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Lancaster Colony Corp. (LANC)

Q3 2019 Earnings Call

CORPORATE PARTICIPANTS

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

Thomas K. Pigott
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OTHER PARTICIPANTS

Frank Camma
Analyst, Sidoti & Co. LLC

Chase West
Analyst, Consumer Edge Research LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Jody 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 2019 third quarter conference call. Conducting today's call will be Dave Ciesinski, President and CEO; and Tom Pigott, CFO.

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

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

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

Thank you, Jody. Good morning, everyone, and thank you for joining us today for Lancaster Colony's fiscal year 2019 third quarter conference call. Before we get started, I want to take a moment to thank Doug Fell, our former CFO and our Transformation Program Officer who is also on the call with us today.

Doug, I extend my appreciation to you for the leadership and guidance you've provided us during your tenure as CFO. As Doug has transitioned into his new role here, over the past several weeks, he has also been assisting Tom Pigott, as Tom settles into his position as our new CFO. I also want to take this opportunity to welcome Tom to the team here at Lancaster Colony. Tom, we're very excited to have you join us and I look forward to working with you as our CFO.

Moving ahead, in conjunction with our earnings call this morning, I want to remind everyone that our discussion today 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, Chief Executive Officer & Director, Lancaster Colony Corp.

Thanks, Dale, and good morning everyone. It's great to be here with you today as we review our third quarter results for fiscal year 2019. It's also my pleasure to welcome Tom to our team. As a reminder, on March 15, 2019, Lancaster Colony announced the establishment of a Transformation Program Office, which will serve to coordinate the company's various capital and integration efforts, including the evaluation of opportunities to move us towards a new ERP platform.

Doug Fell transitioned from his position as CFO, effective April 1, to lead the TPO as the newly appointed Transformation Program Officer. Beyond his experience as our CFO, during Doug's 25 years of service with us, he has also served as our Senior Vice President of Operations and in other leadership positions, all of which make him uniquely qualified to lead the TPO.

Effective April 1, we also appointed Tom Pigott as our CFO. Tom is a food industry veteran with over 30 years of professional experience in finance and accounting, and most recently served as Vice President and CFO of MGP Ingredients.

His prior experience includes Vice President of Finance roles for Nestle USA's Pizza Division and the Kraft Foods Group Meal Solutions Division, where Tom and I worked together. Today Tom and I will provide comments on our fiscal third quarter results and our outlook. Following that Tom, Doug and I will be happy to respond to any of your questions.

For the quarter, consolidated net sales increased 7.3% to a third quarter record $317.9 million versus $296.2 million last year. Excluding net sales attributed to the acquisitions of Bantam Bagels and Omni Baking Company, both of which closed during our fiscal second quarter, consolidated net sales increased 3.5%.

Retail net sales improved 70 basis points to $153 million. Excluding the incremental contribution from Bantam Bagels, retail net sales were essentially unchanged at $152.1 million, as increased sales of frozen garlic bread and shelf-stable dressings and sauces sold under license agreements were offset by reduced sales resulting from the impact of this year's later Easter holiday, lower flatbread sales and the decision to selectively exit some low-margin private-label business. Retail net sales also benefited from favorable net price realization attributed to inflationary pricing, reduced trade spending and lower coupon expenses.

In our Foodservice segment, net sales grew 14.3% to $164.8 million. Excluding the impact from Bantam Bagels and Omni Baking acquisitions, Foodservice net sales increased 7.1% for the quarter, led by continued higher sales at national chain restaurant accounts and our frozen pasta products.

Consolidated gross profit improved 11% to $75.4 million, as influenced by higher sales volumes, cost savings attributed to our ongoing Lean Six Sigma program and inflationary pricing. These gains were partially offset by integration costs for the Omni Baking operations, trade investments to support expanding retail distribution of Bantam Bagels and higher overall warehousing cost.

SG&A expenses increased $8.1 million for the period driven by a higher level of investment in retail brand marketing. Most notably for our New York Bakery brand, as we withheld spending on that brand in the prior year due to supply disruptions. SG&A expenses also reflect increased investment in people and tools to support key growth initiatives and the impact of recent acquisitions.

As influenced by these factors referenced above, consolidated operating income was essentially flat at $37.3 million versus the prior year's $37.5 million. Net income was $30.6 million or $1.11 per diluted share compared to $27.6 million or $1 per diluted share last year. Note that the lower overall tax rate of 20.8% in the current year compared to the prior year rate of 27.4% primarily reflects the favorable impact of the Tax Cuts and Jobs Act of 2017. The regular quarterly cash dividend paid on March 29, 2019 was maintained at the higher level of $0.65 per share set in November of 2018.

Turning our attention to retail sell-through data from IRI for the 13 weeks ending March 31, 2019, we maintained our leadership position in all six of our key categories. During the quarter, we were able to increase share position in two out of the six categories and we saw a modest pullback in share in three of the six categories due to a target – due to our targeted trade reduction activities.

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

Thomas K. Pigott

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

Thank you, Dave, and good morning. Consistent with our past commentary, our balance sheet remains very strong. I will make a few brief comments on the more meaningful changes in our balance sheet since June 30.

From a high level perspective, the decline in our cash balance reflects the impact of cash paid for the Bantam Bagels and Omni Baking acquisitions during the fiscal second quarter, and an increase in capital expenditures in the fiscal year-to-date period.

More specifically, nearly all the decrease in our cash balance of $18 million since June 30 can be summarized as follows. Cash provided by operating activities of $143 million, offset by cash paid for property additions of $44 million and acquisitions of $58 million, and regular dividends of $52 million. In general, our accounts receivable balances remain in line with sales volumes and our expectations. Our days sales outstanding are consistent with past quarters.

Inventories are also in line with expectations and days inventory on hand are also consistent with prior quarters. As I mentioned through three quarters, cash expenditures for property additions totaled $44 million. We estimate our total capital expenditures for fiscal 2019 to be approximately $70 million.

Consistent with our past commentary, we continue to focus on projects to increase capacity and productivity, including our Sister Schubert's capacity expansion project that we expect to be in production near the midpoint of fiscal 2020, our innovation center with a targeted opening date later this quarter and a variety of ongoing packaging and end of line automation projects.

Depreciation and amortization expense totaled $8.2 million for Q3. Including the impacts of the two acquisitions we completed in our fiscal second quarter, we anticipate our depreciation and amortization expense to remain at about the same level as our fiscal fourth – in our fiscal fourth quarter.

The increase in our other assets reflects the addition of intangible assets and goodwill related to the two acquisitions. The increase in our accounts payable since June reflects the accounts payable related to the Bantam and Omni transactions, and our continued emphasis by our procurement team the [ph] expense (10:20) payment terms with our vendors, which has allowed us to reduce our cash conversion cycle by two days.

With respect to our balance sheet capitalization, we remain debt free with $187 million in cash and equivalents. Borrowing capacity under our credit agreement remains at $150 million. Finally and broadly speaking, as expected, our income tax provision for the third quarter was favorably impacted by the Tax Cuts and Jobs Act.

Our tax rate for the third quarter was 21%, reflecting federal and state taxes, partially offset by the favorable impact of employee stock award activity. Looking forward, at this time, we estimate our effective tax rate for the fourth quarter to be 24%. However, the timing and magnitude of employee stock award activity may again favorably influence our ultimate tax rate.

As always, we appreciate you joining us this morning. I will now turn the call back over to Dave for his concluding comments.

David A. Ciesinski

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

Thanks, Tom. To recap our third quarter results, we were pleased to report record net sales for the quarter led by our Foodservice segment. Our Lean Six Sigma program completed another successful quarter with cost savings that helped offset the higher costs we had anticipated for the integration of the Omni Baking operations, and incremental expenditures for product placement and marketing and support of Bantam Bagels.

Turning our attention to Q4, I'd like to update you on a few key items that are relevant to the remainder of our fiscal year. First, we expect the net sales for the first quarter – excuse me, fourth quarter will benefit from the shift in the timing of Easter. Second, we expect packaging and certain commodity costs to remain modestly inflationary. Third, we anticipate continued cost savings from our Lean Six Sigma program in the mid-7 figure range we have achieved during the first three quarters of this fiscal year.

Fourth, we are extremely bullish on both Bantam Bagels and the Omni Baking acquisitions. Case in point, in the 13 weeks ending March 31, Bantam Bagels finished number one in sales in their retail category of frozen bagels. Having said that, as we outlined during the Q2 call, we expect both Bantam and Omni to remain a modest drag on earnings for another few quarters as we continue to strategically invest in these businesses for our future.

Finally, we expect SG&A to be elevated, albeit at a more modest level than the third quarter as we continue to invest in strategic initiatives such as personnel or our TPO to drive the long-term growth of our business.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from the line of Frank Camma of Sidoti. Please go ahead. Your line is open.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Good morning guys. Thanks for taking the questions.

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

A

Good morning Frank.

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

A

Good morning, Frank.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Hey, first question, just on the overall Six Sigma program. Over time, would you expect that to have more of an impact on reducing your cost of sales or your SG&A? I assume it's obviously the entire company, but where is the greater impact over time improving the gross margin or reducing the fixed cost SG&A?

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

A

Great question, Frank. The biggest single opportunity remains in our cost of goods sold. As you know, it's roughly $900 million spend [ph] end to end (14:05). It's just a huge – remains a huge target of opportunity.

Now having said that, what you're seeing in respect to the SG&A, the benefits are showing up on the gross profit line, but there are cases where some of the spend is showing up in the G&A line, be it for let's say IT expenses or otherwise, in some cases if we're using a specific consultant to help us get at that cost.

But the target remains our gross profit and with spend that will be hitting G&A as we go. We are selectively looking at things that are down into the SG&A space now, for example some of our indirect spending, but just the order of magnitude of the opportunity is smaller there than it is in the gross profit area.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Okay. Fair enough. That's what I thought. And so, I know Omni makes the margins a little bit difficult to apples to apples compare, but if I was to perform, in other words, take out the $7.9 million is basically a wash, right. Did that essentially go through booking that as revenue, but it's also the same expense, do I have that right?

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

A

Yes, that's essentially yes, you can for all intents and purposes, it's a breakeven proposition.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Okay.

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

A

I think what's going on beyond that, just beyond just the simple margin dilution of the sale, as we outlined before, it's a factory that we bought and when we bought the factory, what we had to do is go into that factory and we're investing in upgrading the facility.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Okay.

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

A

Some of those upgrades that we're making, for example, include things that are capitalizable. For example, if we go in and we wholesale change out machinery, and we have some of that work underway. In other cases, what we're having to do is make improvements that are hitting the expense line just because of the nature of what we're doing.

Give you case in point, if you go in and you fix floors, but the scope is somewhat small but required, that's going to be expensed. If you go in and you wholesale replace all of the floor, huge swaths of the floor in a factory, that would be capitalizable.

I don't know exactly why it works that way, but I think what – when we're talking about the drag resulting from the acquisition, a lot of what we're doing is going in there and making investments in the factory to get it up to our standards from a quality and food safety perspective and to prepare for the future. It's one of those unfortunate things that it's coming with sort of a transitory cost and hit on the business.

But when you look at the overall economics of it, we spent I think on the order of $25 million to get the facility, which is still going to be probably one-fifth of what it would have cost if we would have tried to Greenfield the facility. If we would have built something from the scratch, much more of that would have been capitalized. This approach is we're just going to end up paying as we go, and you're going to see some of it hit the expense line. But that's what we're talking about.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Okay.

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

A

So yes Frank, so the great – the sales that are effectively a wash are in the Foodservice segment, the investments we're making to upgrade that facility or that cost is still in retail.

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

That's exactly right. That's a great clarification by Tom.

Frank Camma
Analyst, Sidoti & Co. LLC
Q

Oh, okay. Okay, I was [indiscernible] (17:27) like if you look at the sequential operating margins there, they seem to be impacted more than you would expect. So that makes sense.

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

Yes. If you look at both acquisitions, both of those are just proportionate drag in terms of where we're investing on the retail business today. First, the business that we bought was a co-packer for our New York Texas Toast and supported our retail business. So those costs are hitting that business. And the other is in Bantam where we have invested in marketing and trade to expand distribution and to drive trial. There again, that's putting disproportionate weight on the retail business.

Frank Camma
Analyst, Sidoti & Co. LLC
Q

Would you be able to give us just a sense of – I mean granted I know you [indiscernible] (18:13) going through this exercise, but like how many quarters that – so the expense versus capitalization would impact the P&L?

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

Well, I would say on Omni in particular, we probably – it's going to take us through probably the midpoint of our next fiscal year. And I think we probably referred to it a little bit in our call in the second quarter.

Frank Camma
Analyst, Sidoti & Co. LLC
Q

Okay.

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

We probably would have been well-served to explain it a little bit more to give you guys a better understanding of what we're doing. So again, we remain bullish on the proposition. We believe it makes a ton of economic sense. It's just the way it's showing up in the business.

Frank Camma
Analyst, Sidoti & Co. LLC
Q

Okay. And my last one, and then I'll hop off, just in previous calls, you've sort of quantified the retail impact of Easter. I think it's generally been around $3 million to $4 million. Is that somewhere in the range of what we can expect this time?

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

I think so, maybe even a little higher because Easter was so late this year.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Right.

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

A

If you think about, in years past, it might have sort of switched between – I think last year it was on April 1.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Yes.

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

A

This year, it was on April 21. In other years, the year before that, it may have been around April 8 or April 10, where you might have shipments partially falling in one quarter versus the other. This year, really mostly...

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Delayed, yes it's pretty much delayed.

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

A

So it's going to be the higher end of that range that you're talking about, but your range remains in [ph] the high (19:48).

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Okay. Thanks guys.

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

A

That's also disproportionately a retail item as well.

Frank Camma
Analyst, Sidoti & Co. LLC

Q

Right. Okay. Thank you.

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

A

Thanks, Frank.

Operator: [Operator Instructions] And our next question comes from the line of Chase West of Consumer Edge Research. Please go ahead, your line is open.

Chase West
Analyst, Consumer Edge Research LLC

Q

Great. Thanks for the question. Just quickly, can you provide an update on the Buffalo Wild Wings sauces in the retail rollout? Our data suggests a ramp in distribution throughout the quarter, so maybe what [ph] ending (20:21) in the distribution story are you guys in, and longer term could we expect similar distribution to, say, maybe Olive Garden dressings?

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

A

Well that's, Chase, great question. That's certainly objective that we're working towards, so I'll give you an update. As you probably saw in the syndicated data, we continue to shift the item and it continues to perform at a number of retailers particularly well.

Today it's only available in a three pack and that's per our agreement that we have in place with Buffalo Wild Wings and Inspire Brands. We are in the process of working with them to transition beyond a three-pack to individual bottles, at which point in time, we would expect to see the proposition really take off like we've been able to see it do at a place like Olive Garden has.

So we're continuing to work through dialog with Buffalo Wild Wings on that. With their transition in ownership and a change in their strategy, they have a number of different important things that are on their plate. Those talks are actively underway with them. So we're bullish about it. Our retailers are quite bullish about it as well. I think they're bullish about it. They're just working it through their queue of other very important things they are working on.

Chase West
Analyst, Consumer Edge Research LLC

Q

Got it. That's very helpful. Thanks. And then just quickly, I believe the innovation center is due to be completed in Q4. Going forward, should we expect an increase in innovation contribution to the topline over time? I mean maybe longer term do you guys have a percent of sales target for innovation?

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

A

Chase, I would tell you, I'll hit them kind of in sequence. We are scheduled to open it, I believe, on June 18, so it remains on time and on budget. We have an open invitation really to the folks on the call to come out and visit it. We view it as really a cornerstone for what we're going to do with both retail and food service customers.

Even in the last quarter, we had folks out from a number of retailers to walk through it, albeit in construction to see what it looks like and we have appointments that are already set up with customers into the first quarter of next fiscal. In terms of the impact ultimately that it has on our innovation, I would be disappointed and I think our team would be disappointed if it didn't result in an increased rate of innovation and an increased level of relevance to our important customers. I don't know if I would peg a specific target to that, but I would say unequivocally is that we would be disappointed if it didn't accelerate that rate.

Chase West
Analyst, Consumer Edge Research LLC

Q

Great. Thanks. And then just lastly from me, Foodservice continues to be very impressive. At a higher level, could you walk through maybe the whitespace opportunity still left in Foodservice? Are you guys attacking that maybe with data or some other type of internal tool that you've been using? And is there a runway for like the branded product still, just any way we can think about the longer-term opportunity would be great? Thanks.

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

Absolutely. So, we remain bullish about the opportunity. If you think about our business, three quarters of the business today is in national accounts and a lot of that growth is coming as a real function of our priority. I think we've mentioned before that we feel like we have an advantaged portfolio. We're winning with those winners.

In the last year, one of the things that we've done as we have invested in some syndicated tools that gives us chain level data by both traffic and sales, so we can go back and understand who is growing beyond just the top 10 or the top 20 or even the top 50, and we become much more strategic about targeting up and coming chains.

So we believe there continues to be more whitespace, not just in the top 20, but honestly it's in that group that may be in let's say the 50 to 100 that are demonstrating high consistent double-digit growth. And I won't mention chain names, but I think you know some of them as well.

We also remain bullish on the opportunity that's in the branded space. I mean, we've talked about non-commercial. That includes colleges and universities. It also includes healthcare. We've had two initiatives in the last year that have helped us continue to expand that part of our business. One is a range of barbecue sauces and other savory sauces that we call [ph] bull blends (24:52).

And just within this last quarter, we've launched our Simply Dressed line of products and packets and other forms that we think is uniquely suited to target healthcare in colleges and universities, so I mean we're just literally starting. We shipped a few cases in our third quarter. We think that's going to be really a great product range to help us go after that non-com space where consumers are looking for healthier solutions. So we see a lot of headway to continue to grow there. I may be...

Chase West Q
Analyst, Consumer Edge Research LLC

Great. Thanks for the question. Okay, go ahead.

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

Just even in margins, for you Chase and folks on the business, you've seen over the course of time that our margins and foodservice are expanding. And a big part of what's happening there is today a lot of our heaviest Lean Six Sigma activities have been biased against our dressing and dip factories, but principally dressings.

And a lot of that benefit to-date has been going, the automation of end of line has been falling to the benefit of our Foodservice business. Now we're sort of lifting and shifting some of that focus also to look at dough factories, think of Omni, but also think of our own Bedford Heights facility where we make New York Texas Toast where we can expect to see the same sort of benefit.

Chase West Q
Analyst, Consumer Edge Research LLC

Got it. Thank you so much for all the color. I'll pass it on.

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

David A. Ciesinski

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

Well, thank you for joining us today. We look forward to talking with you in August when we'll share more information about our fourth quarter results.

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