Freshpet, Inc.
Second Quarter 2024 Earnings Call Prepared Remarks
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CORPORATE PARTICIPANTS

Rachel Ulsh – *Vice President, Investor Relations and Corporate Communications*
Billy Cyr – *Chief Executive Officer*
Todd Cunfer – *Chief Financial Officer*

PRESENTATION

Rachel Ulsh
Thank you. Good morning, and welcome to Freshpet's second quarter 2024 earnings call and webcast. On today's call are Billy Cyr, Chief Executive Officer, and Todd Cunfer, Chief Financial Officer. Scott Morris, President & Chief Operating Officer, will also be available for Q&A.

Before we begin, please remember that during the course of this call, management may make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These include statements related to our long-term strategy, 2027 goals and pace in achieving these goals, prospects for growth, timing of Freshpet Kitchens expansion and new technology, and 2024 Guidance. Words such as anticipate, believe, could, estimate, expect, guidance, intend, may, project, will, or similar conditional expressions are intended to identify forward-looking statements. These statements are based on management's current expectations and beliefs and involve risks and uncertainties that could cause actual results to differ materially from those described in these forward-looking statements including those associated with such statements. Please refer to the Company's annual report on Form 10K filed with the Securities and Exchange Commission and the Company's press release issued today for a detailed discussion of risks that could cause actual results to differ materially from those expressed or implied in any forward-looking statements made today.

Please note that on today's call, management will refer to certain non-GAAP financial measures, such as EBITDA and Adjusted EBITDA among others. While the Company believes these non-GAAP financial measures provide useful information for investors, the presentation of this information is not intended to be considered in isolation or as a substitute for the financial information presented in accordance with GAAP. Please refer to today's press release for how management defines such non-GAAP measures, why management believes such non-GAAP measures are useful, a reconciliation of the non-GAAP financial measures to the most comparable measures prepared in accordance with GAAP, and limitations associated with such non-GAAP measures.

Finally, the Company has produced a presentation that contains many of the key metrics that will be discussed on this call. That presentation can be found on the Company's investor website. Management's commentary will not specifically walk through the presentation on the call – rather it is a summary of the results and guidance they will discuss today.

With that, I would like to turn the call over to Billy Cyr, Chief Executive Officer.

Billy Cyr

Thank you, Rachel, and good morning, everyone. The message I would like you to take away from today's call is that we are on track to deliver the disciplined growth we committed to achieve this year.

As you know, we aspire to deliver category-leading growth with outsized improvement in profitability. But, as we have learned over the past few years, carefully managing our growth to ~25% enables us to drive operating improvements and manage cash more effectively – making Freshpet an even more attractive business. That is our definition of "disciplined growth." And, if we do that well, consumers will win, customers will win, and our shareholders will win.

Our second quarter results demonstrate the strong progress we are making towards delivering that disciplined growth. We delivered our 24th consecutive quarter of net sales growth over 25% and did it within our existing capacity limits so we maintained exceptional customer service and strong fill rates. That enabled us to operate very efficiently and effectively so we expanded our Adjusted Gross Margin and Adjusted EBITDA margin. The bulk of the operating improvements came in our key focus areas of input costs, quality and logistics – totaling 770 bps of operating improvements.

Those operating results, specifically Adjusted Gross Margin, input, quality and logistics costs, exceed some of the key elements of our 2027 goals. As a result, we are in an even stronger position to achieve or exceed our full set of 2027 targets, as well as raise our guidance for this year. We still need to prove that we can achieve these results consistently before we adjust our long-term targets, however, another quarter of strong performance has made us even more optimistic.

These results were driven by broad-based strength of the key business fundamentals: First, our growth in the second quarter was entirely driven by volume growth. There was no impact from pricing/mix this quarter. Further, we have been seeing a steady trend towards consumers buying larger pack sizes – which slightly reduces the price per pound, but improves the efficiency of our production lines and our distribution systems. This consumer behavior is a positive indication that value seeking consumers move up to larger sizes of Freshpet rather than reducing the size or amount they buy.

Second, from a household penetration perspective, our growth rate is where we need it to be to hit our 2027 target of 20 million households. We are growing households in the low-mid 20's and increasing the buying rate in the low-single digits. That combination results in mid-20's growth rates, which is our targeted level. More encouragingly, our heaviest users are growing even faster than the total user base.

Third, our media plan is also delivering the way we had hoped. It is driving strong household penetration gains in line with our long-term model and at a healthy customer acquisition cost that is comparable to the costs we had prior to the price increases we took over the past two years. Additionally, by balancing our media investment more evenly across the year, we have been able to deliver strong growth while living within our capacity limits.

Fourth, consumers continue to believe that Freshpet represents a good value. The desire for value is being expressed as quality for the price – not just price. We believe consumers find value in a truly differentiated product. That is why it appears that much of the category growth is now coming from the fresh/frozen segment where Freshpet is a leader. Further, our growth is fastest amongst our heaviest users – another strong indicator of the differentiated value that Freshpet represents – even in an environment where consumers are looking for ways to stretch their dollars.

Finally, taking a step back, our growth continues to be supported by the long-term trend towards the humanization of pets. The pandemic created a pet adoption bubble, but we are now back on the same long-term pet population growth trends we have seen for more than a decade. And our volume growth comes from expanding household penetration – which is the model that has worked for us since we first launched our "Feed the Growth" strategy in 2017.

Now I'd like to provide some highlights of the second quarter. We have strong momentum and made great progress against our long-term plan, and you can see that in our financial results. Second quarter net sales were $235.3 million, up 28% year-over-year, all of it being volume-driven as I said earlier. Second quarter Adjusted Gross Margin was 45.9%, above our long-term target for the second consecutive quarter, compared to 39.8% in the prior year period. Second quarter Adjusted EBITDA was $35.1 million, an increase of approximately $26 million year-over-year.

From a retail perspective, we are having a solid year of retail availability growth. Store count growth is in-line with our long-term rates. More importantly, some of our larger customers are engaging with us on potential plans to add second and third fridges in high velocity stores. That is where we expect to see the bulk of our growth. You will see that in TDP growth exceeding ACV growth as we go forward. Specifically, we placed 790 fridges in the second quarter, including new stores, upgrades and second/third fridges, bringing us to a total of 35,602 fridges at retail or more than 1.8 million cubic feet of retail space. As of June 30, 2024, Freshpet could be found in 27,497 stores, 22% of which now have multiple fridges in the U.S. Fill rates continued to be strong and were in the high 90's throughout the quarter, supporting fridge placement and store growth.

Now I'll provide an update on KPI's we track for our Mainstream, Main Meal, More Profitable plans, what we refer to as our "Main & More."

Focusing on the idea of Mainstream… Freshpet is becoming increasingly mainstream, but still has a long runway for growth. According to Nielsen Omnichannel data, which includes ecommerce and direct to consumer, as of June 29, 2024, total U.S. pet food is a $53 billion category. We only have a 3% market share within the $36 billion dog food segment, which is the majority of our business today. Within the fresh/frozen subcategory in measured channels, Freshpet has 96% market share. Fresh continues to outperform the broader pet food category and many retailers believe it is the future of pet food. As a result, Freshpet is now in 66% ACV in Nielsen XAOC, and we continue to add distribution breadth and depth with second and third fridges. Our household penetration gains also demonstrate that we are well on our way to making Freshpet more mainstream. Household penetration at the end of the second quarter was 12.8 million households, up 25% year-over-year and on track to meet our target of 20 million households by 2027. Our high profit pet owning households, or HIPPOH's for short, are growing even faster– up 31% vs. the prior year period. In short, the humanization of pets is a mainstream idea and now it is our job to make fresh food the standard way to feed your pets.

Turning to the Main Meal part of the strategy… Freshpet sales are increasingly concentrated in our heaviest users, HIPPOHs. Currently, 37% of Freshpet users are HIPPOH's and they represented 89% of our sales in the second quarter. Even more encouraging, about 300,000 of our users – or less than 3% of our total users – buy more than $1,000 of Freshpet per year and this group grew 47% over the past year. They now represent ~27% of our business. There is a significant opportunity to increase this percentage and grow our total business.

The key driver to convert more consumers to use Freshpet as the main part of their pet's meal is advertising. We need to educate consumers on the benefits of fresh food for their pets. Multi-packs and larger pack sizes can also help reinforce the idea that our product can be your pet's main meal, and will in turn help increase buy-rate, which was approximately $100 at quarter end – up 3.3% vs. the prior year period. Adding unique, value-added SKU's helps do that. Based on Total US Pet Retail Plus data from Nielsen, we currently have an average of 18.4 SKUs per point of distribution, up from 16.1 SKU's one year ago. Since we have a finite amount of space in our fridge, as we increase the number of second and third fridges we can increase the number of SKUs, amplifying our visibility and marketing impact, widening our product assortment and broadening the appeal of our brand.

Now to the "More" part of Main & More—More Profitable… We had another strong quarter of margin improvement. Adjusted Gross Margin improved 60 basis points versus the strong results we posted in Q1 to 45.9% and we ended the second quarter with an Adjusted EBITDA margin of 14.9%. The key items that drove this improvement were: First, quality: Our team continues to execute well. We still have lots of opportunity for further improvement, but our team has been able to reduce both the number of issues we have to manage, and also the size of any issues. Second, input costs/yield: We have returned to our historic level of input costs as a percent of net sales through a combination of price increases, commodity cost management, and meaningful improvements in our production yields. Further, we believe there is an opportunity to continue to improve efficiency in this area through formulation work, supplier diversification, operating improvements, and new technologies. Third, logistics: We are clearly benefiting from some macro factors on freight—including lower lane rates and fuel costs. But our 99% fill rate in the quarter, the expansion of the service area for our Dallas DC behind increased production in Ennis, and new tools we have put in place to more effectively bid our lanes and improve our customer service are the primary drivers of the improved performance.

Turning to an update on our capacity… We have a disciplined approach to managing capacity and continue to execute on our expansion plans while also improving throughput and yields on existing lines. In Ennis, the fourth line is still on track to start-up by the end of Q3 2024. We began commissioning the line in July and feel good about the test runs so far. In Bethlehem, the team is focused on increasing capacity utilization or OEE, and our seventh line on that campus will test new technology and is expected to start up in the second half of 2025. In Kitchens South, we continue to evaluate ways to add more lines and/or shifts.

We continue to evolve our capacity expansion plans to drive greater capital efficiency. As we have discussed previously, we are intensely focused on: 1. Maximizing the throughput of our existing lines, 2. Maximizing the capacity of our three existing sites, and 3. Developing and implementing new technologies that generate more throughput per line. While we have come a long way since our first facility in Quakertown, PA, the manufacturing systems to make fresh pet food are still not where we'd like them to be. We have invested and will continue to invest heavily in both technology and talent to make our production more stable, reliable, and efficient. We have made tremendous progress, but still believe the opportunities for improvement are sizable.

In summary, I think we are making good progress at delivering the disciplined growth we promised at the beginning of this year. We are highly focused on managing the business to live within our capacity, and believe this has led to the progress we have made on our profitability. We believe our model works very well at approximately 25% growth – generating the right balance of growth, capital investment, and cash generation. And we are increasingly confident that we will be free cash flow positive by 2026.

I'm incredibly proud of the progress we have made and the results we have delivered—especially since Ennis is still sub-scale and we have some exciting new technologies under development that could meaningfully enhance the economics of our bags business. Now we need to continue to execute at a high level and keep raising the bar.

Before I turn it over to Todd, I want to point out that the press release announcing our earnings today has a dateline of Bedminster, NJ instead of our previous home in Secaucus. We have outgrown our corporate offices in Secaucus and have moved into a temporary office space in Bedminster, NJ while our new, purpose-built, leased corporate office is under construction right down the road in Bedminster. We expect to move into the new office in the first half of next year. Our new location in Bedminster will allow us to attract and retain the top marketing and finance talent we need while making it much easier for our team members to go back and forth to our technical base in Bethlehem, PA – enabling much closer collaboration and planning. Our new office will embody our "Pets. People. Planet." mantra and we look forward to sharing it with you when it opens next year.

Now, let me turn it over to Todd to walk through the details of the Q2 results and our updated guidance. Todd…

Todd Cunfer

Thank you, Billy, and good morning, everyone. As Billy mentioned, we are very pleased with the second quarter results, particularly our ability to deliver on profit improvement. Now I'll give you some more color on our financials and updated guidance for the year.

Second quarter net sales were $235.3 million, up 28% year-over-year. Nielsen measured dollar growth was 24% vs. the prior year period, with broad-based consumption growth across channels. We saw 26% growth in XAOC, 24% in US Food, 9% growth in pet specialty, and over 100% growth in the unmeasured channel. It is important to note that Nielsen IQ has expanded their coverage beyond what we previously called the Nielsen MegaChannel to a new US Pet Retail Plus channel that adds online sales via Amazon and Chewy, neighborhood pet retailers, and Farm & Feed stores. Wherever possible, we will use that expanded definition to provide the most comprehensive view of our business and the category. We estimate that this new channel covers more than 85% of our US business today.

Second quarter Adjusted Gross Margin was 45.9%, up 610 basis points year-over-year. This was driven by improvements in input costs, yield, throughput, and quality costs. Specifically, input costs as a percent of net sales improved 460 basis points with better yields, throughput and lower commodity costs, and quality costs improved by 90 basis points.

Second quarter Adjusted SG&A was 31.0% of net sales, compared to 34.9% in the prior year period. We spent 12.2% of net sales on media in the quarter, down from 14.8% of net sales in the prior year period. Total media investment was up 6% year-over-year. Recall, our media plan is less front-loaded this year than in years past so that we can manage our growth to live within our capacity limits. Logistics costs continued to improve and were 5.8% of net sales in the second quarter, a decrease of 220 basis points compared to the prior year period. Like Billy stated, the majority of the improvement was due to strategic actions we have taken to increase fill rates, reduce miles driven by increasing the number of states served by our second distribution center, and negotiate with vendors, with the remainder being more macro-driven with more favorable lane rates. Other SG&A, which was 13% of net sales, increased 90 basis points driven by higher incentive compensation.

Please note that our GAAP P&L includes an $11.1 million true-up of non-cash share-based compensation based on multi-year share-based awards granted in fiscal year 2020. This year's unexpectedly strong profit performance has increased the likelihood of greater vesting on those awards. Excluding this charge, we would have generated $9.4 million of net income.

Second quarter Adjusted EBITDA was $35.1 million, or 14.9% of net sales, compared to $9.0 million, or 4.9% of net sales in the prior year period. This improvement was primarily driven by higher gross margin, as well as improved logistics costs.

Capital spending in the second quarter was $48.3 million. Operating cash flow in the second quarter was $42.4 million, and we had cash on hand of $251.7 million at the end of the quarter. We continue to believe that we have adequate cash to fully fund our growth through 2025 and will be free cash flow positive in 2026. Our strong improvement in Adjusted EBITDA this year also makes it unlikely we will need any additional capital.

Now turning to guidance for 2024… We are updating our outlook to reflect our outperformance in the second quarter, as well as our conviction in our ability to execute in the second half. We are raising our net sales guidance from at least $950 million to at least $965 million, or growth of at least 26%. We are able to do this because of the strong improvements in our operating efficiency – particularly in Bethlehem and Kitchens South – that will allow us to sell a bit more this year and still maintain strong customer service. However, we still need the new roll line in Ennis to start up by the end of September and ramp up production in order to have the supply we need to meet demand. We are also keeping in mind the capacity needed to support next year's growth and do not want to get too far ahead of our original plans.

As far as cadence, we continue to expect net sales to have sequentially lower percentage growth throughout the remainder of the year as we intentionally manage our growth rate while expanding capacity. Our more balanced first half/second half media investment this year has been critical to delivering the growth we have experienced while also living within our capacity constraints – as the first half media really dictates the demand we will have in the second half of this year and the second half media investment will drive the demand we experience in the first half of next year. For this reason, our second half media investment will be significantly larger than the investment we made in the previous year.

For Adjusted EBITDA, we are raising guidance from at least $120 million to at least $140 million to reflect the over-delivery in Q2. We now expect Adjusted Gross Margin to expand by approximately 500 bps for the full year, compared to 300 bps previously. Capital expenditures are now projected to be approximately $200 million, compared to approximately $210 previously, to support the installation of capacity to meet demand in 2025. The modest reduction is due to the timing of certain expansion projects.

In summary, the second quarter results demonstrated disciplined growth and our ability to execute the strategy we laid out. We are very pleased to see our investments in capacity and organizational capabilities are paying off and we are gaining significant scale advantages.

That concludes our overview. We will now be glad to answer your questions. As a reminder, we ask that you please focus your questions on the quarter, guidance and the Company's operations.