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Lancaster Colony Corp. (LANC)

Q1 2021 Earnings Call

CORPORATE PARTICIPANTS

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Thomas K. Pigott

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OTHER PARTICIPANTS

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Analyst, Consumer Edge Research LLC

Todd M. Brooks

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

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Joanne, and I'll be your conference call facilitator today. At this time, I would like to welcome everyone to the Lancaster Colony Corporation Fiscal Year 2021 First Quarter Conference Call.

Conducting today's call will be Dave Ciesinski, President and CEO; and Tom Pigott, CFO. All lines have been placed on mute to prevent any background noise. After the speakers have completed their prepared remarks, there'll be a question-and-answer period. [Operator Instructions] Thank you.

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

Dale N. Ganobsik

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

Thank you, Joanne. Good morning, everyone, and thank you for joining us today for Lancaster Colony's fiscal year 2021 first quarter conference call. Our discussion this morning may include forward-looking statements, which are subject to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially and the company undertakes no obligation to update these statements based upon subsequent events. A detailed discussion of these risks and uncertainties is contained in the company's filings with the SEC. Also note that the audio replay of this call will be archived and available at our company's website, lancastercolony.com, later this afternoon.

For today's call, Dave Ciesinski, our President and CEO, will begin with a business update and highlights for the quarter. Tom Pigott, our CFO, will then provide an overview of the financial results. Dave will then share some

comments regarding our current outlook and strategy. At the conclusion of our prepared remarks, we'll be happy to respond to any of your questions.

Once again, we appreciate your participation this morning. I'll now turn the call over to Lancaster Colony's President and CEO, Dave Ciesinski. Dave?

David A. Ciesinski

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

Thanks, Dale, and good morning, everyone. It's a pleasure to be here with you today as we review our first quarter results for fiscal year 2021. I'd like to begin by extending a sincere thank you to the entire Lancaster Colony team for their tremendous effort during the past eight months as we confronted the impact of the COVID-19 pandemic. From the front-line workers at our plants and distribution centers to all the associates and leaders throughout our business, I'm extremely proud of how we've pulled together and worked in common cause to meet the shifting demands of our business.

Throughout the coronavirus, we've remained steadfast that our mission is fixed: first, to provide for the health, safety and welfare of our teammates; and second, to ensure that we continue to play our role in our country's vital food supply chain. Despite the uncertainty, we completed our fiscal first quarter with consolidated net sales growth of 3.6%. Net sales in our Retail segment grew 16.6%, while net sales in our Foodservice segment declined 9%. Excluding Omni Baking sales, consolidated net sales grew 5.2% and Foodservice net sales declined 6.4%.

Retail net sales benefited from higher demand as the impact of COVID-19 drove higher at-home food consumption. Frozen garlic bread, Olive Garden dressings and frozen dinner rolls were the biggest contributors to the increase in Retail net sales. Based on IRI data, consumption during the period outpaced shipments in a few categories. We are already seeing shipments catch up as we move through our second quarter. Per IRI, notable highlights for the quarter include the following. Sales of Marzetti refrigerated salad dressings grew over 12%. New York Bakery frozen garlic bread grew almost 15%. Branded croutons advanced over 21%. Sister Schubert's frozen dinner rolls increased 24.5%. And Olive Garden dressings grew a very strong 45%. We were also pleased to see that our recent new product introductions added about 4 percentage points to our Retail segment's Q1 sales growth, as the Chick-fil-A and Buffalo Wild Wings sauces continued to perform very well.

In late October, we began the long-anticipated regional rollout of Chick-fil-A sauces in the Southeast region. The news was officially announced on October 22 by our strategic partner, Chick-fil-A, on their social media platform, The Chicken Wire. By week's end, the news had garnered millions of media impressions. As previously outlined, we will be expanding distribution of these items across the United States during the remainder of our fiscal year. Overall, we were thrilled with the top-line growth of our retail business. And we're bullish about the long-term outlook. However, as you will hear later in my comments, this growth came at a substantial cost due to efficiencies that are likely to persist in this pandemic environment.

In our Foodservice segment, the upward trend from the lows we encountered this past April continued throughout the quarter. National account, quick service restaurants and pizza chain customers led the way. Despite the pandemic, we continue to partner closely with key national accounts on a range of new sauces that have and will continue to be featured on their menus in the weeks and months ahead.

Despite the relatively strong top-line results, consolidated gross profit for the quarter was essentially flat at \$92.7 million versus \$92.1 million last year. The benefits from the heavier retail sales mix were offset by the aforementioned higher manufacturing costs due to COVID-19, increased commodity cost and increased freight

costs. As Tom will detail later in the call, the higher manufacturing costs consisted of both hard costs for items such as hazard pay, [ph] production air gaps (00:06:13) and PPE; and soft costs such as manufacturing inefficiencies resulting from our efforts to keep up with the increased demand and maintain adequate service levels.

Before I pass it over to Tom, I would also like to briefly update you on our Bantam Bagel business. Late in Q1, we were notified by Starbucks that due to the impact of the coronavirus pandemic on their breakfast business, they were planning a range of menu changes, including the discontinuation of the Bantam line in the restaurants. As Tom will point out, this resulted in two non-cash adjustments during the period. While we were disappointed by the decision, we remain pleased with the Bantam acquisition and we're very bullish about its future.

I'll now turn the call over to Tom Pigott, our CFO, for his commentary on our Q1 financial results.

Thomas K. Pigott

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

Thanks, Dave. Overall, the results for the quarter reflected strong growth in our Retail segment, higher costs primarily related to the COVID-19 outbreak, as well as some accounting adjustments on the Bantam business. First quarter consolidated net sales increased 3.6% to \$349.2 million. Excluding Omni Baking sales of \$2.8 million in the current year quarter and \$7.9 million in the prior year quarter, consolidated net sales increased by 5.2%. As you recall, Omni Baking sales are attributed to a temporary supply agreement. The supply agreement came to an end in late October as planned.

Consolidated gross profit increased \$0.5 million to \$92.7 million and margins declined by 80 basis points. The favorable revenue growth in the Retail segment was offset by higher manufacturing costs, including costs related to COVID-19 and higher commodity and distribution costs.

The COVID-19-related items included about \$4 million in incremental front-line worker pay and other hard costs of about \$1.5 million for shift separations and expenditures for personal protective equipment as we invested to ensure for the safe operation of our facilities. We also incurred incremental soft costs totaling an estimated \$3 million. These costs were driven by the increased demand and mix changes related to COVID-19. More specifically, these expenses included increased overtime pay, internal freight and distribution costs, and utilization of some less-efficient production lines to help meet demand. Note that compared to our fiscal fourth quarter ended June 30, total pounds produced increased more than 20%.

Selling, general, and administrative expenses increased \$8.7 million or 22.2%. There were three main drivers of the increase. First was the investment we're making on Project Ascent in support of our ERP implementation and related initiatives, which accounted for \$5.6 million of the increase. The remaining \$3.1 million increase was driven by higher spending for digital marketing to attract and retain new customers as well as incremental IT infrastructure costs.

The company recorded two special items this quarter related to the Bantam Bagels business as a result of the discontinuation Dave mentioned. First, we revalued the contingent consideration or earn-out liability to the sellers of Bantam using fair value accounting. Based on this analysis, we reduced the current value of the projected earn-out payment by \$5.7 million, creating the income you see on the contingent consideration line of the P&L. Second, we evaluated the intangible assets of this business, which resulted in an impairment charge of \$1.2 million. Both items were recorded in the Foodservice segment results.

Consolidated operating income declined \$2.8 million to \$48.9 million. This result reflects the items I mentioned earlier, most notably the higher expenditures for Project Ascent and the unfavorable impacts of COVID-19, partially offset by the change in the earn-out projection. Excluding all these items, the key driver of operating income growth was a strong top-line performance with Retail segment.

Our effective tax rate was 24.3% this quarter versus the tax rate of 23.3% in the first quarter of fiscal 2020. We estimate that our tax rate for the remainder of this fiscal 2021 to be 24%. For first quarter, diluted earnings per share decreased \$0.13 to \$1.35. The adjustment to contingent consideration increased earnings per share by \$0.16. Higher expenditures for Project Ascent accounted for \$0.15 of the decline. EPS was also impacted by the impairment charge, lower interest income on our cash holdings, and the increase in the effective tax rate.

With regard to capital expenditures, first quarter payments for property additions totaled \$14.4 million. For fiscal year 2021, we are forecasting total capital expenditures between \$70 million and \$90 million based on plans currently in place. We're in the process of evaluating additional and potentially significant investments to meet the growing demand for our dressing and sauce products. These investments will be additive to this forecast.

In addition to investing in our business, we also return funds to shareholders. Our quarterly cash dividend paid on September 30 was \$0.70 per share, an 8% increase over the prior year amount. Our longstanding streak of annual dividend increases reached 57 years last December. Even with the investments we are making and the increased dividend payments, our financial position remains very strong as we finished the quarter debt free with \$186 million of cash on the balance sheet.

So to wrap up my commentary, this quarter reflected strong growth in our Retail segment and improving trends for the Foodservice segment. We continued to monitor and adjust to the impacts of the COVID-19 outbreak. But overall, the health of the business remains strong.

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

David A. Ciesinski

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

Thanks, Tom. As we look ahead, we will continue to leverage the combined strength of our team, our operating strategy and our balance sheet in support of the three simple pillars of our growth plan: first, to accelerate our base business growth; second, to simplify our supply chain to reduce our cost and grow our margins; and third, to identify and execute complementary M&A to grow our core. Our base business is expected to continue to grow in this difficult environment.

Looking forward to our fiscal second quarter, historically, our biggest sales quarter of the year, sales for both our Retail and Foodservice segment will remain subject to the shifts in demand resulting from COVID-19. We expect our Retail segment sales will benefit from the continued growth of frozen bread products and dressings and sauces. Our licensing platform, in particular, is poised to provide stronger growth in the second half as we expand distribution nationally on both Buffalo Wild Wings and Chick-fil-A sauces.

In Foodservice, we anticipate our quick service restaurant and pizza chain customers will remain a positive for us. We foresee inflationary headwinds from commodity and freight costs for the remainder of the fiscal year. We also expect we'll continue to incur higher operating costs to keep up with the demand and maintain service levels in this challenging pandemic environment. We expect our cost savings programs and favorable net price realizations will help to partially offset these cost increases.

Specific to our supply chain strategy, we're in the final stages of evaluating the significant investment in production capacity to address the increasing demand for our dressing and sauce products. We intend to have more to share with you on this in the future.

Project Ascent, our ERP initiative, remains on track as we've now completed the design and build phases and we are in the testing phase. We expect to continue our testing and preparation through the remainder of this fiscal year followed by the commencement of the deployment phase in early fiscal 2022.

In closing, I would like to, once again, thank the entire Lancaster Colony team for all that they have done during this quarter to fulfill our mission despite all the unprecedented challenges.

This concludes our prepared remarks for today, and we'd be happy to answer any questions you may have. Joanne, over to you.

QUESTION AND ANSWER SECTION

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

Brian Holland

Analyst, D.A. Davidson

Q

Yeah. Thanks. Good morning, everyone. A few quick hitting ones here. Can you give us an update on how much new products contributed in the quarter?

Thomas K. Pigott

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

A

Yeah. So, it's 4 percentage points to the Retail business is what it did.

Brian Holland

Analyst, D.A. Davidson

Q

Okay. Sorry if I missed that when you were commenting...

David A. Ciesinski

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

A

No, Brian. Great question.

Brian Holland

Analyst, D.A. Davidson

Q

Pivoting over to...

David A. Ciesinski

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

A

Just to give you an idea...

Brian Holland*Analyst, D.A. Davidson*

Oh, go ahead.

Q

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

...biased a little bit heavier towards Buffalo Wild Wings as the Chick-fil-A sauce, for all intents and purposes, was really just isolated to Florida. We didn't start to ship that into the Southeast region until the very end of October.

A

Brian Holland*Analyst, D.A. Davidson*

Okay. That's very helpful and good to know. And then, just quickly on the Bantam business. Two-part question here. One, can you quantify the drag from the loss of Starbucks to revenues over the next 12 or so months, as you lap this? And then, kind of as we look across broader Foodservice here, do you see risk of similar menu rationalization across the balance of your portfolio?

Q

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

Well, we'll hit it maybe in sequence. I'll hit the second question first. We don't quite see anything quite like the Bantam item, because most of what we're doing are key menu items that if it's a sauce, let's say, it's usually helping to hero some sort of protein that's on the menu, so i.e., they're featuring some sort of a hamburger build or a chicken sandwich build and our sauce would be central to that. We have seen them work to simplify what they're doing. We haven't seen a downside to that. Really, the bigger impact we're seeing in Foodservice is a movement away from [ph] bulk (00:17:02) packaging to portion control. So, case in point, if you look at our Cryovac business in Foodservice for the period, it was off probably to the tune of somewhere around 20%, but our portion control part of the business is very, very strong.

A

So, we're seeing those sort of things. But in this particular case, I think what's happened is, across all the Foodservice, the breakfast occasion has been hit particularly hard because people continue to work from home, right. So if you think about that morning routine, it continues to be impacted. And I think as Starbucks has watched their businesses evolve, they took the opportunity to step back and say, what needs to be true for us to simplify our breakfast assortment to make sure that we're running as efficiently as possible. The unfortunate thing is the velocity on the items in the stores that were open remain very, very strong. And it just – it was a decision that they've made.

As far as the impact, I would prefer not to get into that. I would tell you that it was in the higher-7 figures, probably the way I would categorize it. But I would flip that with, we also have a real long pipeline of new opportunities that we're in the process of chasing. We had actually sort of tapped the brakes on chasing new opportunities just because of capacity limitations on that business. So, that's why we remain really bullish about where it's going.

Brian Holland*Analyst, D.A. Davidson*

So, in other words, it sounds like you have some degree of confidence that that lost capacity, if you will, it can find another home there just based on customer interest that you had?

Q

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

A

Yeah, exactly. We have a strong team working against it. We have a strong pipeline of new product introductions, some of which are going to take us into the occasion like snacking, like a pizza bit sort of item. So, there's a whole range of really exciting activity and the team [ph] that just fastened their (00:18:59) chinstrap extra tight and we're just pushing forward.

Brian Holland*Analyst, D.A. Davidson*

Q

Okay. And then, Dave, maybe just to get kind of your latest high-level foodservice industry thoughts. I guess, what's particularly noteworthy here, the second wave concerns with COVID-19. So, maybe just kind of what you're seeing kind of since quarter end, if we've seen a plateau in trends, any pullback, anything that you're looking at, one way or the other?

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

A

Yeah. It's a great question and I'll sort of hone you in on transaction data. If we look at – we'll start with Foodservice, first, Brian. If you look at, really, all transaction data, all national accounts for the months of August, September, and October, those three months, they were running roughly down 10% on transaction. However, the transaction size were bigger, so they weren't down as much. When you look at the QSR segment, the QSR segment was probably running somewhere down, like let's say about maybe 8.5%. The casual dining segment was actually doing quite well. That was probably running somewhere down around 10 to 11 points. And midscale is the segment that really continued to drag, right. They were having a harder time with off-premise dining sort of solutions and they were off in the mid-20s.

Here's our thesis, right, that what we foresee happening here? And we've been talking about this really for maybe the last month or so. We have predicted that there was going to be a spike. We believe that it's the combined effect of the fact that weather is getting colder in the Midwest and in the Northeast and other parts of the country. People are heading indoors. Combined with the fact that we think that there's just an overall COVID weariness where people are maybe letting down their guard. So, we fully anticipate that there's going to be a spike in cases.

Here's what I think is likely to happen. I think the QSR segment has done a tremendous job of pivoting to solutions like their drive-through and then to delivery solutions and pick-up. And I think if I had to guess, you may see them pull back slightly, but very much. I would be surprised if we saw that pullback maybe more than a couple of points. I think even casual dining, if you look at concepts like Buffalo Wild Wings and a range of others had done a really nice job of breaking the code on off-prem dining.

I think where you're likely to see that impact most severe is on the mom and pops up and down the street that haven't broken the code on off-prem dining. It is conceivable that you could see schools shut in parts of the country, which might have an impact, although that's probably a tough one to forecast. And I would say areas, in particular, that are heavy into the breakfast occasion, if I had to speculate, will be impacted. Now, the flip side of that, we're already – so I would say, net across the industry, you're going to see a couple of points of pullback that's going to be biased against the midscale and then casual with a lesser effect on QSR.

On the retail side, we're already starting to see a small hook, where it's picking up a couple of points. And I do expect that you're going to see that likely to continue. I think the case is here – we can check in with each other a few months down the road. But I would speculate that they're going to continue to grow through November into

December, and then you'll see them begin to gradually work their way down as a result probably of some more stringent lockdowns state by state. And then, hopefully, in the spring, people are starting to talk about better therapeutics or maybe even a vaccine. So, we're anticipating we're going to be wrestling with this through the remainder of our fiscal year, [ph] and up (00:23:00).

Brian Holland*Analyst, D.A. Davidson*

I appreciate all the color there.

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

A long answer to a short question. I apologize for that.

Brian Holland*Analyst, D.A. Davidson*

No. No. No. That was great. I appreciate the color. If I could just sneak in one more, and then I'll hop out, really just want to understand kind of I think aside from the phantom business update, the thing that stood out the most was, obviously, the margin shortfall in the quarter. I think if I had Tom right, about \$8.5 million of costs tied to COVID, some hard, some soft.

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

Yeah.

Brian Holland*Analyst, D.A. Davidson*

If I pair that – yeah, and if I pair that with your commentary, it sounds like we should expect similar magnitude of headwind over – or at least until you start to lap some of that maybe around Q4. But I want to make sure that I understand on the rest of the business is, how big of an impact were commodities and freight, how much of an offset were you able to get there? I am trying to dimensionalize what you were able to offset, what you couldn't offset. And then it also sounded like some of the margin pressure came from maybe running hot on capacity constraints given obviously what you have to do to maintain employee safety and facilities and the demand. So, if you could just help us understand that, because that's not necessarily – that's an issue near term, but maybe a sign of underlying strength here when you're running that hot. But maybe you can help clear that up for me.

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

Yeah. Yeah. That's a pretty good assessment. So, as we look at the hard costs, those are things that we're doing to run safely and to reward our employees for working during this difficult environment. And that was the \$5.5 million or 150 basis points of margin degradation. But what we saw this quarter that we didn't really experience too much of in the fourth quarter was the soft costs we talked about. So, we're running the factories much harder to keep up with demand and producing a lot more pounds of product, which you can see we're positioning our inventory a little bit – in a little bit stronger position than we've been in the past to try to keep up with this demand.

So as we look at it, as we go into Q2, certainly, the hard costs will continue. And in this case, we do expect the soft costs to continue. Now, as time progresses, we have some actions in place to try to mitigate some of the soft

costs. And over time, as you think about it over the longer term, as Dave mentioned, we are going to be making some more investments in capacity to set ourselves up to drive margin growth over the longer term.

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

A

Brian, and I can even try to put – maybe illustrate it with an example. Tom mentioned that if you looked at Q4 to Q1, our pounds in our factories were up 20%. That's, obviously, a pretty big increase just in pound. But what that doesn't really highlight is the mix of the pounds. We have parts of the business, like Cryovac, which were down 20% and then we had Olive Garden, which we highlighted was up 45%. We had a month where pounds were up 60% on that business. And it's those sorts of swings within our network that are putting a lot of stress and strain on stuff. We're running, for example, bottled items in lines that weren't necessarily optimized to run those. And we're running with them to keep up with service levels to make sure that we're not disappointing our customers and incurring fees.

So, as you pointed out, this was a bit of an extraordinary set of circumstances that are bringing this together. And we do have an aggressive range of actions in place that we think will help us begin to bend the curve on these items. Maybe even – I think we'll see these actions take effect late in Q2 and we'll start to see the greater manifestations of them in Q3, particularly around increasing our own internal capacity and bringing online other co-packers.

Brian Holland*Analyst, D.A. Davidson*

Q

Appreciate all that color, as always. Best of luck going forward.

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

A

Thank you.

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

A

Thanks, Brian.

Operator: Your next question comes from Todd Brooks from C.L. King & Associates. Your line is now open.

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

Q

Hey. Good morning, everybody. Just a few questions for you. Looping back to some of that discussion that Brian just ticked off on the gross profit side. In talking about a couple of line items that you did call out as far as freight costs and some commodity inflation, can we get some more color there on the headwinds that they created in the quarter? And I know some commodities were seeing very spiky behavior versus trend behavior. Where you're seeing pressure, is it more of a spiky nature due to COVID-19 or is this trend behavior due to demand? And do you expect this will have a tail for multiple quarters?

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

A

Well, maybe I'll lead off with a quick answer and let Tom give you more texture. There's a big part of this that is related to COVID. And in particular, what's happened is that it's being driven by an imbalance or supply and demand shortage on drivers. In all of our analysis since the outbreak of COVID, a lot of the trucking schools have either slowed down or shut down. And as a result, what you're seeing in the industry is a shortage of drivers. And intuitively speaking, it kind of makes sense. If you're a candidate who wants to learn to drive a truck, about the last thing you want to do is to climb in a cab of a truck with somebody that you don't know and spend a bunch of time on the road. So, I would say, really, what's catalyzing it isn't a shortage of assets, but it's drivers. And we think that's going to resolve itself on the other side of the pandemic. But Tom, if you want to [ph] dimensionalize it (00:28:46)...

Thomas K. Pigott

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

A

Yeah. So, the freight and costs were in the low 7-digit numbers, commodity inflation as well. But I would tell you on those items that, certainly, the commodities, the [indiscernible] (00:29:01) program is working. We did dial back the trade spending to offset that impact. So, really, as we look at the quarter, the degradation on the margins is really the COVID hard and soft costs.

Todd M. Brooks

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

Q

Okay. Fair enough. Thank you. And then, if we think about SG&A, ex the ERP costs, it looks like if you back out from both the quarters, we were up about 30 basis points year-over-year in the fourth quarter. Thoughts on those other drivers of SG&A, digital marketing spend, incremental IT, infrastructure costs. If you're looking at this expense line, how does the kind of 11.5% experienced in the first quarter compare to what you're expecting over the balance of the year?

Thomas K. Pigott

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

A

So, yeah, when you take out the project expense costs were up 9% in the quarter. In terms of the investment in consumer and digital marketing to retain new customers, we feel very good about the spend. The Nielsen metrics or the IRI metrics we get back suggests we're being successful in attracting and retaining new customers to our retail franchise, which will benefit us for the longer term. So, that investment will continue into the remaining quarters of the year. The IT infrastructure costs. There, we're investing to kind of shore up our overall infrastructure and making some investments around cybersecurity. We expect some of that to mitigate towards the second half of the year. But overall, from a percentage increase, we do expect the first half of the year to be heavier than the second half in terms of the level of the increases.

Todd M. Brooks

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

Q

Okay. Great. And then, finally, if you can look back around to Chick-fil-A, you talked about the Southeastern region rollout that started at the end of October. And you guys are getting your minds around to dimensionalizing the opportunity here. Can you maybe talk to maybe the institutional capability to handle this magnitude of a potential launch, either experience that was brought from other launches of this magnitude or expectations for what you need to build internally to handle this size opportunity? And can we talk – I know there was some talk about the inventory growth being stronger in the quarter as you're trying to probably catch up with some of this outsized demand. But is there – within the \$25 million of growth in inventory, is there an element of that that was building towards this Chick-fil-A launch in the Southeast in the upcoming fiscal quarter? Thank you.

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

A

The answer to the first question on inventory was, yes, part of it was preparing for that launch and part of it was just a seasonal build because as we go into our second quarter with items like Chick-fil-A and other bread products, seasonally we see more consumption. So, that was a deliberate action on our part to prepare for what's coming up ahead of us. As far as just preparations on infrastructure, maybe I'll start first with the people, and I think I would probably characterize our team as consisting of – as of a lot of veterans from other big CPG firms. I spent a lot of years at Kraft and at Heinz, where I managed their US portfolio at Heinz and the grocery business in Kraft. If you look at the person who leads our Retail business, and he's a veteran of P&G where he worked on Old Spice; our Head of Sales was a 25-year Kraft veteran, and we have a lot of CPG veterans throughout our whole supply chain. So I do – I feel very good about the team that we have in place

Now, the second piece of that is the infrastructure. You probably caught in Tom's comments and my comments that we did highlight the fact that we're in the late stages of evaluating a capacity expansion project, and that's tied specifically to these items. And it's also tied to growth that we have in-flight in Foodservice to support our Foodservice Chick-fil-A business. It was a project that we had initiated. We had approved by our board, but we tactically paused as COVID broke out, just to see where things were going to go. Predicated on what we're seeing now, as we're in COVID and the outlook on the Chick-fil-A items and Buffalo Wild Wings, we're reinitiating that project and going forward.

That's going to create a bit of a bridge in between, where we are today and then where we'll go longer term once that other capacity comes online. And what we're planning to do there is the same thing that we've done at other places where we've worked, which is to utilize co-packers and to basically get more throughput through existing lines. So, we have one new line internally in our own network that's going to be coming up and it'll start production in January. We have some initiatives that will speed up throughput on existing lines by changing fillers and things like that, that will also come in line in January. And it will be a combination of those. So, those are all the things that we're doing on the supply side.

Now, what we'll tell you also is we've been very deliberate about throttling things on the demand side. If we had just gone out and worked with Chick-fil-A and made the grand announcement and tried to do this nationally, it would have blown us up. It's a big item. I would submit that really even having worked at Kraft and Heinz, it could potentially have blown them up. It's just it's a big item. Right. And it's not like anybody is sitting around with that sort of capacity. So, that's part of the reason why we've elected to do a test in a market to calibrate how big it is, work with our partners, our customers, so they can figure out how much holding power they need on a shelf. And then take those learnings and take those to other customers out in the marketplace and put together regional rollout, starting with the Southeast into the Midwest and up into the Northeast and then eventually out into the West.

So, that allows us to match the supply and demand. So, really, if you get a sense, we do have a very detailed plan to bring online the capacity to keep up with this. But we're also trying to manage our own destiny by being smart on the demand side.

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

Q

Very, very helpful. Thanks, Dave. Appreciate it.

David A. Ciesinski

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

A

You're most welcome.

Operator: Your next question comes from the line of Ryan Bell from Consumer Edge Research. Your line is now open.

Ryan Blaze Bell

Analyst, Consumer Edge Research LLC

Q

Great. Thank you. Good morning, everyone. You said that the impact on a full year basis for Bantam, given the Starbucks discontinuation, is something in the 7 figures. And then I think I caught something about you saying you're implying that it's reasonable to believe that the Bantam business should find a new home from some of the existing interactions you've had within Foodservice. Is there anything we should think about in terms of potential timing [ph] broadly (00:36:02), and potentially, the magnitude of the replacement of the demand that had been lost due to the Starbucks discontinuation?

David A. Ciesinski

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

A

I'm not sure if I follow this question. Tom?

Thomas K. Pigott

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

A

Yeah, I think what – in terms of kind of the outlook on Starbucks, I think it's a little premature for us to come out and give you the specific flow in terms of how things will come back. I think as Dave mentioned, there's a good pipeline of initiatives and products. But as the discontinuation occurs towards the end of the calendar year, we will definitely feel it in the near term. The longer term, we feel good about the outlook of that business.

David A. Ciesinski

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

A

Yeah.

Ryan Blaze Bell

Analyst, Consumer Edge Research LLC

Q

Okay. That...

David A. Ciesinski

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

A

I would say that the impact of that is going to be felt as we're bringing online a lot of growth from our licensed products as we expand that capacity. So, per the earlier question, as you think about this, it's really Q2. It's going to be into Q2 and Q3 when we're really starting to see the impact of those licenses expand, and that's why as we look out over the horizon, we dimensionalized it for you. But I don't think it's going to be a material impact in the period because of the growth that we're bringing online.

Ryan Blaze Bell

Analyst, Consumer Edge Research LLC

Q

Okay. Thank you. That's very helpful. And could you provide a little bit of context about the foodservice industry with respect to [ph] new occasion (00:37:27) exposure. Breakfast is, obviously, a bit weaker. Is there any way you could talk about how the occasion mix is impacting your business overall?

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

A

Yeah, absolutely. I would love to. So if you look at it, what we've seen is historically breakfast was a big occasion. Obviously, lunch was a big occasion. Post-COVID, what we've seen is breakfast is the occasion that's been most severely impacted, and we see lunch and really dinner occasion that grew. And if you looked at transactions, transactions have trended down. You can think about lots of individuals stopping at, let's say, their favorite coffee shop or wherever to get something to eat on their way to work, those occasions are down. And what you're seeing are occasions where people are going through a drive-through and instead of buying for one, they're buying for four or five. But breakfast, net-net, is the occasion that's most severely impacted.

Really, we don't play very heavily in the breakfast space. If you think about the products that we make, garlic bread, garlic sticks, we make dinner rolls – yeast rolls, Parker House rolls, and then the dressings and sauces, and salad dressing, they tend to play more heavily at lunch and dinner. Where we do have exposure in breakfast, two areas. One was, obviously, the Bantam business at Starbucks. The other occasion that we have or the other customer is Chick-fil-A, where we make an item, but their business tends to be a stand-out that it has resumed growing again, albeit not at the same rate it what was before, but their comps are positive on breakfast. So, as you're looking at sort of occasion to occasion shifts, I don't think this is likely to result in a material impact to our business just because of the products that we're supplying at this point in time.

Ryan Blaze Bell*Analyst, Consumer Edge Research LLC*

Q

Thank you. And I think probably one of the last things for me. Would you be able to discuss your positioning in foodservice relative to some of your key competitors? Obviously, the [ph] robust, honestly, (00:39:32) Retail business isn't helping to offset the softer trends within Foodservice. Could you maybe comment on the potential impacts your competitors might be experiencing? And ultimately, what that might mean in terms of capital allocation decision?

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

A

Yeah. So if you think about it, I'm going to focus most on dressings and sauces and maybe cut it this way. If you look at our business, about two-thirds of our business is in national accounts and a much smaller percentage of our business is in what we call branded or a business up and down the street. Even within the national account business, that three-quarters, 75%, more than 60% of that, about two-thirds of that is tied to QSR. So, just because of how our business is configured, and within QSR, both QSR and pizza QSR. So if you kind of go through the roster, Chick-fil-A, Taco Bells, Domino's, Papa John's, folks like that, that's really where the center of gravity of our business is in foodservice. And the reason why we play there and we played there well over time is because of the way we partner R&D to R&D with these folks.

So, we have one of our – even in a COVID environment, one of our strategic QSR customers is coming in this Friday to do a top to top and a menu development project with us. And we had another very important one that we worked with, albeit over Microsoft Teams, last Friday. So, a lot of that work is continuing. And I think we're somewhat unique in the industry that we are heavily biased towards national accounts and within that QSR, and we sell R&D to R&D. A number of our other competitors tend to either play in commodity-oriented products, let's

say mayo or mustard, where there isn't customization, that might make them a little bit more susceptible to bidding; or they're more heavily developed in the branded piece of the business, right. So, that would include K-12 education, higher education, things like healthcare. It would include a smaller restaurants and then entertainment venues, everything from stadiums to concert venues and things like that.

That's a part of our business where we are – honestly, it's been an opportunity area for us that if you've been listening to our calls over the last handful of years, I've called out and said that I think there's room for us to be strategic about which segments we go after. But for right now, it's serving us well because we're biased on the other side. So as far as our positioning, I would definitely take our positioning for a couple reasons. One, because of our customers. But the second part of it is because of how we partner with those customers. They don't really just view us as a commodity and a cost, but we work marketing to marketing, R&D to R&D, and they view us as a means by which they can create signature items and break through the noise that's out there today, and attract customers.

Ryan Blaze Bell

Analyst, Consumer Edge Research LLC

Q

Great. Thanks a lot for the color there. That's it for me.

Dale N. Ganobsik

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

A

Thanks, Ryan.

David A. Ciesinski

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

A

Thanks, Ryan.

Thomas K. Pigott

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

A

Thanks, Ryan.

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

Todd M. Brooks

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

Q

Hey. Just one follow-up question. If you talked about the work that needs to be done to launch a product of the magnitude of Chick-fil-A, while simultaneously launching a product of the magnitude of the Buffalo Wild Wings, single serve sauces or single bottle sauces. Can you talk about the kind of front end of your license product pipeline? New partners approaching you, willingness to engage in those discussions and take them on, capability to maybe, with the proper lead times, add more meaningful products to this roster of licensed products that's about to really expand with Chick-fil-A and Buffalo Wild Wings.

David A. Ciesinski

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

A

So, generally, I'll give you an overview of the process. And ordinarily, today, it has started with a longstanding foodservice relationship and a partnership. So, not only were we a supplier, but oftentimes we're working with

them to collaborate on new menu items. So, they already have a lot of confidence in our [ph] new (00:44:07) organization. They have a lot of confidence in our supply chain organization. And really, the new introduction that takes place as we introduce people within our Retail business and, in particular, the people that lead the licensing team, and we got a great team of folks that do this work. So, it's a Foodservice and Retail joint call, where they go and they dimensionalize the opportunity.

If the Foodservice customer's interested, then obviously you advance the talks and you begin to talk about particular items and things like that. And we begin the work of dimensionalizing how big is the opportunity. That would be no different than any other Retail launch that we were doing with any of our own brands. Advances from there to a discussion about the license and those negotiations, once you [ph] firm (00:44:56) that up, then you advance into things like packaging design.

One of the things that's very unique about our license model is that the products that we sell in Retail are the exact same formula as the products that we sell in Foodservice [ph] today (00:45:10). So, take Buffalo Wild Wings, it's the exact same formula. The salad dressing for Olive Garden, both [ph] palm branch (00:45:15) and the Italian, it's the exact same stuff. And Chick-fil-A sauce, both items that we're going to be offering, the exact same items. So, there are supply chain efficiencies on the back end. They don't worry about the formula and the stability and stuff like that. They're familiar with it. They're in and out of our factories regularly, performing their own QA checks. So, that brings a measure of confidence as well. Beyond that, once you get into that [ph] network (00:45:41), you design package, then [ph] you're ordering (00:45:44) change parts for the facility and you're into the conversations with customers.

And depending on how exciting the brand is, customers can get really excited and move to the front end of their seat. Obviously, a Chick-fil-A sauce and a Buffalo Wild Wings sauce, even Olive Garden would be those sorts of items. And then we work with our customers to dimensionalize how big is this item, because a big part of this is them figuring out how many casings do they need on the shelf [ph] to have (00:46:14) the holding power. And then we design the end-to-end supply chain with our customers to figure out how we make sure that we service this thing and we grow it sequentially. So, part of it is the exact same work that you would do for any of our own internal items, maybe with one unique overlay, whenever we're changing packaging we're working with our partner on the foodservice side, we're securing their approval.

And then, we also work with them on the launch, because it's just not us announcing the item. Oftentimes, they want to get involved in announcing the item and even talking about it in their own restaurants. So, case in point, Chick-fil-A. Chick-fil-A right now is offering bottled products in all of their restaurants across the United States. And as we move into the holidays, they're going to be offering to sell those as a [ph] free pass (00:46:59). So, they're heroing those items in their restaurants and they're going to be helping us sell them in Retail. And obviously, we have together a mutual beneficial interest in this.

So, that's sort of how the process works, in general. As you look at other customers, as we've continued to evolve this model what we're seeing is more and more of our existing Foodservice customers now are coming to us to explore these opportunities. And we're trying to be cautious and gauge these, making sure that we can service the growth and do it well. We're only as good as our last case that we've shipped. We're only as good as every one of these partnerships. So, we're a firm believers in, let's go slow to go fast, let's be deliberate, because we think it's a cool model at a point in time where these people licensed properties tend to play well in Retail.

Todd M. Brooks

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

Q

Okay. Great. That's very helpful. And just a final – if I take the process you just described in detail is just an 18 month kind of start to finish, or what's that window? So as we look at Chick-fil-A and Buffalo Wild Wings being at the tail end of the process, have you created capacity to start working with new partners in the front end of the process? Thanks.

David A. Ciesinski

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

A

I would tell you that in one of the more recent ones, it was 18 months. You could probably even do it faster than that, depending on how big the item is, right? So, Chick-fil-A, we started having conversations with them in the middle of 2019. And those conversations quickly advanced. And then, we ran the pilot which we announced. We've been calibrating based on the pilot to make sure that we thought very deliberately through our supply chain strategy. And here we are rolling out the region. So, I would say, a year would be very fast, just to make sure that you could keep up with the item. 18 months to get going, I think, is a very reasonable pace.

Todd M. Brooks

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

Q

Okay. Great. Thanks. Very helpful.

Operator: There are no further questions. We will now turn the call back over to Mr. Ciesinski for his concluding comments.

David A. Ciesinski

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

Thank you, Joanne, and thank you, everyone, for your participation this morning. We look forward to sharing our second quarter results with you in early February. In the meantime, we wish all of you guys happy holidays that are coming up that you keep safe, your families keep safe. And we look forward to joining you on the next call here soon. Take care.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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