLC

Q

The last thing I just want to ask you is on your reduced trade spend and couponing. I think that was something that was certainly well planned heading into the quarter. I think you guys talked about that on your previous call actually and you've mentioned trade spend optimization tools. You've talked about that at length.

Can you just delve more into the nature of these decisions? How quickly they are being made at corporate? And related, have you been able to measure the effectiveness of these decisions? I think that these actions are

somewhat newer for you guys, but I'm curious if you've been able to measure effectiveness and whether these tools are working net-net for you guys.

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Yeah. So I think probably about a year ago or so we talked about our priority to invest in the space and we've invested in sort of a range of elasticity tools and others. And essentially what we've done are two things. One, we have centralized some of the decision-making around, for example, should you run a promotion, a two-for-five versus two-for-six into a group of folks that are running the modeling on the elasticity so we know when we're getting a good economic payback for a price and when we're not. And then what we're doing is, there are folks farther out in the field that are working to focus on execution versus what those pricing decisions should be.

So, both the tools and the process are in place. And ideally what we're doing is on an iterative basis looking in each of our categories, whether it's in bakery items or dressings and dips and making those decisions in the context of competition and inflation and everything else.

What I would tell you is, as with any other pricing decision, it requires time with the customer where we sit down and we sort of explain to the customer why we would like to move away from a BOGO to, let's say, a two-for-five or a two-for-six. Sometimes they balk; sometimes they don't. If we feel very strongly about it, we'll really toe the line. If they can create the case with some sort of value-added provision for why that might make sense, we might listen to them. And we will always work with them, but we may decide to go their route.

But I think, culturally, what's evolved here is we're really using the tools. We're centralizing the strategic decision-making within the Retail business around those tools, and the folks in the field are just focusing a bit more on just good execution.

Brett Hundley

Analyst, The Vertical Trading Group LLC

Q

Thanks for the comments.

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Thanks, Brett.

Douglas A. Fell

Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

A

Thanks, Brett.

Operator: [Operator Instructions] Your next question comes from Frank Camma with Sidoti. Your line is open.

Frank Camma

Analyst, Sidoti & Co. LLC

Q

Yes. Good morning.

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

A

Hi, Frank.

Douglas A. Fell

Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

Good morning, Frank.

A

Frank Camma

Analyst, Sidoti & Co. LLC

Hey. You kind of gave us some flavor on some inquiries here on the capital allocation with CapEx. Just wondering if you could comment on the acquisition environment. Any changes there given what's going on...

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

Yeah.

A

Frank Camma

Analyst, Sidoti & Co. LLC

...just in – yeah, can you just give us an update?

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

Sure. So, great question, Frank. We remain really active in that space. I will tell you that we have a range of things that we sort of continue to work through, but that's sort of an evergreen process. As far as sort of specifically the pricing environment, valuations remain lofty even as interest rates go up.

A

Frank Camma

Analyst, Sidoti & Co. LLC

Yeah.

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

So, we haven't really seen a material change in valuations and expectations. But rest assured, we're very aggressively out in the marketplace today.

A

Frank Camma

Analyst, Sidoti & Co. LLC

Okay. I think – so given the fact that you still have an excellent balance sheet, a lot of excess cash, does it ever make any sense to build out even partially your own freight network, or is it just not practical given your different lines?

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

No. It's a great question. So, today, if you look at our business sort of by history, we're heavily dependent within the broker space.

A

If you think about it, essentially it evolves into one of three categories where you can own your own assets, you can work with dedicated providers with longer term agreements, or you can go out and buy on spot market. But by tradition here, Frank, we had been heavily reliant on the spot market where during times where there was a glut of trucks and drivers, we were a beneficiary. For you folks, you think about it this way. This is the way I thought about it. In an interest rate world, we were floating versus fixed.

Frank Camma

Analyst, Sidoti & Co. LLC

Right.

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

And fast forward when things changed, all of the sudden spot market prices went up more aggressively. Now, more nearly into your question, we are looking at doing both; addressing it two ways. One, we are in the marketplace looking to secure drivers and assets. We have a small group of drivers today in our own assets, and we use those today in our most expensive lanes. What we also did just this past quarter is we put out an RFP where we talked to some of the biggest national freight providers, and we're looking to expand our utilization of dedicated freight which essentially allows us to have many of the same benefits of owning the assets, but without having to own them.

The big difference being when you own the trucks, you can ship the product outbound to the customer and then you can benefit from any sort of backhaul that you can generate. You can generate that same sort of benefit with backhaul by going to dedicated. So, we are in the process actively of implementing the expansion of this dedicated work. And based on the results of the pilot, we would expect to expand that even farther.

Frank Camma

Analyst, Sidoti & Co. LLC

Great. Thanks, guys. That's helpful.

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

And ultimately – yeah. Just a last point if I may, Frank. Just ultimately get into a position where freight cost as with other commodities are more predictable for us.

Frank Camma

Analyst, Sidoti & Co. LLC

Right. Right.

Q

David A. Ciesinski

President and Chief Executive Officer, Lancaster Colony Corp.

We don't like the volatility and we know that you folks don't either.

A

Frank Camma

Analyst, Sidoti & Co. LLC

Right. Thanks.

Q

Douglas A. Fell
Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

A

Thanks, Frank.

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

A

Thank you, Frank.

Operator: Your next question comes from Brian Holland with Consumer Edge Research. Your line is open.

Brian P. Holland
Analyst, Consumer Edge Research LLC

Q

Thanks. Just a quick follow-up. Going back to the balance sheet, I think – I believe I have this right that in 2012 and in 2015 you paid a special dividend out. It sounds like there's a lot of stuff still in the pipeline from an M&A standpoint. I think within the past year or so, there's been a more stated preference for M&A as a use of capital as opposed to maybe dividend or stuff like that.

But just sort of curious if you could reset for us kind of what your priorities are for capital allocation and maybe where something like a special dividend or what have you, where that might fall in line relative to M&A, et cetera.

Douglas A. Fell
Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

A

Brian, this is Doug. I don't think much has changed since we've last communicated our thoughts on capital allocation. I think as Dave has mentioned, the number one opportunity is certainly to invest back into our business as we've discussed here today; and then certainly as we've mentioned in our earnings release and the like, certainly to continue to look to extending our dividend increases. Beyond that, M&A is clearly in the forefront of our minds and would be our desire to look for an M&A opportunity before issuing any sort of special dividend. But we continue to evaluate that as we go through time. So, again, I don't think much has changed since our last commentary on capital allocation.

Brian P. Holland
Analyst, Consumer Edge Research LLC

Q

Thanks. I appreciate that.

Douglas A. Fell
Vice President, Chief Financial Officer & Treasurer, Lancaster Colony Corp.

A

Sure thing.

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

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

Thanks, Denise, and thank you, everyone, for joining our call. We look forward to giving you guys an update on our progress in the fall. And in the meantime, we look forward to seeing you guys out in the marketplace.

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

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