Corrected Transcript

25-Jan-2018

Lancaster Colony Corp. (LANC)

Q2 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Leandra 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 2018 Second Quarter Conference Call. Conducting today's call will be Dave Ciesinski, President and CEO; and Doug Fell, Vice President, Treasurer 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] Thank you.

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

Dale N. Ganobsik
Director-Investor Relations, Lancaster Colony Corp.

Thank you, Leandra. Good morning, everyone, and thank you for joining us today for Lancaster Colony's fiscal 2018 second quarter conference call. Let me begin by reminding everyone 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 second quarter results for fiscal year 2018. Doug and I will provide comments on the quarter and our outlook, following that we'll be happy to respond to any of your questions.

For the quarter, consolidated net sales decreased 2.2% to $319.7 million versus $326.8 million last year. Retail net sales declined 1.9% to $179.3 million, as continued growth for Olive Garden dressings, a full quarter of sales contribution from Angelic Bakehouse, reduced trade spending and lower coupon expenses were more than offset by the impact of disruptions in supply of our New York Bakery frozen garlic bread due to the production interruptions at a co-manufacturing facility, and a slowdown in late December outbound shipments due to insufficient freight capacity. Excluding the negative effects from the supply disruption in garlic bread and reduced end of quarter shipments, we estimate that Retail net sales would've increased about 1% versus prior year quarter.

Foodservice net sales decreased 2.5%, driven by the ongoing challenges of diminished customer traffic and lower same-store sales in the United States restaurant industry. Sales to our national chain restaurant accounts, including limited time offer programs, were below the prior year amount, partially offset by inflationary pricing. Consistent with the Retail segment, late December outbound shipments of products to Foodservice customers were slowed by insufficient freight capacity as well.

Excluding the decline of limited time offer programs and reduced end-of-quarter shipments, we estimate that Foodservice net sales would have been near flat compared to prior year quarter. Consolidated gross profit declined 9.8% to $83.9 million, driven by the impact of notably higher commodity and freight cost and lower sales volume. More specifically, the increases in commodity and freight costs for the quarter were about 2% and slightly less than 1% of consolidated net sales respectively.

Savings realized from our Lean Six Sigma program and inflationary Foodservice pricing served to partially offset these costs. Note that the prior year results reflect the benefit of significantly lower ingredient cost with only a modest offset from deflationary pricing, which combined with lower freight costs led to last year's record high gross profit.

Selling, general and administrative expenses increased 2.3% driven by increased amortization and other recurring non-cash charges attributed to Angelic Bakehouse, continued investments in our growth initiatives, and a favorable non-recurring item in the prior year's quarter's corporate expenses related to a closed business operation.

Consolidated operating income declined to $47.3 million from $59.4 million in the prior year on lower gross profit and increased SG&A expenses. The Retail and Foodservice segments were unfavorably influenced by the factors referenced above, resulting in operating margin declines from 23.5% to 20.8% in Retail, and from 13.3% to 9.6% in Foodservice.

Net income was $45.9 million, or $1.67 per diluted share compared to $39 million, or $1.42 per diluted share last year, and was favorably influenced by the Tax Cuts and Jobs Act of 2017. Doug will cover the tax-related matters more comprehensively in his commentary. The regular quarterly dividend paid on December 29, 2017 was $0.60 per share, a $0.05 or 9% increase over last year's amount.

Turning our attention to retail sell through data from IRI for the 12 weeks ending December 31, 2017, we maintained our share leadership position in all six of our key categories. During the quarter, we were able to increase our share position in two out of the six categories, and we saw a modest pullback in the remainder due to our targeted trade reduction activities and the adverse impact from our supply disruption in the frozen garlic bread category.

During the quarter, total consumption for our refrigerated salad dressing business, one which we've updated you on in the past, was up 1.5%. Our base business or dollars generated at full price was up 3.4%, our incremental business or dollars generated on promotion was down 13.3%. During the same period of time, we also expanded distribution of our new Simply 60 dressings and discontinued our Simply Dressed Light, all of which will help strengthen our refrigerated dressing business on a go-forward basis.

With that, I would like to now turn it over to Doug to make some comments about 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 remains strong, and I will comment on some of the larger line items within our balance sheet compared to last year. I will make some specific comments on the impacts of tax reform as well. From a high-level perspective, the increase in our cash balances of nearly $36 million since June can be summarized as follows. Cash provided by operating activities of nearly $84 million, offset by regular dividends of $32 million, treasury stock repurchases of $1 million and property additions of $15 million. In general, consistent with past quarters, our accounts receivable remain in line with expectations and our collections and agings remain solid.

Similar to accounts receivable, our inventory balances are in line with our expectations as we exited the seasonally high retail shipping period of our second quarter. The increase of nearly $7 million in other current assets since June reflects the timing of federal estimated payments and the favorable impacts of the Tax Act, which occurred in late December. Consequently, as of December 31, we have a larger prepaid federal income tax balance than normal. This line item should normalize over the balance of our fiscal year as we adjust our future estimated federal tax payments.

As I mentioned, cash expenditures for property additions totaled $15 million in our first half. This level of spend is in line with our estimated annual CapEx of $30 million for fiscal 2018. Consistent with our past communications, the largest amounts have been spent on the new process and equipment to accommodate growth and plant improvement projects to enhance productivity.

The expansion of our warehousing and production capacity at Angelic Bakehouse continues to remain on schedule. The warehousing phase of this project is expected to be largely completed during Q3. Depreciation and amortization expense totaled $13 million for the first half and we expect similar levels for the second half of fiscal 2018. The significant decline in our other non-current liabilities and deferred income taxes since June 30 largely reflects the one-time benefit of $9 million resulting from the Tax Act mentioned in our earnings release earlier today.

With respect to our balance sheet capitalization, we continue to have no debt and over $621 million in total shareholder's equity. We ended the quarter with nearly $179 million in cash and equivalents and we continue to have available borrowing capacity under our credit facility of nearly $150 million. Finally and broadly speaking, our income tax provision for Q2 was favorably impacted by the Tax Act in two ways. First, a $9 million one-time benefit resulting from the re-measurement of our net deferred tax liability as of December 31. And second, a lower blended effective tax rate.

In consideration of all the significant elements of the Tax Act and excluding the one-time benefit for our deferred tax re-measurement, we estimate our blended effective tax rate will be 28.3% for fiscal 2018. As previously reported in our Q1 commentary, our effective tax rate was then 34.2%. Consequently, our tax provision for Q2 was effectively only 22.5% to adjust for the overprovision in Q1.

As noted in our earnings release, the total impact of the Tax Act on our second quarter net income was approximately $14.5 million or $0.53 per diluted share. Of this total, $9 million or $0.33 per share reflects the one-time deferred tax benefit mentioned previously, while the remaining $5.5 million or $0.20 per share resulted from lower tax rates, nearly half of this amount related to the overprovision in Q1.

Looking forward, at this time, we estimate our effective tax rate for fiscal 2019 to be approximately 24%. We estimate the Tax Act will serve to lower our annual income taxes and in turn raise our annual cash flows in the range of $15 million to $20 million.

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 the second half of our fiscal year, we're implementing corrective actions to recover and meet demand for our frozen garlic bread products. Nonetheless, we expect tour he sales to be somewhat constrained by supply to the end of our third quarter.

With regard to commodity and freight cost, while we anticipate some reduction from the very high levels we experienced in the second quarter, we expect those to remain above last year's level for the balance of the fiscal year. We're actively working with asset carriers and brokers to rebid shipping lanes wherever possible. Early in our fiscal third quarter, selective price increases took effect in both Retail and Foodservice segments in response to higher commodity and freight cost. Additional Retail price increases are planned for early in the fourth quarter of our fiscal year. We project that these price increases will serve to offset the higher commodity and freight costs through the back half of our fiscal year. We will also continue to generate cost savings from our Lean Six Sigma program at or above level, a mid-seven figure level achieved through the first two quarters of our fiscal year.

On the sales volume front, we'll address our challenges through improved execution and new product introductions. For example, late in our fiscal second quarter, we are excited to introduce a three pack of wing sauces to the retail club to our channel under a license agreement with Buffalo Wild Wings. To-date, the product is performing exceptionally well. In the coming months, we will continue to add to our Olive Garden line of dressings with the launch of Parmesan Ranch, another product that we're extremely excited about.

Our fiscal third quarter will also benefit from a shift in timing of Easter holiday sales. In light of the initiatives we now have in place, our current outlook for freight and commodity costs when compared to fiscal year 2017, we expect our consolidated results to show a pickup in both gross margins and operating margins for the last two quarters of fiscal year 2018.

Before I close, I'd like to expand a bit on the recent tax reform legislation. As Doug outlined, excluding the onetime benefit for our deferred tax remeasurement, we expect to see about a 600 basis point reduction in our effective tax rate for fiscal year 2018, and about a 1,000 basis point reduction beginning in fiscal year 2019.

Independent of the new tax legislation, our business priorities remain the same. In mid fiscal year 2017, we launched our growth plan, which consisted the following three priorities: accelerating our base business growth, growing our margins through supply chain optimization; and expanding our core with focused M&A. During the past year, we've rolled out key elements of that growth plan such as category management capabilities and Lean Six Sigma. Both of these initiatives are already generating meaningful value.

Concurrently, we've been performing a comprehensive assessment of our supply chain and business infrastructure to identify opportunities to improve the competitiveness and scalability of Lancaster Colony. The lower tax rate and accelerated depreciation per capital expenditures that the new legislation provides will make the returns on these initiatives all the more compelling. However, we're continuing to work through this assessment with our board and we look forward to sharing the findings with you later this year and early into the next year.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And your first question comes from the line of Brett Hundley with the Vertical Group. Your line is open.

Brett Hundley
Analyst, Vertical Trading Group LLC

Q

Hey. Good morning, guys.

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

A

Good morning, Brett.

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

A

Good morning, Brett.

Dale N. Ganobsik
Director-Investor Relations, Lancaster Colony Corp.

A

Good morning, Brett.

Brett Hundley
Analyst, Vertical Trading Group LLC

Q

Can you please remind me what percentage of your frozen garlic bread is outsourced from a production standpoint. I think it's the one product in your portfolio that has a fairly meaningful proportion of production outsourced?

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

A

That's true. I don't think we've ever necessarily dimensionalized it, but it is a meaningful amount. It may be a worthy benefit for the group to expand about this a bit here while we may. During the most recent quarter, we had a supply disruption due to a fire in this facility. This facility has been a long-term partner of ours for more than 20 years. As our business has grown, they have grown with us. They had the disruption. We've put in place corrective actions including our maintenance people and our engineers in the factory to work with them to get it online.

We've also gone out and secured incremental co-manned facility until we're completely back online with production. But what's complicating the matter is this is a seasonal business where consumption spikes during this particular period of time. They're not dissimilar from let's say catch up during July 4 or Memorial Day. So the disruption took place at the very time when we want to be building inventory going into a peak season, which in turn depleted the inventory and it's made it challenging because even though we have the factories up and online, it's difficult just to keep up with the demand because of the seasonal nature of the spike and when it takes place. So rest assured, we have everything up against this and we expect itself to begin to be resolved, but it did have a measurable impact in the quarter.

Brett Hundley
Analyst, Vertical Trading Group LLC

Q

Okay. And yeah, I mean, one of my recent concerns about co-manufactured product relates to one of the nation's largest retailers out there really focusing hard on working capital accounts, customer service levels and things like that. And I've been worried about those producers out there that have co-manufactured product being at a relative disadvantage to captive producers out there. And frankly. with the way you guys are positioned, I expected that to be a relative to competitive advantage for you because of the fact that you do produce most of your stuff in-house. Can you give us a sense for your exposure to customers that are really focused on customer service levels right now within your frozen garlic breads? So in other words, this production impact that you're seeing, is that leverage to retailers like that and are you at risk of seeing longer-term business disruptions related to that? I hope that question makes sense.

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

A

No. No, it does. I would back up maybe just a second and then address the first question. All things being equal, as an operator I would prefer to own my facility or the company, too, so that they can have direct control over the circumstances. Having said that, I've been involved in situations that most of the companies I've been in the past where they have long-term co-packer relationships, and this is a fact in one of these relationships. And this factory literally integrates into our distribution centers and everything else, so today they've been a very cost effective and service friendly operator for us to work with. Having said that, I go back to my first comment that we would rather control it at the end of the day. Moving forward and beyond that, you ask a question about how do we take and consider the long-term implications of what's taking place. If you think about the way it's flowed through the P&L, the first thing that we did is we went and we pulled promotional events, as you would expect, and we also pulled back on advertising so that we weren't [ph] docking (19:57) demand at a time we didn't necessarily want to.

So when you look at the business in more detail, you're going to see a slowdown in the aggregate and then you're going to see a greater slowdown on promotion versus base business. As we get on the other side of this, and production gets back to where we wanted it, it's matching the need on the demand side, what we would begin to do is resume those activities sort of in the normal course.

You're likely to see a couple of effects. On the downside, you're going to see a little bit of a constrained situation on supply that impacts demand. On the other side, what you're likely to see is we've depleted the pipeline in the business. So once we're back in business, you're going to see basically retailer inventories start to build back, so that's why we believe this is going to have somewhat of a little impact in Q3 and then, like I said, resolve itself thereafter.

Brett Hundley
Analyst, Vertical Trading Group LLC

Q

Okay. Okay. That's really helpful. My last question then I'll yield the floor is just on pricing. You talked about selective price increases that you've taken previous to today, future ones that you're going to be looking to allocate to a complete raw material cost basket. And I hear that selectively with some other companies trying to look at the cost basket as a whole to include energy, logistics, et cetera. You guys sound pretty confident with your commentary on taking that pricing to market and having those discussions with your customers, can you just color that a little bit for us and maybe talk to your category leadership, your market positioning, your portfolio, whatever it is and your views on that?

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

A

Sure. So I'll take it in two tranches, the first tranche that I'll speak to, Brett, is Foodservice. So as you and most of the other folks on the phone are familiar with, we have contracts that have escalators and de-escalators. So in our Foodservice national account escalators are going into effect, they went into effect this month. And the second side of that business is what we call our branded business which are things that are sold under our brand to smaller operators or to non-com segments like colleges, universities and healthcare. Those price increases have also gone into effect and they're rolling out the door.

On the retail side as you recall when we were together on the phone in the fall, we talked about implementing price increases and we said, hey, look, given the rapid acceleration that we saw in commodities, we felt like we could not get there by pulling trade alone. So we felt compelled to take the price increase. We've had those conversations and we find that we are, after some pushback, getting price realization in those categories. I think the difference versus prior periods is every one of the retailers that we're talking to are expecting a lot of information about how we're justifying these. And as a case in point, we have a new VP of Procurement that joined us probably about eight months ago now. A gentleman that was a long-term Nestlé executive and then was at Kraft and then Kraft Heinz subsequently, has been actively involved in going out on sales calls with our sales folks, meeting with buyers to walk through the underlying cost assumptions.

So I think once we get to that level of granularity, they don't like it. Some customers actually do. After a little pushback I think they're happy to see it, but there are some others that don't. So net-net I think it's just the onus is on us to be able to document what's happening and to go out. One piece that's new in this quarter, and I know we're sort of at the frontend of the earnings calls this season, is what's happened in freight. And most of you probably saw the article on the front page of The Journal today that talked about this. What we're seeing on freight, which has broken out from our commodity costs, is really an unprecedented spike that happened in this quarter. And it was driven – it started at the last quarter with the two hurricanes, but really it jumped up almost in order of magnitude thereafter and in sort of a one, two, three punch. The first was the bomb cyclone that took effect.

The second thing was the fact that it got incredibly cold, bomb cyclone notwithstanding in the Northeast between Christmas and New Year. And then the last was the implementation of the ELD, these electronic logs, that in turn combined, [ph] for it (24:35) to get very difficult for us to get trucks, particularly refrigerated trucks. We usually don't dimensionalize the stuff, but just to put it in an order of magnitude, we had 60 trucks between Retail and Foodservice that were stranded between that period of time because we couldn't get drivers in independent of what we were willing to pay. We've since seen that normalize. We're continuing to see the upcharges come in but we are not having the difficulty getting drivers that we saw. So there was a particular pinch point that happened in that window for us between Christmas and New Year.

Brett Hundley
Analyst, Vertical Trading Group LLC

Q

Thank you very much.

Operator: Your next question comes from Michael Gallo with C.L. King. Your line is open.

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

Q

Hi. Good morning. My question is just on the food...

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

A

Good morning.

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

A

Hey, Michael.

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

Q

Good morning. The Foodservice side of the business, obviously it's been for several quarters now you've had some weak restaurant sales and some of the national customers as well. It would seem things showed some signs of improvement in the fourth quarter, and obviously you have some large new launches going on at some major national chain accounts on the soft side that I would think would help you somewhat. So I guess you just start to look at the second half of the year and you begin to lap that, as well as having maybe a better alignment of pricing. Would you expect that we should actually see the Foodservice business starting to return to more normalized growth? Thanks.

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

A

Yeah. Here's how I would think about it, Michael. First on the pricing, the pricing is in effect. And for the first time, we're going to start to see positive price realization on this business after in some cases deflationary pricing, so it's actually unwinding last year around the same time the other way so now it's swinging to the positive. That's the first thing that's going to create a tailwind.

In this particular quarter, we had an unusually high amount of limited time offerings. I don't think we -I'm looking at Doug here, we haven't traditionally dimensionalized these. But just to give you an idea, if you go back and you look at let's say the previous 12 or 14 quarters, this was the second highest that we had had over that period of time. So we were lapping that and the LTOs that we had this period around were lower which resulted in a more negative offset.

The other thing that happened in this business is of the 60 trucks that I described, 30 of them were tied into this business. You put all that together, normalized trucking, you put into it the fact that the LTO comp that we have in this upcoming quarter is lower. And the fact, as you're pointing out, we are seeing in some selective pockets signs of life, we would expect to see this business start to get better. I'm not going to go all the way forward, Michael, and say that we're going to expect to see normalized growth, but I think you're going to see it bounce off of where we were this quarter and start to turn towards growth.

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

And then in terms of just the issues in New York Bakery, I mean it sounds like the plant is back up and running. You're trying to catch up but demand is obviously good. I guess as we look beyond the third quarter, is there any reason we shouldn't expect to see that return to kind of the normalized growth rates kind of Q4 and beyond, and might there be even a catch-up where at some point you ship in more product or would that just be some share shift and those shipments are kind of lost forever?

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

So here's the way we're looking at it right now. There are a couple of things that we believe are going to happen that I would be happy to share with you. The first is as we work our way through this, there was a [ph] big B mode (28:27) of retailer inventory. Not only did this get tight within our supply chain to constrain our ability to ship, but it even resulted in limited out of stocks on retailer shelves. So what we expect to see is as we're able to produce more than near-term demand, we have the opportunity to go back and replenish trade inventory so that's going to provide a tailwind for the business.

The other thing that we're going to do is resume the normal levels of marketing and promoting against the business, and then we also have some new item news that we were planning to launch into the next fiscal year. So at this point I don't expect to see this result in a structural dislocation in the business. It was obviously an unfortunate case of bad execution on our part that we're pushing to resolve and get on the other side of.

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

Thanks very much.

Operator: Your next question comes from the line of Frank Camma with Sidoti. Your line is open.

Frank Camma
Analyst, Sidoti & Co. LLC Q

Hey. Good morning, guys.

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

Good morning, Frank.

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

A

Good morning, Frank.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

A couple of questions. Just clarification on the tax rate. You gave a lot of good detail there but you said 24% for fiscal 2019, and I think you gave sort of a blended rate for 2018. But is it safe to assume that your next two quarters you report that 24% since it's now in that calendar year or how do we model that, I guess?

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

A

Good question, Frank. And sorry for not being a little bit more clear on that. For the balance of fiscal 2018, we are using 28.3%.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Okay, great. The other question is in the past – I know it obviously changes year to year, but in the past you've sort of given us a range of what you expect when there's an early Easter, any chance you can give us just, just sort of a rough idea of what that means for the shift in sales for Q3 this year?

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

A

Yeah. In terms of just a rough ballpark figure, as a percentage of the retail sales it's going to be about 1%.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Okay. Okay, great. And my last question is more of a big picture question on just given that Amazon Wholefoods now together and online, I mean, still not big in your categories, but it does seem to be growing pretty quickly. Given that it's not a physical location, it's hard to – it's different from the way you promote these things, how do you approach promoting your products, your brands in that category given where it's likely to be over the next several years and a tremendous growth in the investments behind it? How do you look at that and you know capture that growth?

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

A

Sure. I'll address that, Frank. What we're doing today is we're really focused in our activity close in on the retailers' online activities. So if you think of Kroger's ClickList program and there's a whole range of other retailers that have comparable programs, and that's really where we're devoting the lion share of our time today. We are doing sales on a more limited basis with Amazon, particularly on some of our dry products. And we're in the process of figuring out how we can do that at scale and make sure that we're doing it profitably.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

And do you – is it something that you can be more promotional with given the way it works or is it like – how do you view that? Are you still sort of – obviously you pulled back on promotions overall this quarter so that helps profits, but like I guess how do you view that like as far as – you're already number one market share in all these categories, so...

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

Yeah. So it's – I'll just share with you sort of a long-term view for not only us but everybody in the industry is in a situation like this where more and more of the business starts to go to online. And in our categories, particularly things like frozen and refrigerated which have been the slowest to adopt, but having – just sort of setting that aside and saying any brand, any CPG company, the real risk is here you become "below the fold". That is the retailers start to present options to consumers. You're below that fold. They're no different than Amazon results if you are shopping for something at home. And I think that's the area that we're focusing on. To-date, the retailers are evolving in the way that they're tying in their online promotions with in-store promotions. In most retailers, the run, it's almost two separate marketing arms.

Frank Camma
Analyst, Sidoti & Co. LLC
Q

Right.

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

I think as they start to integrate their online business more into what they're doing in-store, I think we're going to see more and more of that. But I think that's ultimately for us and the industry, the big watch out is that you essentially land below the fold and you become somewhat disintermediated.

Frank Camma
Analyst, Sidoti & Co. LLC
Q

Right. Right. Thanks. That's helpful.

Operator: Your next question comes from the line of Alton Stump with Longbow Research. Your line is open.

Alton K. Stump
Analyst, Longbow Research LLC
Q

Thank you and good morning, guys.

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

Good morning, Alton.

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

Good morning, Alton.

Alton K. Stump
Analyst, Longbow Research LLC

Q

I guess I'd just ask about the Foodservice business. Of course you mentioned in the press release about overall restaurant industry volumes being down. We had heard that [indiscernible] (34:16) we're getting better particularly during the early part of calendar 4Q, some of that weather related, it became seasonally warm. I guess was it a case of the overall industry being down or was it more about like just your particular major customers maybe – I don't think...

[indiscernible] (34:33)

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

A

Alton, if I can sort of walk you through it, you looked at almost the flow of our business from October, November, into December. The latter half of December was particularly tough for us. And we don't know if it was a big slowdown because of the bomb cyclone and the cold weather, but we did see a pretty significant slowdown in December. What I can tell you on the other side is we're looking at orders on a go-forward basis. They seem to have resumed to more of a normalized level, but that change in traffic patterns into restaurants, then exacerbated by the fact that we were having trouble getting trucks out of our own docks into combined to put pressure on the business. So I think if you were to look across the scope of let's say the last 18 months, I don't know if I'm in a position to say, well, looks like it's getting a lot better. But I don't believe it's getting worse.

Alton K. Stump
Analyst, Longbow Research LLC

Q

Got it. Makes sense, that's helpful. And then I guess just back on the Retail side of things, anything noteworthy from a competitive environment standpoint that you're seeing, particularly in the quarter addressing this business?

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

A

Yeah. I'll walk through some of them for you. We've focused a lot on New York justifiably, our Olive Garden business and the portable salad dressing continues to perform exceptionally well. We launched a 32 ounce item that we expected to net cannibalize the 24 ounce and the 16 ounce. What we're finding is that it's not, and the velocity in that business remains very, very high, the brand continues to grow so we're extremely excited about that. It remains a great growth story inside of the Retail segment.

What I also mentioned in my comments on that was we work closely with our partners at Darden Restaurants and Olive Garden, and we've agreed to launch an Olive Garden Parmesan Ranch that we've co-developed with the restaurant folks. We've tested it in their restaurants as well as with consumers, and it's performed exceptionally well. And we're particularly excited about that because the Parmesan – or just the ranch segment is about 2.5 times the size of Italian. So if we can achieve any measure of the growth that we've seen on the Italian side, we think we have the right to really continue to grow there.

Moving over to Sister Schubert, we had a very good holiday season, Thanksgiving and Christmas both. We continue to expand distribution behind a 20-count size. Again, we're not exactly sure how it's going to perform in the marketplace, what we were looking for was this idea of expandable consumption that if we could get more into the freezer, that consumers would consume it more often and that in fact is proving out. So that business continues to perform very, very well.

On the refrigerated dressing side, I made some comments. A year ago we were talking about excessive trade activity from a couple of competitors and we were following suit. And we shared with you how we intended to go in and make some strategic changes to our lineup, to our packaging and to address our trade strategy, and we've worked our way through that and on the businesses as I described to you. Our business is returning to growth, we're just below the category average now. Most of the competitors, except for one, have also pulled back trade and we've used this intervening period to clip SKUs and to focus on higher performing SKUs. So we remain pretty bullish about that category as well. I'm going to knock on [indiscernible] (38:19) here on the desk that I'm sitting on and tell you that I think the worst is behind us and better times are here to come. So I'm not going to – hopefully not jinx myself.

Flexing over to dips, we had a good but not a great caramel season. And dips remains the next focal area for that team that I described on Marzetti that they're going to focus on. We do have some new items that we're readying for launch early into next year that I think are going to be very exciting, and we'll change things up significantly.

And then I'll move around and talk about some of our smaller what we call specialty brands in the portfolio that really don't get a lot of attention, our Cardini's, Girard's and a range of others. And there too, we're making packaging changes and we're changing formulations on SKUs and those are going to be shipping here in the next few months as well. So as you look across the balance of the portfolio, we feel like a lot of the innovation activities are starting to take root, we just need to do more and do it faster.

Alton K. Stump
Analyst, Longbow Research LLC

Q

That's great. Thank you so much for all the color.

Dale N. Ganobsik
Director-Investor Relations, Lancaster Colony Corp.

A

Thank you, Alton.

Operator: Your next question comes from the line of David Stratton with Great Lakes Review. Your line is open.

David M. Stratton
Analyst, Great Lakes Review

Q

Good morning, and thanks for taking the question. When we look at...

Dale N. Ganobsik
Director-Investor Relations, Lancaster Colony Corp.

A

Good morning, David.

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

A

Good morning, David.

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

A

Good morning, David.

David M. Stratton
Analyst, Great Lakes Review

Q

Thank you. When we look at the impact from the new tax bill on your CapEx and your expected expenditures, particularly in areas where you see room for growth, has that adjusted your guidance for the year or do you have any plans in place at this point where that money might be allocated?

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

A

I'll walk you through that. So we went into the year and I think the guidance we provided was that we expected to spend about $30 million and we remain on track to spend that $30 million. With really the one big slug of that was going to expand capacity at Angelic Bakehouse which is on time and on budget. We're getting ready to open up the new freezer and be able to utilize that space within a week or so.

And the other area where we said we were going to devote CapEx was up against our Lean Six Sigma program which has really fully taken root. And as I mentioned in my comments, we're generating solid mid-seven figure net benefits against that every single quarter now, so we're excited about that. As we think about things on a go-forward basis, really our expectation is to not use the windfall to drive a change in strategy. We set a strategy around the items that I described earlier on, David, accelerate in our base business growth, improving our supply chain and optimizing it and improving our margins, and then looking for smart bolt-on acquisitions.

And really the big change for us is the change in deductibility and how it's going to help improve the IRRs. But honestly, if a project was on the bubble, I don't know if just a change in the tax rate would for us justify pushing it over the line. Really, what we're trying to do is just be very disciplined where we're putting that money. I think it's been one of the hallmarks of Jay and the team here that led the business for really a really long time and we expect it to stay true to that.

David M. Stratton
Analyst, Great Lakes Review

Q

Great. And then you mentioned potential acquisitions, is there anything on the horizon or could you kind of give us an update on the landscape and what you see there?

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

A

Sure. Well, we're always out shopping I can tell you that much for sure. We have a couple of things that we're looking at, but nothing necessarily that's imminent. As far as prices, and what's going on in terms of multiples, I don't – we haven't seen it necessarily trickle down into the way people are thinking about multiple expectations. I think the landscape largely remains the same. So I think good assets are expensive but not out of reach. It's a lot of times just convincing the seller that the time is right to sell.

David M. Stratton
Analyst, Great Lakes Review

Q

Thank you.

Dale N. Ganobsik
Director-Investor Relations, Lancaster Colony Corp.

A

Thanks, Dave.

Operator: And your last question comes from the line of Brian Holland with Consumer Edge Research. Your line is open.

Brian P. Holland
Analyst, Consumer Edge Research LLC
Q

Thanks. Good morning, gentlemen.

Dale N. Ganobsik
Director-Investor Relations, Lancaster Colony Corp.
A

Good morning, Brian.

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

Good morning, 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

So most of my questions have been answered. I did want to ask a housekeeping and forgive my ignorance if you addressed this. Appreciate the color that you gave on the top line impact from the production and supply issues, as well as the freight capacity. Did you give a sense – or if you didn't quantify this, if you could, the impact on the operating margin line?

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

Of commodities or of freight? Are you asking...

Brian P. Holland
Analyst, Consumer Edge Research LLC
Q

Just anything, I guess, and you can give it in the aggregate, would be fine as well.

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

Sure. Sure.

Brian P. Holland
Analyst, Consumer Edge Research LLC
Q

Just anything outside of just normal commodity. I mean, obviously with commodity inflation you had, but anything that you sort of would define as beyond unusual in the quarter that you wouldn't think is sustainable beyond the next quarter or two?

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

Yeah. So a couple of things, maybe I'll look to Dale and Doug to jump in. I may be hitting commodities first. I think the way we characterized it, so if you're thinking about your modeling, is on commodities, we said the amount was 2% of net sales. And by the way, that's a net number, that's net of procurement activities that we had. The gross inflation that we had in this particular quarter was even higher than that. As we look at the outlook on inflation, we expect to see it to start to moderate. So as we look at eggs in particular, eggs were a high watermark in this particular quarter and we're starting to see that abate somewhat, offset then, of course, by pricing activities and stuff like that.

On the fray, I think the way we characterize that, and this isn't the disruption in timing but this is the cost increase that we incurred. I think we characterize that as slightly less than 1% of an upcharge just in transportation cost within the quarter is the way we've explained that. We would expect that to remain higher than prior quarters, but then start to come down. The real measure that we're looking at here is what we call PNOC which is pricing net off of the commodity. So that would be – if you look at commodities both gross inflation and then net inflation after our, let's say, procurement activities and things like Lean Six Sigma and then we look at pricing. And for the last four quarters and in the last two quarters, in particular, we've had very negative PNOC where the commodities have significantly outweighed our ability to cover on pricing. As we swing into the back half, we're going to start to see PNOC swing in our favor for the first time due to the Lean Six Sigma activities, procurement where we've been able to get out in front of some of this stuff as well, so that's probably worthy of note.

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

Brian....

Brian P. Holland
Analyst, Consumer Edge Research LLC
Q

Go ahead.

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

Brian, this is Doug. The one thing that Dave alluded to that I think is worthy of emphasis is the pricing of the eggs. And as he mentioned, they are beginning to come down, but they are still going to be at levels still higher than that over the prior year. And we live in a bit of a delicate balance with the laying flock, and certainly the issues that were happening over in Europe. And so I think a big piece of what Dave is conveying is the continued decline in the egg price that we anticipate seeing. Should there be an interruption in the supply of eggs somewhere around the globe, that could certainly swing things the other way pretty quickly and abruptly so just a bit of caution on that.

Brian P. Holland
Analyst, Consumer Edge Research LLC
Q

Thank you both, tremendous color. Last question for me just kind of a big picture. Taking note of what we're seeing in the scanner data for you guys. You talked a little bit about Sister Schubert's last quarter. I think it's interesting when you sort of flesh out the data, the kind of growth that you're seeing on the other side of SKU rationalization efforts and the tighter focus on your best performing SKUs. I think that's netting out to something like high-single digit growth into year-end, which is obviously very impressive.

We're seeing total point to distribution declines accelerating for you. I think across crew times and dips for instance. And I think you talked about being proactive in SKU rationalization last quarter as well. Maybe two things. One, is that certainly – is the support – what we're seeing in data support of what you talked about last quarter with being proactive. And obviously, the second part of that is innovation? How long and how painful is this process in the near term? And if we look at Sister Schubert's, is that a fair proxy for what you think you could do on certain of these brands where you tighten that focus here?

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

A

Yeah. Sister Schubert is the role model. That's the blueprint that we're using. So if you go back we reduced the number of SKUs to what the team called Sister 7 and re-focused all of their selling activities against getting that assortment right to ensure that instead of having items number 1, number 14, number 15 and then number 5, 6 and et cetera, that first and foremost you have items number 1 through 7. And then layering on top of that [audio gap] (48:04) innovation, and that is the model. So that's the model that's being applied across the board.

If you look at dips, for example, which you called out, if you look at where we are losing distribution on that or the Otria dips, they candidly just were underperforming. So we've discontinued that sub-line and we have innovation that we're ready and that's going to come in behind it. At the same time, I want to be forthcoming with you guys as well though that a lot of this is intentional. That being said, I don't like seeing the timing while we're dipping down before we're coming back up. What I'd like to see longer term is a tighter match of our timing between when we're making discontinuation decisions and when we're launching the new items. So I think let's say that we're launching part of the blue book or the playbook effectively, but we're not all the way there, that we want to tighten it up.

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

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

Well, thank you everybody on the call today for joining us. We look forward to talking with you this spring as we share our third quarter results. And we hope to get a chance to see some of you out in the marketplace early this year. We'll talk to you guys later. Bye now.

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