Freshpet, Inc.
First 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
Good morning, and welcome to Freshpet's first 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, focus, 2027 goals, pace in achieving these goals, prospects for growth and new technologies, and 2024 Guidance. Words such as 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 and inaccuracies in third party data. 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 these strong quarterly results prove that some of the most critical financial metrics in our 2027 goals are achievable. Now we must prove to you that we can deliver them consistently over time. These results did not happen by accident. They were the result of a disciplined focus on the key drivers of profit improvement and the changes we have made as an organization. And we are determined to continue those disciplined efforts until these results become a long-term trend.

Further, these results demonstrate that with increased scale comes increased profitability, which was the basis of our Fresh Future plan that we announced in early 2023. It was then that we pivoted to a more balanced approach to growth and profitability versus our previous, single-minded focus on growth alone. We were able to deliver these results because of the strength of the Freshpet business model and consumer proposition, and strong improvement in the key fundamentals that drive our business. There are several important points I would like you to take away from these results:

First, our growth model continues to deliver. We have successfully absorbed the most significant pricing we have ever faced, delivered strong volume-based growth in the quarter, and returned to the greater than 20% household penetration growth rate embedded in our long-term targets. Further, we added those households at a customer acquisition cost (CAC) that is comparable to the levels we experienced prior to the price increases of the last two years. This demonstrates the strength of the Freshpet growth model, the power of our marketing, and also provides the confidence that the model can continue to deliver the 25% net sales growth embedded in our FY 2027 goals.

Second, we have improved our operational effectiveness. We are now delivering significant year-on-year improvements in our quality, input and logistics costs – the costs that we have been intensely focusing on – and that has resulted in a step change in our Adjusted Gross Margin and Adjusted EBITDA margin. Our operational achievements stem from our efforts to build strong organizational capability at all levels – beginning with our Freshpet Academy that has strengthened our production workforce and also including some of the senior leaders we have hired in the past year and a half. And, while these operational improvements are significant, we believe we are just getting started and that our team is capable of delivering this type of operational excellence more consistently over time and, potentially, doing even better.

Finally, we are demonstrating the capability and operating discipline needed to balance capacity and demand at such a high rate of growth: We are adding capacity on-budget and on-time, and at a pace that enables us to keep up with our high growth rate without carrying too much excess capacity. This enables us to deliver strong fill rates to our customers while simultaneously improving our margins and is the result of the rigor and discipline that we have put in place around our growth planning. This is the balancing act between growth and capital investment that we have described to you previously and we are increasingly mastering it at a high rate of growth.

While we are pleased with the performance we delivered, we are not satisfied. We need to deliver this level of performance consistently over time and once we have proven our ability to do that we would consider revising our long-term targets. But right now we are focused on maintaining momentum in each of the remaining three quarters of this year. As we have mentioned many times before, the manufacturing systems to make fresh pet food are still in their infancy. We are investing heavily in organizational capability and technology to make those systems more reliable, consistent and efficient – and are making good progress on many aspects of the process– but we also know that we are still in the early days of the fresh pet food category and the opportunities for improvement are sizable. We fully intend to realize those opportunities over time and have numerous initiatives under way to do that.

Now let me walk through some highlights of the first quarter. We had strong momentum in the first quarter and made tremendous progress against our long-term plan, and you can see that in our financial results. First, we started the year with very strong net sales growth, with first quarter net sales of $223.8 million, up 34% year-over-year, driven primarily by volume growth of 31%, and 3% price/mix. Second, we saw significant improvement in Adjusted Gross Margin as well as Adjusted EBITDA. First quarter Adjusted Gross Margin was 45.3% compared to 41.1% in the fourth quarter and 38.5% in the prior year period. First quarter Adjusted EBITDA was $30.6 million, an increase of approximately $28 million year-over-year. Our diluted earnings per share were 37 cents. Excluding a mark-up in the value of our equity investment, EPS was 17 cents per share. I have been looking forward to the day that I could say those words for a very long time, and I expect that to become a habit going forward.

In addition to those financial highlights, we made progress on our retail availability and visibility as well. We placed 617 fridges in the first quarter, including new stores, upgrades and second/third fridges, bringing us to a total of 34,812 fridges at retail, or more than 1.7 million cubic feet of retail space. As of March 31, 2024, Freshpet could be found in 27,097 stores, 23% of which now have multiple fridges in the U.S. Fridge placements and store growth were supported by continued strong fill rates that ended the quarter in the high 90's again.

We have rallied the organization around our Mainstream, Main Meal, More Profitable plans, what we refer to as "Main & More." We're making the Freshpet brand more mainstream and getting people to use it as a main meal component, and this creates intensity and concentration of the business that we believe will allow us to be more profitable.

Focusing on the idea of Mainstream… According to Nielsen Omnichannel data, which includes ecommerce and direct-to-consumer, as of March 30, 2024, total U.S. pet food is a $53 billion category. We only have a 3.0% market share within the $37 billion dog food segment, which the majority of our business is today—leaving a vast runway for growth. Within the fresh/frozen subcategory in measured channels, which continues to outperform the broader pet food category, Freshpet has 96% market share. The idea of the humanization of pets is becoming more and more mainstream, appealing to every income group and demographic, and it is our goal to make fresh food the standard way to feed your pets.

Our household penetration at the end of the first quarter was 12.367 million households, up 24% year-over-year and growing. Our high-profit pet-owning households, or HIPPOH's for short, are growing even faster– up 34% vs. the prior year period. We remain on track to meet our target of 20 million households by 2027. Overall retail availability continued to grow, with ACV of almost 65%, and we continue to see upside in continued distribution gains going forward. We will continue to focus on increasing the percentage of stores with second and third fridges.

Turning to the concept of Main Meal… We use our advertising to educate consumers on the benefits of fresh food for their pets and that is the key driver to convert more consumers to use Freshpet as a main meal. Today, 48% of Freshpet buyers use the product as the main component of their pet's meal and there is a significant opportunity to increase this percentage even with our heavy users. 37% of Freshpet users are HIPPOH's and they represented 89% of our sales in the first quarter. By focusing on fresh, healthy food, offering a wide range of price points, and expanding our recipes, we believe consumers will naturally convert from using Freshpet as a topper to more of a main meal item – centering the plate around fresh. This concept of converting toppers into main meal users will in turn increase buy-rate too, which was $96.84 at quarter end – up 5% vs. year-ago. Based on MegaChannel data, we currently have an average of 18.9 SKUs per point of distribution – up from 16.4 SKU's one year ago. We plan to increase the number of SKU's available at each retailer by adding second and third fridges, which amplifies our marketing spend and drives visibility for the brand, while also allowing us to showcase a wider range of our portfolio.

Turning to the “more” part of Main & More—More Profitable… As I mentioned earlier, we significantly improved margins this quarter with solid operating performance thanks to the work of our team. Quality, yield, input costs, and throughput all drove the over-delivery. Last quarter, I suggested that we had reached an inflection point and were turning a corner on profitability because we are now at a point where we can leverage our scale, increased business intensity and concentration. We are now seeing those benefits of scale play out and they are driving increased profitability.

First quarter Adjusted Gross Margin increased 680 basis points year-over-year to 45.3%, and Adjusted EBITDA as a percent of net sales was 13.7% compared to 1.8% in the prior year period. Logistics has been a key area of focus for us, and it was only 6.4% of net sales in the first quarter, improving 290 basis points year-over-year and coming in below our long-term target of 7.5%. We are greatly encouraged by these results, and we believe there is a significant opportunity to drive further profit improvement going forward, with our Ennis facility still ramping up production, and our continued work on OEE to increase yield and throughput.

That leads me to an update on our capacity: We feel confident in our expansion and efficiency projects, which are all on-budget. Ennis currently has three lines operating today, one roll line and two bag lines, and this facility is producing ~25% of our total production volume. Our fourth line in Ennis is slightly ahead of schedule and expected to start-up by the end of the third quarter. This additional line kicks off Phase II in Ennis and will alleviate some complexity of changeovers and SKU assortment since it will be our second roll line in this facility.

We have continued to evolve our capacity expansion plans to drive greater capital efficiency. We are intently focused on: First, maximizing the throughput of our existing lines by investing in an operational excellence program designed to increase our OEE. We have seen steady progress on this – particularly in Bethlehem – where the program has been underway for more than a year. Second, maximizing the capacity of our three existing sites so that we can avoid the high cost of incremental infrastructure and overhead. For example, in Bethlehem, we are converting storage space to add a seventh line; in Kitchens South, we believe there is room to add one or two more lines in the existing building; and, in Ennis, we are looking at ways to add more lines as well. Third, developing and implementing new technologies that generate more throughput per line, and improve yield and quality. We have developed one technology that has shown great promise, and others are in earlier stages of development. It is still too early to tell when these might impact our capacity or P&L, but we believe these technology investments are important because our need for capacity will only grow as time progresses and we continue to believe that our manufacturing expertise will be a key strategic advantage over the long haul. Scott, who successfully pioneered the development of our existing products and processes, is leading our efforts to develop and commercialize these potentially breakthrough technologies.

As I said earlier, our first quarter results demonstrate that scale leads to improved profitability. Todd will walk through our updated guidance, but I’d like to provide an update of our results vs. our long-term targets. We are clearly ahead of the pace required to deliver our original 2027 goals – which gives us increased confidence in our ability to either meet or exceed those goals – but we need to show we can deliver these results consistently. Albeit encouraging, it is still early in the year, and we want to be measured in our forecasts for the balance of the year. We knew the first quarter sales were going to be strong because of our sizable media investment in Q4 of 2023 and the momentum that generated – and the 34% first quarter net sales growth still exceeded our own forecast. We plan to carefully manage our topline growth for the remainder of the year so that we do not get ahead of our installed capacity or organizational capability. We believe our model works very well at approximately 25% growth – generating the right balance of growth, capital investment, and cash generation.

Adjusted Gross Margin of 45.3% in the first quarter was above our 2027 target of 45%, giving us even more reason to believe we can deliver our long-term goals. We were able to deliver this despite the fact that Ennis is still sub-scale and in start-up mode, and we have not implemented any of the new technologies we are working on yet. Further, our Freshpet Operational Excellence program is still in the early innings, and we believe there is lots of upside as we implement that program. But – as I mentioned earlier – we want to demonstrate consistent performance at this level before we commit to anything beyond that.

Adjusted EBITDA margin of 13.7% in the first quarter is tracking ahead of plan to achieve our goal of 18% Adjusted EBITDA margin in 2027. As you know, we tend to front-load our media investment. Q1 media investment as a percent of net sales was more than 300 bps higher than it will average for the year so when you adjust for that media spending cadence, Q1's Adjusted EBITDA margin was closer to 17% – very close to our 2027 goal. We believe that if we can consistently deliver the Adjusted Gross Margin we delivered in Q1, that we can deliver the remaining building blocks of our Adjusted EBITDA margin target of 18% through effectively leveraging the added scale that comes with our growth. Operating cash generation of $5.4 million was ahead of our plan, further increasing our confidence we can self-fund our growth with no need for additional equity and potentially not even needing any new debt.

In summary, we are off to a fast start this year. We have more work to do to prove to our shareholders that we can maintain or exceed this level of performance, but we are confident in our ability to execute based on what we know today and what is within our control. Now, let me turn it over to Todd to walk through the details of the Q1 results and our updated guidance. Todd…

Todd Cunfer

Thank you, Billy, and good morning, everyone. As Billy mentioned, we had an excellent first quarter. Now I'll give you some more color on our financials and updated guidance for the year.

First quarter net sales were $223.8 million, up 34% year-over-year. Nielsen measured dollar growth was 26% vs. the prior year period, with broad-based consumption growth across channels. We saw 28% growth in XAOC, 25% in US Food, 13% growth in pet specialty, and over 100% growth in the unmeasured channels.

First quarter Adjusted Gross Margin was 45.3%, up 680 basis points year-over-year. This was driven by improvements in input costs, quality, yield and throughput. Specifically, input costs as a percent of net sales improved 390 basis points – reflecting a small amount of pricing from last year's price increase, improving yields in our manufacturing operation, and lower commodity costs. Quality costs improved by 240 basis points, and plant costs improved by 60 basis points – both driven by strong operating performance across all three manufacturing sites. Within plant costs we were able to build much needed inventory which contributed about 100 bps in the quarter.

First quarter Adjusted SG&A was 31.7% of net sales, compared to 36.7% in the prior year period. We spent 14.3% of net sales on media in the quarter, down from 15.5% of net sales in the prior year period. Total media investment was up 23% year-over-year – in-line with our plan to have our media spending a bit less front-loaded this year. Logistics costs continued to improve and were 6.4% of net sales in the first quarter, a decrease of 290 basis points compared to the prior year period. We believe that about one third of this improvement was due to market conditions such as lane rates and diesel costs, and the remainder was due to deliberate actions we took to increase fill rates, reduce miles and other efficiency-focused efforts. In fact, our logistics costs in the quarter were $1.3 million lower than in the year-ago period despite shipping 31% more pounds of finished product.

First quarter Adjusted EBITDA was $30.6 million, or 13.7% of net sales, compared to $3.0 million, or 1.8% of net sales in the prior year period. This sharp increase was driven by better-than-expected net sales and improvement across input, quality, logistics, and plant costs.

Capital spending for the first quarter was $46.5 million, in-line with our expectations. Operating cash flow was $5.4 million, and we had cash on hand of $258 million at the end of the quarter. We continue to believe that we have adequate cash to fully fund our growth through 2024 and will be free cash flow positive in 2026. We also believe that we will have access to traditional, non-dilutive forms of capital to bridge a gap in 2025, if it occurs.

Now turning to guidance for 2024. We are maintaining our net sales guidance of at least $950 million until we have greater confidence that we will have adequate rolls capacity to meet a higher level of demand later this year. This will also allow us to manage our growth to deliver the right balance between growth and capital investment. As we have said, we are carefully managing our growth to live within our capacity plans. If we do find that our production performance from existing lines and facilities exceeds our plan, we would be comfortable letting the growth drift a bit higher this year. However, we also need to be mindful that we need to have adequate capacity to meet demand for next year as we exit the year. So, we are managing this closely and will not commit to a higher level of growth until we are sure that we can supply it reliably – both this year and next year – even if that means our growth rate later in the year is below our long-term rate of 25%. We can re-accelerate as capacity becomes available.

In terms of cadence, we still expect the first quarter to have had the highest percent net sales growth year-over-year and expect sequentially lower percent growth throughout the remainder of the year. We may pull back media to control growth in-line with the long-term algorithm. Not because demand is slowing, we are just managing the pace of growth as we expand capacity.

We are raising our Adjusted EBITDA outlook from our previous guidance of $100 to $110 million, to now at least $120 million to reflect the over-delivery in Q1. While our performance to date has been very encouraging, we will not commit to a higher level of profitability for the balance of the year until we have proven that we can repeat Q1's performance reliably. As such, our revised guidance adds the Q1 over-delivery to our target for the year, but has not changed our expectations for the remaining quarters yet. We now expect Adjusted Gross Margin to expand by at least 300 bps for the full year, compared to 100 bps previously, and expect commodity deflation in 2024. Capital expenditures will be approximately $210 million to support the installation of capacity to meet demand in 2025, consistent with previous guidance.

In summary, we are encouraged by the first quarter results; however, it is still early and given the potential for the environment to change as we progress throughout the year, and the unforeseen issues that arise from time to time – especially for high growth businesses, we are going to be prudent in our forecasting. We said last quarter that we were at an inflection point and believe we have turned the corner on profitability. We have gained scale and are beginning to see the benefits of that. Like Billy mentioned, there is more upside longer-term as we continue to work on operational efficiencies and bring more capacity online across our facilities, especially in Ennis. For now, though, we feel comfortable maintaining our long-term targets of 45% Adjusted Gross Margin and 18% Adjusted EBITDA margin because we want to prove we can consistently deliver on our profitability metrics over time before we commit to new targets.

Finally, this step change in our profitability adds to our confidence that we will be able to fulfill our mission of elevating the way we feed our pets with fresh food that nourishes all. We are building Freshpet into an iconic, market leading brand that is redefining what pet food is, and that we believe is better for pets, people, and the planet. 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.