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Earnings Call

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Call Participants

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James Ronald Salera

Stephens Inc., Research Division

Robert Frederick Dickerson

Jefferies LLC, Research Division

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Presentation

Operator

Good morning. My name is DD, 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 2024 Second Quarter Conference Call.

Conducting today's call will be Dave Ciesinski, President and CEO; and Tom Pigott, CFO. [Operator Instructions]

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

Dale N. Ganobsik

Vice President of Corporate Finance, Investor Relations & Treasurer

Good morning, everyone, and thank you for joining us today for Lancaster Colony's Fiscal Year 2024 Second Quarter Conference Call. Our discussion this morning may include forward 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, lanastercolony.com, later this afternoon.

For today's call, Dave Ciesinski, our President and CEO, will begin with the business update and highlights for the quarter. Tom Pigott, our CFO, will then provide an overview of the financial results. Dave will then share some comments regarding our current strategy and outlook. At the conclusion of our prepared remarks, we'll be happy to respond to any 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, CEO & Director

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 2024. In our fiscal second quarter, which ended December 31, we are pleased to report record financial results as consolidated net sales increased 1.8% to \$485.9 million. Gross profit grew 19% to \$121.5 million and operating income increased 28.1% to \$65.8 million. I'm very thankful for the effort and commitment by all of our teammates throughout Lancaster Colony that enabled us to deliver these strong results.

In our retail segment, net sales growth of 2% was driven by carryover pricing, volume gains for our successful licensing program, continued strong performance for our New York Bakery frozen garlic bread and increased demand for our Reames frozen egg noodles. Retail segment sales volume measured in pounds shipped, declined 1.9%. Excluding the impact of a product down weighting initiative, and our reduced commitment to private label bread, retail sales volume increased 1.2%.

Specific to our licensed product, retail scanner data for the quarter showed Chick-fil-A sauces up 6% to \$38.7 million and Olive Garden dressings, up 2.1% and to \$34.4 million. Buffalo Wild Wings sauces were about flat at \$19.3 million, which compares to a strong quarter last year when sales increased over 26%. Our category-leading New York Bakery frozen garlic bread saw sales growth of 4% to \$88.7 million for a share of 43.1.

Sales of our Reames frozen egg noodles increased 17.9% to \$16.5 million to capture a 70.3 share of the frozen pasta noodle category. I'm also happy to report that Chick-fil-A refrigerated salad dressings, which we launched nationally last May, are also performing well. With scanner data showing \$9.4 million in sales during the quarter. When combined with the sales of our Marzetti brand dressings, our refrigerated dressing sales have grown to represent a category-leading 27.7%.

In the food service segment, sales growth of 1.5% and was led higher by demand from several of our national chain restaurant accounts, along with volume growth for our brand and foodservice products. Foodservice sales volume measured in pounds shipped increased 4.6%. During the period, Foodservice segment net sales were adversely impacted by pass-through price decreases, which resulted from commodity deflation.

During Q2, we were pleased to deliver gross profit of \$121.5 million and a gross margin of 25%, an increase 360 basis points versus last year. This increase was driven by favorability in our pricing net of commodities or PNOC following 2 years of unprecedented inflation along beneficial impacts of our cost savings initiatives. Our focus on supply chain productivity, value engineering and revenue management remain core elements to further improve our financial performance.

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

Thomas K. Pigott

VP, Assistant Secretary & CFO

Thanks, Dave. This quarter featured continued top line growth, improved gross margin performance and higher operating income. The gross profit and operating income results exceeded our expectations and set a second quarter record for the company.

Second quarter consolidated net sales increased by 1.8% to \$485.9 million, decomposing the revenue performance approximately 1.5 percentage points was driven by volume mix and the remainder was driven by pricing. Pricing was favorable in the retail segment but deflationary in the Foodservice segment due to lower commodity prices. Consolidated gross profit increased by \$19.4 million or 19% versus the prior year quarter to \$121.5 million. Gross margins expanded by 360 basis points to 25%. The gross profit growth was primarily driven by favorable PNOC performance and the company's cost-saving initiatives.

Commodity costs were deflationary versus the prior year, remained elevated versus historical levels.

Selling, general and administrative expenses increased 9.7% or \$4.9 million. The increase reflects investments to support the growth of the business, including higher consumer spending and increased brokerage costs. Consumer spending increased versus a low comparative period to support retail segment growth initiatives. Reduced expenditures for Project Ascent, our ERP initiative, partially offset these increases. Costs related to the project continued to wind down totaling \$2 million in the current year quarter versus \$7.5 million in the prior year quarter.

Consolidated operating income increased \$14.4 million or 28.1% due to the gross profit improvement, partially offset by the higher SG&A expenses I mentioned. Our tax rate for the quarter was 23.4%. We estimate our tax rate for the remainder of fiscal '24 to be 23%. Second quarter diluted earnings per share increased \$0.42 or 29% to \$1.87. The net impact of the reduction in Project Ascent expenses was favorable by \$0.15 versus the prior year.

With regard to capital expenditures, our year-to-date payments for property additions totaled \$37.1 million. For fiscal '24, our forecasted total capital expenditures remain at \$70 million to \$80 million. The forecast reflects a decline versus the prior year spending with the Horse Cave expansion project now substantially complete. In addition to investing in our business, we also returned funds to shareholders. Our quarterly cash dividend of \$0.90 per share paid on December 29 represented a 6% increase from the prior year's amount. Our enduring streak of annual dividend increases stands at 61 years.

Net cash provided by operating activities for the second quarter was a robust \$105.9 million driven by the higher net income and reduced working capital. Our financial position remained strong with a debt-free balance sheet and \$133.8 million in cash.

So to wrap up my commentary, our second quarter results reflected continued top line increases, record gross profit and operating income performance and investments to support further growth.

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

David A. Ciesinski

President, CEO & Director

Thanks, Tom. As we look ahead, Lancaster Colony will continue to leverage the combined strength of our team, our operating strategy and our balance sheet in support of the 3 simple pillars of our growth plan. The number one, accelerate core business growth; the number two, simplify our supply chain to reduce our cost and grow our margins; and number three, to expand our core with focused M&A and strategic licensing.

Looking ahead to our fiscal third quarter, we project retail sales will continue to benefit from our expanding licensing program that will include contributions from the launch of Texas Roadhouse steak sauces. I am also excited to share that we have added Subway as a new partner to our retail licensing program with an initial offering of 4 different Subway sandwich sauces, including their most popular Sweet Onion Teriyaki. Both Texas Roadhouse steak sauces and Subway sandwich sauces will begin shipping to retailers later this month.

In the Foodservice segment, we expect sustained volume growth from select quick service restaurant customers. Deflationary pricing is expected to remain a headwind for Foodservice segment net sales in the coming quarter. With respect to our gross profit, we anticipate some continued favorability in our PNOC. But a sequentially lower level compared to our fiscal second quarter.

With respect to our ERP initiative, Project Ascent, following the successful completion of the implementation phase during our fiscal first quarter, we are devoting our attention to leveraging the capabilities of this system to strengthen our execution and support our continued growth.

Finally, as we announced in December, we had a change in our Board of Directors effective January 1 of this year with the appointment of Alan Harris as our Chairman, replacing Jay Gerlach. Alan has served as a Director on the Lancaster Colony board since 2008 and was appointed lead independent director in 2018. While Jay is stepping down from his role as Executive Chairman, he will remain actively engaged as a director.

I would like to extend my deepest gratitude to Jay for his leadership and many years of dedication to Lancaster Colony, both as an executive and as the Chair of our Board. Jay was appointed to Lancaster Colony's Board of Directors in 1985 and is the corporation's longest serving director.

I would also like to congratulate Alan on his new appointment. Both Jay and Alan bring extensive leadership experience and strategic oversight to our Board, which will continue to benefit our company and our shareholders going forward.

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

Question and Answer

Operator

[Operator Instructions] Your first question comes from Jim Salera of Stephens.

James Ronald Salera

Stephens Inc., Research Division

Congrats on a nice quarter. I wanted to start with the inflationary headwind on Foodservice. I think if we back in, it's like a 300 basis point headwind in the quarter. If we think about the back half of the year, is that 300 basis point number a good kind of sticking point to think about? Or is it going to increase, decrease as we progress through the year?

Thomas K. Pigott

VP, Assistant Secretary & CFO

Hey, Jim. Yes, it's Tom. We expect it to increase a little bit. We're in the 300 to 400 basis point for the back half on Foodservice, deflationary.

James Ronald Salera

Stephens Inc., Research Division

Okay. And is that...

Thomas K. Pigott

VP, Assistant Secretary & CFO

Maybe Jim, just a reminder on that, that just as the way it went up, when it goes down, it's a mark-to-market pass-through. So it's sort of no-harm event on gross profit that also drives modest margin accretion as we talked to you about in the past. It's just one of the nuances of that business in our portfolio.

James Ronald Salera

Stephens Inc., Research Division

Right. Great. Yes, that's helpful. So that's broad-based across the portfolio. It's not just like a few key accounts, that's just kind of the whole Foodservice...

Thomas K. Pigott

VP, Assistant Secretary & CFO

No.

David A. Ciesinski

President, CEO & Director

No. And it's really driven by our basket of commodities, so soybean oil first among them. on that part of the business.

James Ronald Salera

Stephens Inc., Research Division

Okay. Great. Maybe one other question. You guys got a nice lift from PNOC in the quarter, obviously. Think about it stepping sequentially down. As we think about back half gross margins, should it be somewhere between kind of 1Q and 2Q's level? Or do we expect it to step down below what 1Q as well. I think like 23 -- 23.5 [indiscernible] first quarter.

Thomas K. Pigott

VP, Assistant Secretary & CFO

So yes. Jim as we're -- I'll answer your question kind of as versus prior year. So if you look at the first half, we were up 200 basis points versus prior year on gross margins. As we look at the back half, we expect it to moderate or more in the 150 to 200, but this is very much dependent on the commodity basket and how things play through. From a tailwind perspective, we are seeing some commodity deflation in our forecast, and we're seeing some nice supply chain productivity results, and those are baked into our outlook in the back half.

Operator

Your next question comes from Alton Stump of Loop Capital.

Alton Kemp Stump

Loop Capital Markets LLC, Research Division

I would also echo your comments, Dave, as it pertains to Jay having known him for almost 20 years. Great to hear that he is taking his next step but will still be involved with the company and also congrats on the quarter, of course, as well.

Thomas K. Pigott

VP, Assistant Secretary & CFO

Thank you.

David A. Ciesinski

President, CEO & Director

Thank you. We'll pass your regards on to Jay.

Alton Kemp Stump

Loop Capital Markets LLC, Research Division

I want to ask about the Subway announcement, which you kind of sit through there, pretty quickly there, Dave. I mean, that's obviously -- it seems like pretty good news if not huge news, you've had several major announcements over the last couple of years. I know you talked about this before, but how much of an impact do you think the huge success you've had over the last few years with Chick-fil-A is having on whether it's Texas Roadhouse, Subway, Arby's, et cetera. I would have to think that, that has led to an increased incentive for these guys to reach out to you and [indiscernible] maybe something similar to what you're doing within the Chick-fil-A. I guess maybe just some color on -- of this recent snowball of, of course, new sign-ups you've got and how much of that you think if not directly certain indirectly, is a result of big success you've had with Chick-fil-A?

David A. Ciesinski

President, CEO & Director

Yes. Yes. I think as we -- I've shared with a lot of the covering analysts on the phone and you, Alton. Olive Garden was our first foray into the space. And together with Darden Restaurants and Olive Garden, we learned our way through this. And what we learned first and foremost is that the proposition in retail was relevant. And second, that the proposition could actually be net accretive to the Foodservice business in terms of the positive perception around the brand.

Fast forward, as we've moved beyond Darden and obviously continue to nourish that relationship, but added Buffalo Wild Wings and Chick-fil-A. I think it's just allowed us to demonstrate this proposition a little bit more broadly, Texas Roadhouse was a collaborative conversation. It was actually brokered by one of our big customers in retail. And then Subway was one that was an inbound conversation as well. So it's an interesting time. And I think it's a manifestation of the fact that the lines between retail and Foodservice are blending. We're seeing more occasions that are at home. And our partners out there in Foodservice are becoming increasingly open to this idea.

And on the retail side, I think our important partners, be that Kroger, Walmart or [indiscernible] or whoever like the idea of bringing relevant new items to these categories. So it's -- nothing -- no tree

grows to the moon, but I think our intention here is just to continue to work carefully to look for good partners where we line up at the values level. We're looking for long-term relationships in this space. And we're going to try to see how far we can take this.

We do have a pipeline of other folks that we're talking to. We're not ready to necessarily share with you now because these conversations take time. And we're even starting to look at categories beyond things that are necessarily sold in the restaurant and maybe even other categories that we played in today.

So I would love to tell you we have another Chick-fil-A on the hook, but I think we all know there's just one Chick-fil-A out there. But I think this in conjunction with how we're thinking about organic innovation, and M&A into the future, hopefully, will give us a balanced sources of growth for our retail business that allows us to compete in the top quartile of our peer group, and that's really our long-term aspiration.

Alton Kemp Stump

Loop Capital Markets LLC, Research Division

Great. And then I guess just as a follow-up on that, obviously, of course, the Horse Cave facility is up and running now. It's your biggest facility. Is that also playing a role in just being able to be more aggressive and signing new partners? Because obviously, I think you had some pretty meaningful capacity constraints prior to that facility opening.

David A. Ciesinski

President, CEO & Director

Well, that's correct. We were constrained on retail bottle capacity. And then also just the SAP implementation created a lot of organizational noise. So one of the things that we've been happy to be able to focus on in fiscal year '24 is just really getting back to basics of focusing on good execution. The theme for this fiscal year is execute to grow. And I think it captures the essence of both elements there, right? Good execution in our plan, focusing on our GMPs, be they safety and quality. Good execution in the plant around productivity and then making sure that we do this in a way that we can work our way through the external circumstances with where consumers are to achieve growth at the higher end of our peer group.

Alton Kemp Stump

Loop Capital Markets LLC, Research Division

Great. And then one last one, and then I'll hop back in queue. I guess this is probably for Tom. But Tom, just to make sure on your comments on the gross margin front because if you look at the first half of the year, the bulk of that, as you mentioned, a 200-plus basis point growth came here in 2Q. So as I think by your comments about 150 to 200 basis points, you used to say that basically that you think that the back half could be similar to maybe a bit lower of an increase year-over-year versus the full first half of the year, just not a huge increase, obviously, [360] basis points, I think, if my math is right, that was all in 2Q. Am I right on that?

Thomas K. Pigott

VP, Assistant Secretary & CFO

That's correct. And I think part of the reason is that as you get into Q4, there's less -- our expectations based on our commodity outlook and our pricing models, we don't expect this on a PNOC performance year-over-year in Q4 versus Q3 and what we experienced in Q2.

Alton Kemp Stump

Loop Capital Markets LLC, Research Division

[indiscernible]

David A. Ciesinski

President, CEO & Director

In the retail business, we continue to have the benefit of pricing. And the pricing, as you might imagine, in this environment is winding down. So that's going to continue to diminish during the period. We'll continue to see favorability on the commodity side but when you put pricing and the commodities together, that's the reason why we expect to see this diminish marginally.

Operator

And our next question comes from Robert Dickerson of Jefferies.

Robert Frederick Dickerson

Jefferies LLC, Research Division

I've got a few questions, try to keep it quick. I guess just kind of on the back of your last comment on pricing in retail and how that kind of rolls off, which I totally get. Like could there be some kind of price deflation on year end in retail in the back half? I'm just thinking through maybe some credit investment needs given kind of a broader backdrop right now on the promotional side from a lot of companies within retail. And then also, I mean, it seems like there's a little bit of a maybe a more challenged comp, let's say, last Q3. That's the first question.

David A. Ciesinski

President, CEO & Director

Yes. So great question. So what you're going to see is still some marginal pricing that plays through on the deflationary side of pricing. We started to see these trends of softness emerge, let's say, in November and into December. And really, at that point in time, Rob, we started to put plans in action. So for those of you that are tracking weekly data, we went out on Olive Garden, for example, and we took our entry price point size of 16-ounce where at Walmart, it had floated above \$4. And we supported the price down into like a \$3.95 price point, I think it's where at on the shelf right now.

We also made adjustments. It was sort of a game time audible on Sister Schubert where we had planned actually to take our promoted price point from the prior year at 2 for 7, up to 2 for 8, predicated on the softness we are seeing out there in the consumer environment, we actually communicated with retailers, we wanted to roll back to 2 for 7, and obviously, they were happy enough to honor that. So that would show up as a decrease versus the prior year, but it was, let's say, a decrease versus our own algorithm internally.

Those are probably cases and points of other areas where we're going out. We're selectively looking brand by brand at the entry price point that matters is that our GAAP versus private label that matters, is it our promoted price point that matters, and we're putting support in there. So I think what you're likely to see some marginal tick up in trade support. But you're going to likely see some, hopefully, some volume offsets on that.

And what we're trying to do is long term orient ourselves towards household penetration, which we think is really probably the more important metric to watch when it comes to the health of the business. And then again, just brand by brand go in and tune things up a little bit, just to make sure the brand sits at a good place.

Sister Schubert is an interesting one, if I could go deeper. So we elected to take the promoted price point back down to 2 for 7. Parenthetically, we are also in the throes of going through the product down weighted on that where we went from 1.5 ounce per roll down to 1.25 ounce which is pretty consistent with what the industry is anyway. We didn't have one complaint during the season. And so we were able to address lagging margin issues we had on that business. As we had skyrocketed but we felt like it was more important to watch our promoted price points. So that's how we're handling it.

But back to your original question, which I think is an important one. I would say marginal upticks on trade. But at this point, given our categories, we don't see a wholesale reset. A work for a long time for Bill Johnson and he had this saying, "profitless prosperity." And I think we're all just somewhat cautious about where we are investing and chasing things down. So we feel like watching household penetration

is a good strategic way to think about this and then making those investments that really protect for the short term and the long term. So you ask a short question, I gave you a long answer, I apologize.

Robert Frederick Dickerson

Jefferies LLC, Research Division

Yes. Yes. It's usually the other way around. [indiscernible] I appreciate that. Okay. And then I guess when I look at your dressings and sauces business, which clearly has the higher margins, clearly been going great for you, kind of over like over time, it seems like there's maybe like a little lift with the launch, things do well. But at the same time, it seems like recently, maybe the frozen breads are kind of driving more of the growth than dressings and sauces.

So I'm just curious, like the licensing dynamic has been going great for you in retail. At the same time, like, have you seen any recent shifts in consumer behavior, like I totally appreciate your prior comments on some of the price pack architecture and driving household penetration that's key. But at the same time, I'm just thinking like we keep hearing kind of value-seeking consumer that's maybe buying more, I don't know, frozen dinner rolls and they're buying amazing Maui subway sauce, I don't know...

David A. Ciesinski

President, CEO & Director

Yes. It's -- no, this one is a bigger question. So I'll try to keep the answer crisp, because I know we're on a time line here. Maybe we'll take them category at a time, I think we're in a season where New York Texas Toast is particularly relevant because that spaghetti and meat sauce [meal occasion] is a good value for consumers. And our team has done a nice job of using digital marketing to make sure that we're working with our big retailers to try to get into that basket. So on -- for example, on one of their shopping apps, if they see pasta going in and pasta sauce going in, they're going to be presented with -- sometimes it's just the brand, not even a coupon and what we find is that there's really solid conversion on those occasions. But on toast, highly relevant in this season.

On rolls. I think we, there again, it's relevant. I don't know in the case of Sister Schubert, if I would say that, wow, it's right in the sweet spot of a recession if we ever got there like toast is. But I would tell you as consumers eat it home, it's a great product and it rounds out the rest of a great meal occasion.

On our sauces, I think where we're seeing some cases of trade down, we're not different than any of the others. What you're seeing is a trade down from traditional food into, for example, the mass merchants. In some cases, mass merchants down into discounters, some larger sizes to smaller sizes. Affluent consumers are going to club. So we're seeing a lot that and we're sort of monitoring that as it goes.

On licensed sauces, you got a couple of things going on. Chick-fil-A sauce is continuing to grow in the mid-single digits, albeit off of the pace that they were on before. I think that is so unique that consumers are continuing to support it. We did see some softness in Olive Garden as consumers traded out. We could watch them trade from larger sizes, small sizes and small sizes out. That's why we went in and made that price point adjustment. We feel like we're in a good place there.

Buffalo Wild Wings and Arby's, where, for all intents and purposes, really launched and supported last year. Buffalo Wild Wings at this point in time, we were getting tens of millions of dollars of free advertising on TikTok. And you're going to note if you're looking at weekly scanner data, we're going to have a rough few weeks, probably more like 8 weeks. As we comp that period. The business still year-on-year is up more than 25%. So -- and if you look at it on a 2-year stack, it's up considerably more than that.

So in this case, I don't think it's whether or not the proposition is relevant. We have some hard comps. Things like Arby's, a really unique SKU, a unique occasion. We've got crazy support from retailers last year behind us. And this year, without the support, it's not selling quite as well off the shelf. What I would maybe ground on with every one of these, Rob, is what we're trying to look at is the velocities of the item and where do they play in the greater condiment space. And all of these play in the top quarter of the category in terms of velocity. So we feel like some are -- they're the Mickey Mantle's of the lineup and some of these are maybe more position players, but all of them seem to have an important role with our retailers. And again, hopefully, that gives you some of the flavor -- the context you're looking for.

Robert Frederick Dickerson*Jefferies LLC, Research Division*

Yes. No, that was even better than the last answer. I'll pass it on.

Operator

And our next question comes from Brian Holland of D.A. Davidson.

Brian Patrick Holland*D.A. Davidson & Co., Research Division*

Yes. So I wanted to ask -- I wanted to ask about the PNOC trend. So [indiscernible] for not modeling this appropriately in Q2 and accounting for, hey, a more normalized environment means. You get some mix benefit as well skewing towards retail in 2Q. But I just want to make sure if we kind of disaggregate the mix benefits kind of flowing through in a normal year versus PNOC. Is the PNOC spread widening and becoming increasingly favorable if we look to recent quarters to Q2. And if we think about the back half, is the commentary that the PNOC spread narrows relative like 2Q was a peak PNOC spread? Or is the second half a little bit more -- commentary more about the mix impact where lower-margin Foodservice is a higher percentage of your total net sales, if that makes sense.

David A. Ciesinski*President, CEO & Director*

Yes. Well, let me take the -- I'll take the first crack at the answer, Brian, and then I'll turn it over to Tom maybe to try to go even deeper. And the first thing I would tell you is, I don't think I'm egg on your face in this case. I think one of the hard things about this past quarter, really the last 6 months for all of us has been trying to forecast where commodities are going to go.

Soybean oil, for example, if we were looking at where was soybean oil in September, well, in September, soybean oil was more than \$0.60 and that right now, it's trading at \$0.45, right? It even went back far that you go back a year, it was at \$0.60. So the falloff we've seen in soybean oil has been pretty precipitous.

Over that same period of time, if you looked at week, let's say, in August, we would have been trading somewhere between 700 to 750 right now. It's like at 588. So again, a pretty steep fall off and corn has fallen off even more. So I think one of the things that's made call on it harder this time within this narrow window is I think we've seen commodities come off more aggressively than maybe we were anticipating. We've been pleasantly surprised. And I think if anything, that probably impacted things. If you look at just -- this is one of the tie-out we did. And maybe, Tom, I'll let you talk about versus where they were modeling in terms of consensus and where we came out favorable, maybe the sources of that variance [indiscernible].

Thomas K. Pigott*VP, Assistant Secretary & CFO*

Yes. So Brian, to build on Dave's point, I think what we saw versus the -- at the time we talked to you last, we saw favorability in soybean oil, flower and grain, eggs, all of those contributed to the favorable PNOC performance versus our expectations as well. And I think, as Dave hit on, we're very cognizant of making the appropriate reinvestments to protect the business on trade, and that's something that will continue to evolve as the year progresses.

But to get to your question in terms of the flow of the PNOC, and Dave mentioned this earlier, we're in a space right now where you have more carryover pricing in retail and the commodity favorabilities that we accreted this quarter. As you progress further, there's less of that carryover pricing and there's a bit of a need to reinvest. So to get to your question, I think Q2, from when we look at our PNOC projections is the strongest quarter of the year. And Q3 will be favorable and then less so in Q4 based on -- this is all based on our commodity outlook, our projections for trade reinvestment, which can change, but that's how we're looking at it right now.

David A. Ciesinski*President, CEO & Director*

And I think modeling the business, Brian, that the commodity deflation continues in the PNOC notwithstanding. I think what you're going to find is that as commodities come down, it's going to be a mark-to-market and Foodservice with very modest margin improvement just because, obviously, the way the math flows, but we do expect the overwhelming majority of the deflation to stick on the Foodservice business. And you're going to see -- [indiscernible] the retail business, which means you're going to drive retail margin improvement, which when you, guys, if you haven't got a chance to go through the [queue] you'll see that broken out in there in more detail.

So I think the mix of the businesses in terms of margin. Our hope is that this commodity deflation sticks, we should begin to see our retail business revert to some of the historical margins that we've had there.

Brian Patrick Holland*D.A. Davidson & Co., Research Division*

That's helpful. Just to put a button on that. And as we look towards the second half of the year, the PNOC spread tightening is more about pricing saving and maybe more trade. And assuming just continued sort of stable commodity prices, is that the [indiscernible].

Thomas K. Pigott*VP, Assistant Secretary & CFO*

Yes, I think that's directionally the way we're looking at it. Yes.

Brian Patrick Holland*D.A. Davidson & Co., Research Division*

Okay. Great. And then the SG&A was up more than I was forecasting. It was a source of deleverage. And I know you called out consumer investment. So maybe, Dave, use this opportunity twofold. One, this state of the consumer in the retail channel and behavior of the retailers, what you're seeing there as far as, and I know you did mention some of this earlier with some of the pricing and the trade that you're doing. But is the expectation in the second half of the year that in the SG&A line, we need to increase? I know something you teased last quarter potentially something where you would have to step up on. Is that -- did that come to fruition in Q2? And should we assume that, that maintains maybe a source of deleverage in the second half of the year, consumer investment?

David A. Ciesinski*President, CEO & Director*

Sure. So the consumer investment, if you remember, last year, we were light in the first half, heavy in the back half. This year, we told you when we started, we were going to be normalizing that spend across both halves, right? So what I would expect on the consumer side is that our spending will not go up period-on-period because it was actually elevated last year, right? We don't have the intention of pulling it back. But if you're looking at just consumer support below the line, we don't have intentions right now of elevating that. So when you look at our total spending on a year, you're going to see us elevate it because you heaved up a little bit earlier on.

Operator

And your next question comes from Andrew Wolf of CL King.

Andrew Paul Wolf*CL King & Associates, Inc., Research Division*

Congratulations as well. I'll say maybe just soybean oil on my face or something. But --it's all good.

David A. Ciesinski*President, CEO & Director*

It's a big commodity for the whole food complex.

Andrew Paul Wolf

CL King & Associates, Inc., Research Division

No. On the PNOC to start with at least. Just on the 360 basis point expansion in gross margin year-over-year. Either give us the actual size or maybe a sense of the size, like PNOC, like how much was -- would you allocate to PNOC versus some of the value engineering that you spoke of, such as the downsizing the units [indiscernible], et cetera.

Thomas K. Pigott

VP, Assistant Secretary & CFO

Yes. So the -- so the PNOC was a little over 200 basis points and the cost savings initiative was a little over 100 basis points. That's kind of how it played through the P&L.

Andrew Paul Wolf

CL King & Associates, Inc., Research Division

Got it. And now in that 100 basis points for the everything for the value engineering and all the Horse Cave running much better, is that fairly sustainable for a while? Because I mean, there's a lot of little things in there, whereas the PNOC is just sort of market determined more or less. Well, As you talk about the total, PNOC coming down because of the market and just the way the industry is and what about the second -- even though it's 100 bps plus, how much -- how sustainable do you see value engineering and other cost savings?

David A. Ciesinski

President, CEO & Director

Yes. So I think what we've told you in the rest of covering analysts is that we were shooting for about \$20 million of cost out every single year. And I think that remains true. How we get that from period to period is going to evolve. This time around was a little heavier on procurement and logistics, where we were able to use some of the softness that's out there for line haul on ambient and temperature-controlled trailers to generate some sources of savings. We did have some benefit in productivity, but it was lighter -- manufacturing productivity, excuse me. As we sort of look, going forward, I think what you're probably likely to see in the out-years, out-periods is things like logistics, we're running business. We speak now to capitalize on the favorable rates, and we'll lock in those savings and we'll look to source more savings coming from the manufacturing side and value engineering.

That downside an initiative that we illustrated is a good example of, one, where we felt like strategically was not going to diminish the consumer experience in any way. And it was just a prudent move to put in place to get the margins a little bit closer to where they had been historically. So that gives you a sense, I hope.

Andrew Paul Wolf

CL King & Associates, Inc., Research Division

Absolutely. And the other thing I wanted to ask about PNOC, regards the -- it's going to be less of a contribution going forward. So I just want to make sure for us modeling outside of the company. When you're saying that, are you thinking sequentially? Or are you saying the year-over-year contribution because the third quarter...

Thomas K. Pigott

VP, Assistant Secretary & CFO

Year-over-year.

Andrew Paul Wolf

CL King & Associates, Inc., Research Division

The third quarter or the fourth quarter and the second quarter. So you -- I mean, we can make [indiscernible]

Thomas K. Pigott

VP, Assistant Secretary & CFO

We're doing it year-over-year.

David A. Ciesinski

President, CEO & Director

And Andrew, I think the watch out just to make sure that we remain aligned is that if you look at the last probably 18 months, our PNOC has been driven by a capital P, PNOC with pricing, fuel service pricing that was marking to market and retail pricing. Now as we look forward, that's -- the P is going to go small P on us. That's what we're talking about. What remains to be seen is what's going to happen on these commodities, right?

Because one of the unique things about our company is we took on 2 years of 20% inflation. And I think we told you guys it was \$160 million a year. If you look at the deflation that we've seen, it's still a very, very small component of the overall inflation we saw last couple of years. So as if commodities continues to [plate board] in basis on soybean oil, we'd see an important component because of our pasta and breads. And then transportation rates remain where they are. We didn't even get into the cost of diesel fuel, which is up, I don't know, \$0.70, \$0.75 versus where it was last year. As long as we continue to see room for those commodities to run, we could see commodity deflation. So how we get PNOC will be different than it's been in the past. But we don't expect to see pricing at this point in time. That's one thing our retailers wouldn't want to hear from us about is if we came to the door and said, we'd like to take a price increase.

Andrew Paul Wolf

CL King & Associates, Inc., Research Division

Okay. That's understood. And if I could just ask a couple of volume questions before I stop asking questions. So first, in the retail, there was like over a 300 basis point swing. When you take out the impact from some discontinued private label and the down weighting. And also the same question as before, can you kind of allocate between the 2? And I guess, give us a sense of what the outlook is there, good for profits, but not obviously. And I guess what it's saying is that the tonnage is kind of distorted because the units are a lot better when you down weight.

David A. Ciesinski

President, CEO & Director

Yes. If you look at the units, it's a different -- it's a slightly different picture. We're but -- we're still seeing a deceleration on units. But Dale, why don't you go ahead?

Dale N. Ganobsik

Vice President of Corporate Finance, Investor Relations & Treasurer

Yes. So Andrew, the down weighting was about 2/3 of it, and then the other 1/3 was the private label.

Andrew Paul Wolf

CL King & Associates, Inc., Research Division

Okay. Got it. And I just want to underline something. You mentioned that just Sister Schubert was kind of following the category, so they're not a much competitive risk. I mean, is that sort of what the industry is up to right now? It would make sense in this environment. But is this down weighing pretty widespread and you don't feel you're going to be leading yourselves into like a competitive disadvantage?

David A. Ciesinski

President, CEO & Director

No, no. I think when we've done these in the past, Andrew, and we've done a handful. I mean we haven't done a ton of them. But ordinarily, what we're doing is we're moving into the industry standard, we haven't done these where we've led the industry down. So we've certainly conformed.

Now on Sister Schubert, which is one where we made those adjustments, I would tell you, if I look at the category trends, the period ending at the beginning of November, October 29, the 13 week in the 4-week period, last 4 weeks or so, it's continued to perform better than where it was before that. So I think this is an occasion with a little bit of tailwind, and I think that's a question that Rob was asking. So we are seeing just given the environment, a little bit of tailwind and we're getting our fair share of it.

Andrew Paul Wolf

CL King & Associates, Inc., Research Division

Got it. The last thing, and this will be just a follow-on to that. So I guess better -- the sharper price point helps the units. How is the per unit profitability for you and for the retailer like profit pennies -- pennies per item.

David A. Ciesinski

President, CEO & Director

Yes. Penny profit? I would tell you from the way we've talked about really with you, guys, is more in terms of our margins. And I think the margin story on retail is the important point, and you can infer that we're making more profit per unit because the margins are improving on those. Retailers, what I would tell you is what we're not seeing is them margin up on us. So I would say there's no reason to think that their penny profit is changing in a big way. I think as we were looking at other categories in the event we were working against private label heavily. I think the watch out is there's a propensity sometimes for them to margin up on the brand as a means by which to drive incremental penny profit off of a branded player and then drive trade down to private label and if they have their price point architecture, right, they can win there as well.

In most of our categories, you roll through produce, that's not an issue. If you look at our sauces and licensing, not much of an issue. You move around to our bread items, it's a watch out, right? If you look at our frozen noodle business, not much of an issue in there. So if I had to guess their penny profit, I would guess it's pretty consistent. But I think if I was working at one of the other [mega cap] CPGs where Tom and I worked together, we may be thinking differently about this. Is that -- my guess is that's a [hammer] that they're using to get their big brands to conform to their aspiration.

Andrew Paul Wolf

CL King & Associates, Inc., Research Division

Okay. Well, it sounds like you guys are managing that -- those category situations pretty well.

David A. Ciesinski

President, CEO & Director

We're certainly -- we're doing our best. And I think your point is an important way to think about it, too, with some of these brands because you have to -- for all of us on -- this side working at manufacturer, we need to put ourselves in the shoes of our big retail partners. And I think the corollary color is they can make more \$0.01 profit per item, but if they're not careful, they trade consumers down and they drive their category down, which they usually don't like as well. So it becomes kind of a holistic story, which is what's the overall health of the category? What's the health of their shopping basket? And then what's their penny profit like.

Operator

[Operator Instructions] Our next question comes from Todd Brooks of the Benchmark Company.

Todd Morrison Brooks

The Benchmark Company, LLC, Research Division

A couple questions for you here at the end of the call. First, and thank you for highlighting on the PNO side that this becomes more the C than the P going forward. If we look at retail pricing, Dave, in the past, you've talked about not necessarily chasing incremental volume by lowering pricing. And I'm just wondering flipping what you just said about your retailers not looking for incremental pricing increases from you. If you look at customer elasticities now at retail, your thoughts on holding the price. It looks like if you normalize the volume trends, volume trends are pretty good, which I think would argue that maybe there's some confidence in the ability to hold pricing at retail going forward, but would love to get your thought on that.

David A. Ciesinski

President, CEO & Director

So if you look at [\$52.13] down to 4 or 5 weeks. Obviously, you can see the tension on consumers elasticities. So that much is readily apparent. The elasticities on our products just aren't such that you drop a list price, you're able to get it back. You can't make enough, you can't move enough volume.

What we find is that there are certain occasions like on price points where if we can get below a cliff, you can get significantly more benefit than you might imagine just in the simple elasticities. I'll give you -- I'll go back to the example that we provided around that \$4 price point. Our elasticity models probably would have predicted a pickup of X, and we saw a pickup on that move that was somewhere so far between 2.5 to 3x of what would have been predicted. So in that case, it made sense.

And what we also try to do in those conversations with our retailers is, obviously, we're at the table with them, and we're trying to figure out how to make the -- our brand healthier, but also make category healthier. And in this case, our customer partners said, "Hey, if you're willing to make this investment, I'm willing to make some investments and give you in caps." So what you're likely to see for a brand like Olive Garden, which I mentioned here, but some of our other brands is you're going to see more support in the back half of the year on things like in cap where if we can make a reasonable investment and get support in things like in cap feature and display, there, again, you're going to get far better performance than your elasticities would necessarily project. So that becomes part of what we're trying to do, right?

Todd Morrison Brooks

The Benchmark Company, LLC, Research Division

Yes. Absolutely. And then my second question, and obviously, we're all surprised by the gross margin performance in the quarter, which was great to say. I guess with the magnitude of the bounce back. In the past, you've talked about listening getting back to 26%, 27% gross margins without a meaningful correction in commodities would be difficult to do. We've seen a correction. I don't know if it qualifies as how you would label it meaningful. But with the magnitude of the lift that we saw in Q2, can you just talk a little bit longer term about your thoughts in this type -- if we stay in this type of commodity environment that we're in right now, what do you think the gross margin potential for Lancaster is?

David A. Ciesinski

President, CEO & Director

Well, what we said is our aspiration is to get the business to the midpoint of our peers. We still think that's doable. As it pertains to deflation, this is a tricky one because as go soybean oil, goes a big piece of our business. And we've seen the more recent pullback on the Board. And I think what we're asking ourselves is, is this likely to stick? What drove this up early on. And Todd, I know you and I and others had conversation together, was a policy shift towards renewable diesel fuel. So all of a sudden, we saw incremental demand for soybean oil because it was being moved over to diesel fuel that we've seen a pullback.

And the policy hasn't necessary change. But if you look at the board today going out to 2025, it's depressed out to about \$0.44, so off a couple of cents versus where it is. What we're trying to figure out is that because that's a correlation between a fall off on, let's say, crude oil, which is also soft and you guys are looking at it as much as we are, what's that trading at about \$76 a barrel today, but -- or is there some sort of anticipation that after another election, we may see a policy change. It's just really hard for us to guess.

But I think in order for us to get -- to revert back to that point that you're talking about, we're going to have to believe that there are structural reasons for oil to remain low, both on the -- or soybean oil, not oil, but soybean oil to be low both on the board and on basis. And once that date comes true, I think, yes, then we're going to have more confidence to say a lot of this cost that we've taken out structurally is going to come off.

Now here's what I would tell you, what we try to do in the meantime is when we see pullbacks, we try to buy opportunistically with forward agreements. And lock in some of the favorable pricing period-on-period because what we don't know is, hey, is there going to be another [indiscernible] drops a bad crop in Brazil, a bad soybean crop in the U.S. because weather is something else. So what we're trying to do with this plays out is by when there's an advantaged opportunity to lock in favorability until we get to a point where the policy side of it works itself out.

Todd Morrison Brooks

The Benchmark Company, LLC, Research Division

Knowing that your ability to contract and lock going forward and strategies around that varies based on price and the ability to do so. Tom, if you're looking at the commodity basket, second half of the year, which I would expect to have pretty good visibility into at this point. How does it compare to the 2Q reality on kind of the commodity piece of PNOC?

Thomas K. Pigott

VP, Assistant Secretary & CFO

Yes. We're looking at deflation at similar levels with some moderation in the fourth quarter, but there are pieces that you really can't forward cover like the basis we pay to process the soybeans, things like eggs are more difficult. So there is just cautioned it's like there's some unpredictability in all of this. That's the outlook we have.

David A. Ciesinski

President, CEO & Director

Tom makes a great point. We're all keeping our eyes on what's happening with AVI, the avian influenza that's out there.

Todd Morrison Brooks

The Benchmark Company, LLC, Research Division

Congrats.

Operator

And our next question comes from Robert Dickerson of Jefferies.

Robert Frederick Dickerson

Jefferies LLC, Research Division

Sorry, just a very easy quick follow-up. Just the balance sheet, right? I mean you talked about in the script, cash balance is great. CFO was good coming through the quarter. Clearly, you still have no debt. And some of these ERP initiatives, clearly are rolling off. So we think margins going up, I assume kind of cash flow gets back to a pretty place and you don't have any debt. So I guess more from a managerial perspective, it doesn't seem like you have a tremendous amount of kind of organic cash or CapEx needs outside of traditional working capital. So -- and you've also been fairly quiet, let's say, for a number of years for some time on the acquisition front, but there could be some cash build. So maybe just -- maybe provide any incremental color that you can -- how you're thinking about that cash just outside of the standard verbiage on dividends, et cetera?

Thomas K. Pigott

VP, Assistant Secretary & CFO

Sure. Yes. So I think we still see opportunity to invest in the business. We've made the big investment in Horse Cave, which certainly helps us from a capacity standpoint. But as we look at kind of into the future, certainly, there's automation opportunities that we want to invest in with the labor market remaining tight. And those are good return projects. So we'll continue to invest back into the base. That's always priority one. And that's our best return in lowest risk investments.

And then when you look at M&A, our strategy is to really look at opportunities where we can lever our core competencies, really in dressings and sauces is kind of our focus area. We see sauce category continues to be a nice growing. And so we're going to continue to look at opportunities in that space to really continue to grow this area of dressings and sauces where we tend to have strong culinary capabilities, nice retail sales team that's able to execute well. And with the Horse Cave investment, we have high-speed lines and capabilities to produce at a very low cost. So that's the focus of our M&A strategy. And certainly, now that we have the SAP project behind us, as well as the Horse Cave expansion. We're certainly more open to looking at opportunities to scale the business further.

Operator

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

David A. Ciesinski

President, CEO & Director

Well, thank you, everyone. We really enjoyed meeting with you today. We look forward to being with you again in May when we report our next quarter's results. Have a good rest of the day.

Operator

This concludes today's conference call. Thank you for participating, and you may now disconnect.

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