

CENTRAL GARDEN & PET CO

Form 10-Q

May 08, 2008

Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended March 29, 2008

or

**TRANSITION REPORT PURSUANT OF SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-33268

**CENTRAL GARDEN & PET COMPANY**

**Delaware**  
(State or other jurisdiction  
of incorporation or organization)

**68-0275553**  
(I.R.S. Employer  
Identification No.)

**1340 Treat Blvd., Suite 600, Walnut Creek, California 94597**

(Address of principle executive offices)

**(925) 948-4000**

(Registrant's telephone number, including area code)

## Edgar Filing: CENTRAL GARDEN & PET CO - Form 10-Q

**(Former name, former address and former fiscal year, if changed since last report)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

|   |            |
|---|------------|
| Common Stock Outstanding as of April 30, 2008         | 22,278,940 |
| Class A Common Stock Outstanding as of April 30, 2008 | 48,233,003 |
| Class B Stock Outstanding as of April 30, 2008        | 1,652,262  |

**Table of Contents****PART I. FINANCIAL INFORMATION**

|         |   |    |
|---------|---|----|
| Item 1. | <u>Financial Statements</u>   | 4  |
|         | <u>Condensed Consolidated Balance Sheets as of September 29, 2007 and March 29, 2008</u>                            | 4  |
|         | <u>Condensed Consolidated Statements of Operations Three and Six Months Ended March 31, 2007 and March 29, 2008</u> | 5  |
|         | <u>Condensed Consolidated Statements of Cash Flows Six Months Ended March 31, 2007 and March 29, 2008</u>           | 6  |
|         | <u>Notes to Condensed Consolidated Financial Statements</u>   | 7  |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                        | 17 |
| Item 3. | <u>Quantitative and Qualitative Disclosures About Market Risk</u>   | 23 |
| Item 4. | <u>Controls and Procedures</u>  | 23 |

**PART II. OTHER INFORMATION**

|          |  |    |
|----------|--|----|
| Item 1.  | <u>Legal Proceedings</u>   | 23 |
| Item 1A. | <u>Risk Factors</u>  | 23 |
| Item 2.  | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 24 |
| Item 3.  | <u>Defaults Upon Senior Securities</u>                             | 24 |
| Item 4.  | <u>Submission of Matters to a Vote of Security Holders</u>         | 24 |
| Item 5.  | <u>Other Information</u>   | 25 |
| Item 6.  | <u>Exhibits</u>  | 25 |

**Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995**

This Form 10-Q includes forward-looking statements. Forward-looking statements include statements concerning our plans, objectives, goals, strategies, future events, future revenues or performance, capital expenditures, financing needs, plans or intentions relating to acquisitions, our competitive strengths and weaknesses, our business strategy and the trends we anticipate in the industries and economies in which we operate and other information that is not historical information. When used in this Form 10-Q, the words estimates, expects, anticipates, projects, intends, believes and variations of such words or similar expressions are intended to identify forward-looking statements. All forward-looking statements, including, without limitation, our examination of historical operating trends, are based upon our current expectations and various assumptions. Our expectations, beliefs and projections are expressed in good faith, and we believe there is a reasonable basis for them, but we cannot assure you that our expectations, beliefs and projections will be realized.

There are a number of risks and uncertainties that could cause our actual results to differ materially from the forward-looking statements contained in this Form 10-Q. Important factors that could cause our actual results to differ materially from the forward-looking statements we make in this Form 10-Q are set forth in our Form 10-K for the fiscal year ended September 29, 2007 and our Form 10-Q for the quarter ended December 29, 2007, including the factors described in the section entitled Risk Factors and in Item 1A below. If any of these risks or uncertainties materialize, or if any of our underlying assumptions are incorrect, our actual results may differ significantly from the results that we express in or imply by any of our forward-looking statements. We do not undertake any obligation to revise these forward-looking statements to reflect future events or circumstances. Presently known risk factors include, but are not limited to, the following factors:

seasonality and fluctuations in our operating results and cash flow;

fluctuations in market prices for seeds and grains;

supply shortages in small animals and pet birds;

adverse weather conditions;

declines in consumer spending during economic downturns;

inability to comply with the terms of our indebtedness;

**Table of Contents**

limitations in our debt capacity as a result of deterioration in operating results coupled with our current outstanding indebtedness and seasonal borrowing needs;

dependence on a few customers for a significant portion of each of our businesses;

consolidation trends in the retail industry;

uncertainty of our product innovations and marketing programs;

competition in our industries;

risks associated with our acquisition strategy;

dependence upon our key executive officers;

rising energy prices, fuel and related petrochemical costs;

implementation of a new enterprise resource planning information technology system over the next several years;

potential environmental liabilities;

risk associated with international sourcing;

litigation and product liability claims; and

the voting power associated with our Class B stock.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****CENTRAL GARDEN & PET COMPANY****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share and per share amounts)

(unaudited)

|  | September 29,<br>2007 | March 29,<br>2008   |
|--|-----------------------|---------------------|
| <b>ASSETS</b>  |                       |                     |
| Current assets:  |                       |                     |
| Cash and cash equivalents  | \$ 21,055             | \$ 7,577            |
| Accounts receivable (less allowance for doubtful accounts of \$13,803 and \$14,420)  | 247,429               | 342,528             |
| Inventories  | 378,365               | 416,848             |
| Prepaid expenses and other   | 38,659                | 33,953              |
| <b>Total current assets</b>  | <b>685,508</b>        | <b>800,906</b>      |
| Land, buildings, improvements and equipment net  | 201,609               | 196,204             |
| Goodwill   | 598,758               | 204,562             |
| Other intangible assets net  | 100,314               | 98,797              |
| Deferred income taxes and other assets   | 60,633                | 131,827             |
| <b>Total</b>   | <b>\$ 1,646,822</b>   | <b>\$ 1,432,296</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                       |                     |
| Current liabilities:   |                       |                     |
| Accounts payable   | \$ 135,972            | \$ 126,946          |
| Accrued expenses   | 75,968                | 92,510              |
| Current portion of long-term debt  | 3,352                 | 3,350               |
| <b>Total current liabilities</b>   | <b>215,292</b>        | <b>222,806</b>      |
| Long-term debt   | 607,171               | 692,141             |
| Other long-term obligations  | 44,802                | 4,740               |
| Convertible redeemable preferred stock   | 750                   |                     |
| Minority interest  | 1,834                 | 2,297               |
| Shareholders equity:   |                       |                     |
| Common stock, \$.01 par value: 22,297,985 and 22,280,305 shares outstanding at September 29, 2007 and March 29, 2008         | 221                   | 221                 |
| Class A common stock, \$.01 par value: 47,860,603 and 48,221,552 shares outstanding at September 29, 2007 and March 29, 2008 | 478                   | 482                 |
| Class B stock, \$.01 par value: 1,652,262 shares outstanding   | 16                    | 16                  |
| Additional paid-in capital   | 553,728               | 557,541             |
| Retained earnings (accumulated deficit)  | 217,335               | (52,201)            |
| Accumulated other comprehensive income   | 5,195                 | 4,253               |
| <b>Total shareholders equity</b>   | <b>776,973</b>        | <b>510,312</b>      |

|       |              |              |
|-------|--------------|--------------|
| Total | \$ 1,646,822 | \$ 1,432,296 |
|-------|--------------|--------------|

See notes to condensed consolidated financial statements.

**Table of Contents****CENTRAL GARDEN & PET COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share amounts)****(unaudited)**

|   | <b>Three Months Ended</b> |                           | <b>Six Months Ended</b>   |                           |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
|   | <b>March 31,<br/>2007</b> | <b>March 29,<br/>2008</b> | <b>March 31,<br/>2007</b> | <b>March 29,<br/>2008</b> |
| Net sales   | \$ 485,660                | \$ 484,688                | \$ 803,058                | \$ 798,473                |
| Cost of goods sold and occupancy  | 321,814                   | 324,878                   | 537,342                   | 544,341                   |
| Gross profit  | 163,846                   | 159,810                   | 265,716                   | 254,132                   |
| Selling, general and administrative expenses                                    | 117,616                   | 115,160                   | 213,561                   | 200,096                   |
| Impairment of goodwill  |                           |                           |                           | 400,000                   |
| Income (loss) from operations   | 46,230                    | 44,650                    | 52,155                    | (345,964)                 |
| Interest expense  | (12,693)                  | (9,780)                   | (24,098)                  | (21,285)                  |
| Interest income   | 289                       | 266                       | 965                       | 554                       |
| Other income  | 1,596                     | 1,191                     | 1,685                     | 1,674                     |
| Income (loss) before income taxes (tax benefit) and minority interest           | 35,422                    | 36,327                    | 30,707                    | (365,021)                 |
| Income taxes (tax benefit)  | 13,258                    | 15,403                    | 11,409                    | (96,411)                  |
| Minority interest   | 714                       | 471                       | 814                       | 463                       |
| Net income (loss)   | \$ 21,450                 | \$ 20,453                 | \$ 18,484                 | \$ (269,073)              |
| Net income (loss) per share:  |                           |                           |                           |                           |
| Basic   | \$ 0.30                   | \$ 0.29                   | \$ 0.26                   | \$ (3.77)                 |
| Diluted   | \$ 0.30                   | \$ 0.28                   | \$ 0.26                   | \$ (3.77)                 |
| Weighted average shares used in the computation of net income (loss) per share: |                           |                           |                           |                           |
| Basic   | 71,422                    | 71,427                    | 71,358                    | 71,295                    |
| Diluted   | 72,028                    | 72,035                    | 72,102                    | 71,295                    |

See notes to condensed consolidated financial statements.



**Table of Contents****CENTRAL GARDEN & PET COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

|   | <b>Six Months Ended</b> |                  |
|---|-------------------------|------------------|
|   | <b>March 31,</b>        | <b>March 29,</b> |
|   | <b>2007</b>             | <b>2008</b>      |
| <b>Cash flows from operating activities:</b>  |                         |                  |
| Net income (loss)   | \$ 18,484               | \$ (269,073)     |
| <b>Adjustments to reconcile net income (loss) to net cash used in operating activities:</b> |                         |                  |
| Depreciation and amortization   | 14,282                  | 16,069           |
| Stock-based compensation  | 2,306                   | 6,767            |
| Excess tax benefits from stock-based awards   | (1,313)                 | (24)             |
| Minority interest   | 814                     | 463              |
| Deferred income taxes   | (883)                   | (113,419)        |
| Gain on sales of property   |                         | (7,931)          |
| Loss on sale of a business  |                         | 1,590            |
| Loss (gain) on sale of equipment  | (12)                    | 2                |
| Impairment of goodwill  |                         | 400,000          |
| Other impairments   |                         | 2,000            |
| <b>Change in assets and liabilities (excluding businesses acquired):</b>                    |                         |                  |
| Accounts receivable   | (92,813)                | (94,975)         |
| Inventories   | (76,662)                | (37,116)         |
| Prepaid expenses and other assets   | (7,448)                 | 7,747            |
| Accounts payable  | 26,196                  | (10,621)         |
| Accrued expenses  | 2,022                   | 9,643            |
| Other long-term obligations   | (832)                   | (1,248)          |
| <b>Net cash used in operating activities</b>  | <b>(115,859)</b>        | <b>(90,126)</b>  |
| <b>Cash flows from investing activities:</b>  |                         |                  |
| Additions to property and equipment   | (30,952)                | (13,132)         |
| Proceeds from property sales, net of expenses   |                         | 12,053           |
| Businesses acquired, net of cash acquired   | (18,347)                | (4,998)          |
| Collection of note  | 3,340                   |                  |
| Restricted investments  | 31                      | (39)             |
| <b>Net cash used in investing activities</b>  | <b>(45,928)</b>         | <b>(6,116)</b>   |
| <b>Cash flows from financing activities:</b>  |                         |                  |
| Borrowings on revolving line of credit  | 452,000                 | 385,000          |
| Repayments of revolving line of credit  | (306,000)               | (302,000)        |
| Repayments of long-term debt  | (1,241)                 | (934)            |
| Proceeds from issuance of common stock  | 2,291                   | 1,472            |
| Redemption of preferred stock   |                         | (750)            |
| Excess tax benefits from stock-based awards   | 1,313                   | 24               |
| Payment of financing costs  | (416)                   | (125)            |
| <b>Net cash provided by financing activities</b>  | <b>147,947</b>          | <b>82,687</b>    |

Edgar Filing: CENTRAL GARDEN & PET CO - Form 10-Q

|  |           |           |
|--|-----------|-----------|
| Effect of exchange rate changes on cash and cash equivalents | 33        | 77        |
| Net decrease in cash and cash equivalents                    | (13,807)  | (13,478)  |
| Cash and equivalents at beginning of period                  | 28,406    | 21,055    |
| Cash and equivalents at end of period                        | \$ 14,599 | \$ 7,577  |
| Supplemental information:                                    |           |           |
| Cash paid for interest                                       | \$ 24,619 | \$ 22,307 |
| Cash paid for income taxes net of refunds                    | \$ 878    | \$ 77     |
| Liabilities assumed in connection with acquisitions          | \$ 3      | \$ 1,396  |
| Conversion of preferred stock to common stock                | \$ 2,250  | \$        |
| Note receivable from sale of property                        | \$        | \$ 3,850  |

See notes to condensed consolidated financial statements.

**Table of Contents**

**CENTRAL GARDEN & PET COMPANY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Three and Six Months Ended March 29, 2008**

**(unaudited)**

**1. Basis of Presentation**

The condensed consolidated balance sheet of Central Garden & Pet Company and subsidiaries (the Company or Central ) as of March 29, 2008, the condensed consolidated statements of operations for the three months and six months ended March 31, 2007 and March 29, 2008 and the condensed consolidated statements of cash flows for the six months ended March 31, 2007 and March 29, 2008 have been prepared by the Company, without audit. In the opinion of management, all adjustments (which include only normal recurring adjustments, except as discussed in note 2) considered necessary to present fairly the financial position, results of operations and cash flows of the Company for the periods mentioned above, have been made.

For the Company's foreign business in the UK, the local currency is the functional currency. Assets and liabilities are translated using the exchange rate in effect at the balance sheet date. Income and expenses are translated at the average exchange rate for the period. For the six month period ended March 29, 2008, there was a comprehensive loss of \$270.0 million, which includes a net loss of \$269.1 million and foreign currency translation adjustments of \$0.9 million that are excluded from net earnings but reported in accumulated other comprehensive income, a separate component of shareholders' equity. For the six month period ended March 31, 2007, comprehensive income was \$20.4 million, which included net income of \$18.5 million and foreign currency translation adjustments of \$1.9 million. Deferred taxes are not provided on translation gains and losses, because the Company expects earnings of its foreign subsidiary to be permanently reinvested. Transaction gains and losses are included in results of operations.

Due to the seasonal nature of the Company's garden business, the results of operations for the three and six month periods ended March 29, 2008 and March 31, 2007 are not indicative of the operating results that may be expected for the entire fiscal year. These interim financial statements should be read in conjunction with the annual audited financial statements, accounting policies and financial notes thereto, included in the Company's 2007 Annual Report on Form 10-K, which has previously been filed with the Securities and Exchange Commission.

***Minority Interest***

Minority interest in the Company's condensed consolidated financial statements represents the 20% interest not owned by Central in a consolidated subsidiary. Since the Company controls this subsidiary, its financial statements are fully consolidated with those of the Company, and the minority owner's 20% share of the subsidiary's net assets and results of operations is deducted and reported as minority interest.

***Recently Adopted Accounting Pronouncements*** Effective September 30, 2007, the Company adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48). As a result of the implementation of FIN 48, the Company recognized a \$0.5 million increase to its reserve for uncertain tax positions and a cumulative effect adjustment to decrease retained earnings. At the adoption date, the Company had \$1.6 million of unrecognized tax benefits, \$0.8 million of which would affect the effective tax rate if recognized. The Company has not recorded any significant changes to the unrecognized tax benefits during the current fiscal year and does not anticipate that there will be any significant changes to these unrecognized tax benefits within the next twelve months.

Interest and penalties related to uncertain tax positions are recognized in income tax expense. As of the adoption date, the Company had approximately \$0.4 million of accrued interest and penalties related to uncertain tax positions.

The Company's major taxing jurisdictions are the United States and various states. Tax years 2004 through 2007 for the Internal Revenue Service and 2002 through 2007 for various states remain open to examination. The Company does not believe that the outcome of any examination will have a material impact on the Company's financial statements.

***Recently Issued Accounting Pronouncements*** In December 2007, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 141(R) Business Combinations, which establishes accounting principles and disclosure requirements for all transactions in which a company

## Edgar Filing: CENTRAL GARDEN & PET CO - Form 10-Q

obtains control over another business. This accounting pronouncement is effective for the Company in its fiscal year beginning September 27, 2009. The Company is currently evaluating the impact of SFAS No. 141(R) on its consolidated financial statements.

---

**Table of Contents**

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment to ARB No. 51. This standard prescribes the accounting by a parent company for minority interests held by other parties in a subsidiary of the parent company. SFAS No. 160 is effective for the Company in its fiscal year beginning September 27, 2009. The Company is currently evaluating the impact of SFAS No. 160 on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which provides companies an option to report selected financial assets and liabilities at fair value. SFAS No. 159 requires companies to provide information to assist financial statement users to understand the effect of a company's choice to use fair value on its earnings, as well as to display on the face of the balance sheet the fair value of assets and liabilities chosen by the company for fair value accounting. Additionally, SFAS No. 159 establishes presentation and disclosure requirements designed to simplify comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for the Company in its fiscal year beginning September 28, 2008. The Company is currently evaluating the impact of SFAS No. 159 on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The standard also establishes a framework for measuring fair value and provides for expanded disclosures about fair value measurements. SFAS No. 157 is effective for the Company's fiscal year beginning September 28, 2008. The Company is currently evaluating the impact of SFAS No. 157 on its consolidated financial statements.

**2. Goodwill**

The Company accounts for goodwill in accordance with SFAS No. 142, Goodwill and Other Intangible Assets, and tests goodwill for impairment annually, or whenever events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This assessment involves the use of significant accounting judgments and estimates as to future operating results and discount rates. Changes in estimates or use of different assumptions could produce significantly different results. An impairment loss is generally recognized when the carrying amount of the reporting unit's net assets exceeds the estimated fair value of the reporting unit. The Company uses discounted cash flow analysis to estimate the fair value of its reporting units. Current accounting convention also requires a comparison of current market capitalization to book value.

Based on the Company's most recent annual impairment test in fiscal year 2007, the Company determined that there was no goodwill impairment as of September 29, 2007. However, due to the continuing depressed stock price, as of December 29, 2007, shareholders' equity (book value) was approximately \$775 million and the market capitalization was approximately \$390 million. As a result, the Company concluded there was an indicator of possible goodwill impairment.

Accordingly, the Company updated its analysis and evaluation of goodwill for possible impairment as of December 29, 2007, which included a comparison of market capitalization to the combined fair values of the Company's four reporting units. Based on the Company's updated analysis and sustained decline in market capitalization, the Company determined that it was required to take a non-cash charge of \$400 million in the first fiscal quarter to recognize the impairment of goodwill, comprised of \$202 million relating to the Garden Segment and \$198 million relating to the Pet Segment. This non-cash charge of \$400 million reduced the Company's net earnings for the six months ended March 29, 2008 by \$290.4 million, or \$4.07 per share.

**3. Long-Term Debt**

As of March 29, 2008, the Company had \$650 million in senior secured credit facilities consisting of a \$350 million revolving credit facility maturing in February 2011 and a \$300 million term loan maturing in September 2012. Interest on the revolving credit facility is based on a rate equal to prime plus a margin, which fluctuates from 0% to 0.375%, or LIBOR plus a margin, which fluctuates from 0.75% to 1.50%, determined quarterly based on consolidated total debt to consolidated EBITDA for the most recent trailing 12-month period. Interest on the term loan is based on a rate equal to LIBOR plus a margin, which fluctuates from 1.50% to 1.75% or the prime rate plus a margin, which fluctuates from 0.50% to 0.75%, at the Company's option. The August 2007 amendment provides that the margin on loans increases when the leverage ratio exceeds 4.5 to 1.0. The term loan is payable in quarterly installments of \$750,000 with the balance payable in September 2012. These facilities are secured by substantially all of the Company's assets and contain certain financial covenants which require the Company to maintain minimum levels of interest coverage and maximum levels of total debt to EBITDA and that restrict the Company's ability to repurchase stock, make investments in or acquisitions of other businesses and pay dividends above certain levels over the life of the facilities.

## Edgar Filing: CENTRAL GARDEN & PET CO - Form 10-Q

The Company was in compliance with all financial covenants as of March 29, 2008. There was \$247.0 million outstanding at March 29, 2008 under the \$350 million revolving credit facility plus \$15.9 million outstanding under certain letters of credit. The remaining potential available borrowing capacity was up to \$87.1 million. The Company's borrowing capacity is also subject to compliance with the financial covenants in these credit agreements.

**Table of Contents****4. Stock-Based Compensation**

The Company has various non-qualified stock-based compensation programs, which provide for stock option grants and restricted stock awards. The grant date fair values of stock options and restricted stock awards are amortized over the vesting period. Stock options may be granted to officers, key employees and directors. The Company accounts for stock-based awards in accordance with SFAS No. 123(R), Share-Based Payment. Stock compensation expense is recognized over the requisite service period using the straight-line attribution method.

Stock options are generally granted with 30 month cliff vesting and 42 month expiration, but are also granted with graded vesting increments of 20% or 25% per year and expiring up to eight years from the date of grant. In fiscal 2008, 2.2 million performance options were granted that vest based on pre-determined Company goals for each of the next five years and expire at the end of the sixth year. We currently estimate the performance-based options are probable of achievement and are recording the related expense over the estimated service period using the accelerated method. To the extent Company goals are not achieved, the amount of stock-based compensation recognized will be adjusted in the future.

During 2004 and 2005, respectively, the Company granted service-based nonvested stock option awards that were due to expire in June 2008 and June 2009. The grant price of the option awards were approximately \$12 to \$15 per share, significantly in excess of the current market price. In 2008, the Company modified options to purchase 1.4 million of these shares held by non-executive employees to extend the expiration date of these awards by three years. The primary purpose of the extended expiration was to encourage retention. The change to the expiration terms will result in an increase in stock-based compensation expense of approximately \$0.1 million in fiscal 2008.

The Company recognized share-based compensation expense of \$5.8 million and \$1.3 million for the three month periods ended March 29, 2008 and March 31, 2007, respectively, and \$6.8 million and \$2.3 million for the six month periods ended March 29, 2008 and March 31, 2007, respectively as a component of selling, general and administrative expenses.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model. Expected stock price volatilities are estimated based on the Company's implied historical volatility. The expected term of options granted is based on analyses of historical employee termination rates and option exercises. The risk-free rates are based on U.S. Treasury yields, for notes with comparable terms as the option grants, in effect at the time of the grant. For purposes of this valuation model, no dividends have been assumed. Assumptions for the six month periods ended March 29, 2008 and March 31, 2007 used in the Black-Scholes model are presented below:

|                                | March 29,<br>2008 | March 31,<br>2007 |
|--------------------------------|-------------------|-------------------|
| Stock plans:                   |                   |                   |
| Average expected life in years | 4 years           | 5 years           |
| Expected volatility            | 31%               | 28%               |
| Risk-free interest rate        | 2.0%              | 4.6%              |

The following table summarizes option activity for the six months ended March 29, 2008:

|                                   | Number of<br>Shares<br>(in thousands) | Weighted<br>Average Exercise<br>Price per<br>Share | Weighted Average<br>Remaining<br>Contractual Life<br>(in years) | Aggregate<br>Intrinsic Value<br>(in<br>thousands) |
|-----------------------------------|---------------------------------------|--|---|---|
| Outstanding at September 29, 2007 | 4,724                                 | \$ 12.89   | 3 years   | \$ 60,910   |
| Granted                           | 2,237                                 | \$ 4.63  |   |   |
| Exercised                         | (33)                                  | \$ 4.70  |   |   |
| Cancelled or expired              | (529)                                 | \$ 13.61   |   |   |
| Outstanding at March 29, 2008     | 6,399                                 | \$ 9.99  | 5 years   | \$ 63,912   |
| Exercisable at March 29, 2008     | 895                                   | \$ 12.60   | 3 years   | \$ 11,272   |





**Table of Contents**

The weighted average per share fair value of options granted during the six months ended March 29, 2008 and March 31, 2007 was \$1.25 and \$5.08, respectively. The total intrinsic value of options exercised during the six months ended March 29, 2008 and March 31, 2007 was \$0.2 million and \$2.3 million, respectively.

As of March 29, 2008, there was approximately \$8.0 million of total unrecognized compensation cost related to nonvested stock options, which is expected to be recognized over a remaining weighted-average vesting period of three years.

**Restricted Stock Awards:** As of March 29, 2008, there were 0.6 million shares of restricted stock awards outstanding. The awards generally vest in 20% or 25% annual increments beginning two or three years from the date of grant.

The following table summarizes restricted stock award activity during the six months ended March 29, 2008:

|                                 | Number of<br>Shares<br>(in thousands) |
|---------------------------------|---------------------------------------|
| Nonvested at September 29, 2007 | 648                                   |
| Granted                         | 403                                   |
| Vested                          | (426)                                 |
| Forfeited                       | (60)                                  |
| Nonvested at March 29, 2008     | 565                                   |

The weighted average per share grant-date fair value of restricted stock awards granted during the first six months of fiscal 2008 and fiscal 2007 was \$4.29 and \$15.60, respectively.

As of March 29, 2008, there was approximately \$5.6 million of unrecognized compensation cost related to nonvested restricted stock awards, which is expected to be recognized over a remaining weighted-average period of two years.

**5. Earnings per Share**

The following is a reconciliation of the numerators and denominators of the basic and diluted per share computations for income (loss) from continuing operations.

|  | Three Months Ended<br>March 29, 2008     |        |           | Six Months Ended<br>March 29, 2008 |        |           |
|--|--|--------|-----------|------------------------------------|--------|-----------|
|  | Income                                   | Shares | Per Share | Income (Loss)                      | Shares | Per Share |
|  | (in thousands, except per share amounts) |        |           |                                    |        |           |
| <b>Basic EPS:</b>                                  |  |        |           |                                    |        |           |
| Net income (loss) available to common shareholders | \$ 20,453                                | 71,427 | \$ 0.29   | \$(269,073)                        | 71,295 | \$(3.77)  |
| <b>Effect of dilutive securities:</b>              |  |        |           |                                    |        |           |
| Options to purchase common stock                   |  | 18     |           |                                    |        |           |
| Restricted shares                                  |  | 582    | (0.01)    |                                    |        |           |
| Convertible preferred stock                        |  | 8      |           |                                    |        |           |
| <b>Diluted EPS:</b>                                |  |        |           |                                    |        |           |
| Net income (loss) available to common shareholders | \$ 20,453                                | 72,035 | \$ 0.28   | \$(269,073)                        | 71,295 | \$(3.77)  |

**Table of Contents**

|   | Three Months Ended<br>March 31, 2007 |        |           | Six Months Ended<br>March 31, 2007 |        |           |
|---|--------------------------------------|--------|-----------|------------------------------------|--------|-----------|
|   | Income                               | Shares | Per Share | Income                             | Shares | Per Share |
| (in thousands, except per share amounts)    |                                      |        |           |                                    |        |           |
| Basic EPS:                                  |                                      |        |           |                                    |        |           |
| Net income available to common shareholders | \$ 21,450                            | 71,422 | \$ 0.30   | \$ 18,484                          | 71,358 | \$ 0.26   |
| Effect of dilutive securities:              |                                      |        |           |                                    |        |           |
| Options to purchase common stock            |                                      | 542    |           |                                    | 680    |           |
| Convertible preferred stock                 |                                      | 64     |           |                                    | 64     |           |
| Diluted EPS:                                |                                      |        |           |                                    |        |           |
| Net income available to common shareholders | \$ 21,450                            | 72,028 | \$ 0.30   | \$ 18,484                          | 72,102 | \$ 0.26   |

Options to purchase 6,399,288 shares of common stock at prices ranging from \$4.26 to \$17.99 per share were outstanding at March 29, 2008 and options to purchase 4,340,032 shares of common stock at prices ranging from \$4.26 to \$17.99 per share were outstanding at March 31, 2007.

For the three month periods ended March 29, 2008 and March 31, 2007, options to purchase 3,804,788 and 1,171,508 shares of common stock, respectively, were outstanding but were not included in the computation of diluted earnings per share because the option exercise prices were greater than the average market price of the common shares and, therefore, the effect would be anti-dilutive. Shares of common stock from the assumed conversion of the Company's convertible preferred stock, issued in February 2004, were included in the computation of diluted EPS for the three month periods ended March 29, 2008 and March 31, 2007.

For the six month period ended March 31, 2007, options to purchase 552,917 shares of common stock were outstanding but were not included in the computation of diluted earnings per share because the option exercise prices were greater than the average market price of the common shares and, therefore, the effect would be anti-dilutive. Shares of common stock from the assumed conversion of the convertible preferred stock were included in the computation of diluted EPS for the six month period ended March 31, 2007. The potential effects of stock awards and the assumed conversion of the Company's convertible preferred stock were excluded from the diluted earnings per share calculation for the six month period ended March 29, 2008, because their inclusion in a net loss period would be anti-dilutive to the earnings per share calculation.

**6. Segment Information**

Management has determined that the Company has two operating segments which are also reportable segments based on the level at which the Chief Executive Officer reviews the results of operations to make decisions regarding performance assessment and resource allocation. These operating segments are Pet Products and Garden Products.

**Table of Contents**

|  | <b>Three Months Ended</b> |                           | <b>Six Months Ended</b>   |                           |
|--|---------------------------|---------------------------|---------------------------|---------------------------|
|  | <b>March 31,<br/>2007</b> | <b>March 29,<br/>2008</b> | <b>March 31,<br/>2007</b> | <b>March 29,<br/>2008</b> |
| <b>Net sales:</b>                          |                           |                           |                           |                           |
| Pet Products                               | \$ 229,801                | \$ 230,914                | \$ 432,089                | \$ 432,537                |
| Garden Products                            | 255,859                   | 253,774                   | 370,969                   | 365,936                   |
| <b>Total net sales</b>                     | <b>\$ 485,660</b>         | <b>\$ 484,688</b>         | <b>\$ 803,058</b>         | <b>\$ 798,473</b>         |
| <b>Income (loss) from operations:</b>      |                           |                           |                           |                           |
| Pet Products                               | \$ 29,285                 | \$ 28,195                 | \$ 47,092                 | \$ (152,571)              |
| Garden Products                            | 28,842                    | 26,111                    | 26,709                    | (179,947)                 |
| Corporate                                  | (11,897)                  | (9,656)                   | (21,646)                  | (13,446)                  |
| <b>Total income (loss) from operations</b> | <b>46,230</b>             | <b>44,650</b>             | <b>52,155</b>             | <b>(345,964)</b>          |
| Interest expense net                       | (12,404)                  | (9,514)                   | (23,133)                  | (20,731)                  |
| Other income                               | 1,596                     | 1,191                     | 1,685                     | 1,674                     |
| Income taxes (tax benefit)                 | (13,258)                  | (15,403)                  | (11,409)                  | 96,411                    |
| Minority interest <sup>(1)</sup>           | (714)                     | (471)                     | (814)                     | (463)                     |
| <b>Net income (loss)</b>                   | <b>\$ 21,450</b>          | <b>\$ 20,453</b>          | <b>\$ 18,484</b>          | <b>\$ (269,073)</b>       |
| <b>Depreciation and amortization:</b>      |                           |                           |                           |                           |
| Pet Products                               | \$ 4,122                  | \$ 4,234                  | \$ 8,717                  | \$ 8,603                  |
| Garden Products                            | 2,456                     | 2,155                     | 3,900                     | 4,325                     |
| Corporate                                  | 857                       | 1,690                     | 1,665                     | 3,141                     |
| <b>Total depreciation and amortization</b> | <b>\$ 7,435</b>           | <b>\$ 8,079</b>           | <b>\$ 14,282</b>          | <b>\$ 16,069</b>          |

|   | <b>September 29,<br/>2007</b> | <b>March 29,<br/>2008</b> |
|---|-------------------------------|---------------------------|
| <b>Assets:</b>  |                               |                           |
| Pet Products  | \$ 478,714                    | \$ 492,132                |
| Garden Products                                       | 456,484                       | 586,326                   |
| Corporate   | 711,624                       | 353,838                   |
| <b>Total assets</b>                                   | <b>\$ 1,646,822</b>           | <b>\$ 1,432,296</b>       |
| <b>Goodwill (included in corporate assets above):</b> |                               |                           |
| Pet Products  | \$ 403,715                    | \$ 204,562                |
| Garden Products                                       | 195,043                       |                           |
| <b>Total goodwill</b>                                 | <b>\$ 598,758</b>             | <b>\$ 204,562</b>         |

(1) Minority interest is associated with the Garden Products segment.

**Table of Contents****7. Consolidating Condensed Financial Information of Guarantor Subsidiaries**

Certain 100% wholly-owned subsidiaries of the Company (as listed below, collectively the Guarantor Subsidiaries) have guaranteed fully and unconditionally, on a joint and several basis, the obligation to pay principal and interest on the Company's \$150,000,000 9-1/8% Senior Subordinated Notes (the Notes) issued on January 30, 2003. Certain subsidiaries and operating divisions are not guarantors of the Notes and have been included in the financial results of the Parent in the information below. These Non-Guarantor entities are not material to the Parent. Those subsidiaries that are guarantors and co-obligors of the Notes are as follows:

Farnam Companies, Inc. (including Thompson's Veterinary Supplies, Inc.)

Four Paws Products Ltd.

Grant Laboratories, Inc.

Gulfstream Home & Garden, Inc.

Interpet USA, LLC

Kaytee Products, Inc.

Matthews Redwood & Nursery Supply, Inc.

New England Pottery, LLC

Norcal Pottery Products, Inc.

Pennington Seed, Inc. (including Phaeton Corporation (dba Unicorn Labs), Pennington Seed, Inc. of Nebraska, Gro Tec, Inc., Seeds West, Inc., All-Glass Aquarium Co., Inc. (including Oceanic Systems, Inc.) and Cedar Works, LLC.)

Pets International, Ltd.

T.F.H. Publications, Inc.

Wellmark International (including B2E Corporation and B2E Biotech LLC)

In lieu of providing separate audited financial statements for the Guarantor Subsidiaries, the Company has included the accompanying consolidating condensed financial statements based on the Company's understanding of the Securities and Exchange Commission's interpretation and application of Rule 3-10 of the Securities and Exchange Commission's Regulation S-X.

**CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS**

**Three Months Ended March 29, 2008**

(in thousands)

(unaudited)

|                                     | Parent     | Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|-------------------------------------|------------|---------------------------|--------------|--------------|
| Net sales                           | \$ 139,508 | \$ 378,745                | \$ (33,565)  | \$ 484,688   |
| Cost of products sold and occupancy | 96,670     | 261,773                   | (33,565)     | 324,878      |

Edgar Filing: CENTRAL GARDEN & PET CO - Form 10-Q

|   |           |           |                       |
|---|-----------|-----------|-----------------------|
| Gross profit  | 42,838    | 116,972   | 159,810               |
| Selling, general and administrative expenses                                      | 33,052    | 82,108    | 115,160               |
| Income (loss) from operations   | 9,786     | 34,864    | 44,650                |
| Interest net  | (9,667)   | 153       | (9,514)               |
| Other income  | (835)     | 2,026     | 1,191                 |
| Income (loss) before income taxes and minority interest                           | (716)     | 37,043    | 36,327                |
| Income taxes  | 8,125     | 7,278     | 15,403                |
| Minority interest   | 471       |           | 471                   |
| Net income (loss) before equity in undistributed income of guarantor subsidiaries | (9,312)   | 29,765    | 20,453                |
| Equity in undistributed income of guarantor subsidiaries                          | 29,765    | (29,765)  |                       |
| Net income (loss)   | \$ 20,453 | \$ 29,765 | \$ (29,765) \$ 20,453 |

**Table of Contents****CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS****Three Months Ended March 31, 2007****(in thousands)****(unaudited)**

|   | <b>Parent</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|---------------|-----------------------------------|---------------------|---------------------|
| Net sales   | \$ 144,096    | \$ 378,778                        | \$ (37,214)         | \$ 485,660          |
| Cost of products sold and occupancy   | 98,265        | 260,763                           | (37,214)            | 321,814             |
| Gross profit  | 45,831        | 118,015                           |                     | 163,846             |
| Selling, general and administrative expenses                                      | 35,928        | 81,688                            |                     | 117,616             |
| Income from operations  | 9,903         | 36,327                            |                     | 46,230              |
| Interest net  | (12,510)      | 106                               |                     | (12,404)            |
| Other income  | (1,361)       | 2,957                             |                     | 1,596               |
| Income (loss) before income taxes and minority interest                           | (3,968)       | 39,390                            |                     | 35,422              |
| Income taxes (tax benefit)  | (1,646)       | 14,904                            |                     | 13,258              |
| Minority interest   | 714           |                                   |                     | 714                 |
| Net income (loss) before equity in undistributed income of guarantor subsidiaries | (3,036)       | 24,486                            |                     | 21,450              |
| Equity in undistributed income of guarantor subsidiaries                          | 24,486        |                                   | (24,486)            |                     |
| Net income (loss)   | \$ 21,450     | \$ 24,486                         | \$ (24,486)         | \$ 21,450           |

**CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS****Six Months Ended March 29, 2008****(in thousands)****(unaudited)**

|  | <b>Parent</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|--|---------------|-----------------------------------|---------------------|---------------------|
| Net sales                                    | \$ 235,094    | \$ 622,434                        | \$ (59,055)         | \$ 798,473          |
| Cost of products sold and occupancy          | 166,239       | 437,157                           | (59,055)            | 544,341             |
| Gross profit                                 | 68,855        | 185,277                           |                     | 254,132             |
| Selling, general and administrative expenses | 59,321        | 140,775                           |                     | 200,096             |
| Goodwill Impairment                          | 400,000       |                                   |                     | 400,000             |
| Income (loss) from operations                | (390,466)     | 44,502                            |                     | (345,964)           |
| Interest net                                 | (21,015)      | 284                               |                     | (20,731)            |
| Other income (loss)                          | (798)         | 2,472                             |                     | 1,674               |

Edgar Filing: CENTRAL GARDEN & PET CO - Form 10-Q

|   |              |           |             |              |
|---|--------------|-----------|-------------|--------------|
| Income (loss) before income taxes and minority interest                           | (412,279)    | 47,258    |             | (365,021)    |
| Income taxes (tax benefit)  | (108,899)    | 12,488    |             | (96,411)     |
| Minority interest   | 463          |           |             | 463          |
| Net income (loss) before equity in undistributed income of guarantor subsidiaries | (303,843)    | 34,770    |             | (269,073)    |
| Equity in undistributed income of guarantor subsidiaries                          | 34,770       |           | (34,770)    |              |
| Net income (loss)   | \$ (269,073) | \$ 34,770 | \$ (34,770) | \$ (269,073) |

**Table of Contents****CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS**

Six Months Ended March 31, 2007

(in thousands)

(unaudited)

|   | Parent     | Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|------------|---------------------------|--------------|--------------|
| Net sales   | \$ 245,176 | \$ 621,373                | \$ (63,491)  | \$ 803,058   |
| Cost of products sold and occupancy   | 169,151    | 431,682                   | (63,491)     | 537,342      |
| Gross profit  | 76,025     | 189,691                   |              | 265,716      |
| Selling, general and administrative expenses                                      | 63,848     | 149,713                   |              | 213,561      |
| Income from operations  | 12,177     | 39,978                    |              | 52,155       |
| Interest net  | (23,368)   | 235                       |              | (23,133)     |
| Other income (loss)   | (2,452)    | 4,137                     |              | 1,685        |
| Income (loss) before income taxes and minority interest                           | (13,643)   | 44,350                    |              | 30,707       |
| Interest taxes (tax benefit)  | (5,513)    | 16,922                    |              | 11,409       |
| Minority interest   | 814        |                           |              | 814          |
| Net income (loss) before equity in undistributed income of guarantor subsidiaries | (8,944)    | 27,428                    |              | 18,484       |
| Equity in undistributed income of guarantor subsidiaries                          | 27,428     |                           | (27,428)     |              |
| Net income (loss)   | \$ 18,484  | \$ 27,428                 | \$ (27,428)  | \$ 18,484    |

**CONSOLIDATING CONDENSED BALANCE SHEET**

March 29, 2008

(in thousands)

(unaudited)

|  | Parent   | Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|----------|---------------------------|--------------|--------------|
| <b>ASSETS</b>                                    |          |                           |              |              |
| Cash and cash equivalents                        | \$ 7,089 | \$ 488                    | \$           | \$ 7,577     |
| Accounts receivable, net                         | 96,393   | 272,015                   | (25,880)     | 342,528      |
| Inventories                                      | 131,401  | 285,447                   |              | 416,848      |
| Prepaid expenses and other assets                | 13,302   | 20,651                    |              | 33,953       |
| Total current assets                             | 248,185  | 578,601                   | (25,880)     | 800,906      |
| Land, buildings, improvements and equipment, net | 56,050   | 140,154                   |              | 196,204      |
| Goodwill   | 204,562  |                           |              | 204,562      |
| Investment in guarantors                         | 723,542  |                           | (723,542)    |              |



Edgar Filing: CENTRAL GARDEN & PET CO - Form 10-Q

|  |                     |                   |                     |                     |
|--|---------------------|-------------------|---------------------|---------------------|
| Deferred income taxes and other assets         | 78,701              | 151,923           |                     | 230,624             |
| <b>Total</b>                                   | <b>\$ 1,311,040</b> | <b>\$ 870,678</b> | <b>\$ (749,422)</b> | <b>\$ 1,432,296</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>     |                     |                   |                     |                     |
| Accounts payable                               | \$ 59,010           | \$ 93,816         | \$ (25,880)         | \$ 126,946          |
| Accrued expenses and other current liabilities | 45,500              | 50,360            |                     | 95,860              |
| <b>Total current liabilities</b>               | <b>104,510</b>      | <b>144,176</b>    | <b>(25,880)</b>     | <b>222,806</b>      |
| Long-term debt                                 | 691,814             | 327               |                     | 692,141             |
| Other long-term obligations                    | 2,107               | 2,633             |                     | 4,740               |
| Minority interest                              | 2,297               |                   |                     | 2,297               |
| Shareholders equity                            | 510,312             | 723,542           | (723,542)           | 510,312             |
| <b>Total</b>                                   | <b>\$ 1,311,040</b> | <b>\$ 870,678</b> | <b>\$ (749,422)</b> | <b>\$ 1,432,296</b> |

**Table of Contents****CONSOLIDATING CONDENSED BALANCE SHEET**

September 29, 2007

(in thousands)

(unaudited)

|  | Parent              | Guarantor<br>Subsidiaries | Eliminations        | Consolidated        |
|--|---------------------|---------------------------|---------------------|---------------------|
| <b>ASSETS</b>                                    |                     |                           |                     |                     |
| Cash and cash equivalents                        | \$ 14,706           | \$ 6,349                  | \$                  | \$ 21,055           |
| Accounts receivable, net                         | 57,646              | 207,276                   | (17,493)            | 247,429             |
| Inventories                                      | 117,726             | 260,639                   |                     | 378,365             |
| Prepaid expenses and other assets                | 17,904              | 20,755                    |                     | 38,659              |
| Total current assets                             | 207,982             | 495,019                   | (17,493)            | 685,508             |
| Land, buildings, improvements and equipment, net | 52,486              | 149,123                   |                     | 201,609             |
| Goodwill   | 598,758             |                           |                     | 598,758             |
| Investment in guarantors                         | 583,611             |                           | (583,611)           |                     |
| Deferred income taxes and other assets           | 37,025              | 123,922                   |                     | 160,947             |
| <b>Total</b>                                     | <b>\$ 1,479,862</b> | <b>\$ 768,064</b>         | <b>\$ (601,104)</b> | <b>\$ 1,646,822</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>       |                     |                           |                     |                     |
| Accounts payable                                 | \$ 59,047           | \$ 94,418                 | \$ (17,493)         | \$ 135,972          |
| Accrued expenses and other current liabilities   | 31,195              | 48,125                    |                     | 79,320              |
| Total current liabilities                        | 90,242              | 142,543                   | (17,493)            | 215,292             |
| Long-term debt                                   | 606,741             | 430                       |                     | 607,171             |
| Other long-term obligations                      | 3,322               | 41,480                    |                     | 44,802              |
| Convertible redeemable preferred stock           | 750                 |                           |                     | 750                 |
| Minority interest                                | 1,834               |                           |                     | 1,834               |
| Shareholders' equity                             | 776,973             | 583,611                   | (583,611)           | 776,973             |
| <b>Total</b>                                     | <b>\$ 1,479,862</b> | <b>\$ 768,064</b>         | <b>\$ (601,104)</b> | <b>\$ 1,646,822</b> |

**CONSOLIDATING CONDENSED STATEMENT OF CASH FLOWS**

Six Months Ended March 29, 2008

(in thousands)

(unaudited)

|  | Parent    | Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|-----------|---------------------------|--------------|--------------|
| Net cash provided (used) by operating activities | \$ 60,637 | \$ (115,993)              | \$ (34,770)  | \$ (90,126)  |
| Additions to property and equipment              | (6,218)   | (6,914)                   |              | (13,132)     |

Edgar Filing: CENTRAL GARDEN & PET CO - Form 10-Q

|  |           |         |        |           |
|--|-----------|---------|--------|-----------|
| Proceeds from property sales, net of expenses    |           | 12,053  |        | 12,053    |
| Businesses acquired, net of cash acquired        | (4,998)   |         |        | (4,998)   |
| Restricted investments                           | (39)      |         |        | (39)      |
| Investment in guarantor subsidiaries             | (139,790) | 105,020 | 34,770 |           |
| Net cash provided (used) by investing activities | (151,045) | 110,159 | 34,770 | (6,116)   |
| Repayments on revolving line of credit           | (302,000) |         |        | (302,000) |
| Borrowings on revolving line of credit           | 385,000   |         |        | 385,000   |
| Repayments of long-term debt                     | (830)     | (104)   |        | (934)     |
| Proceeds from issuance of common stock           | 1,472     |         |        | 1,472     |
| Redemption of preferred stock                    | (750)     |         |        | (750)     |
| Excess tax benefits from stock-based awards      | 24        |         |        | 24        |
| Payment of financing costs                       | (125)     |         |        | (125)     |
| Net cash provided (used) by financing activities | 82,791    | (104)   |        | 82,687    |
| Effect of exchange rate changes on cash          |           | 77      |        | 77        |
| Net decrease in cash and cash equivalents        | (7,617)   | (5,861) |        | (13,478)  |
| Cash and cash equivalents at beginning of period | 14,706    | 6,349   |        | 21,055    |
| Cash and cash equivalents at end of period       | \$ 7,089  | \$ 488  | \$     | \$ 7,577  |

**Table of Contents****CONSOLIDATING CONDENSED STATEMENT OF CASH FLOWS****Six Months Ended March 31, 2007****(in thousands)****(unaudited)**

|   | <b>Parent</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|---------------|-----------------------------------|---------------------|---------------------|
| Net cash used by operating activities               | \$ (24,476)   | \$ (63,955)                       | \$ (27,428)         | \$ (115,859)        |
| Additions to property                               | (9,019)       | (21,933)                          |                     | (30,952)            |
| Businesses acquired, net of cash acquired           | (7)           | (18,340)                          |                     | (18,347)            |
| Collection of note related to litigation settlement | 3,340         |                                   |                     | 3,340               |
| Restricted investments                              | 31            |                                   |                     | 31                  |
| Investment in guarantor subsidiaries                | (113,713)     | 86,285                            | 27,428              |                     |
| Net cash provided (used) by investing activities    | (119,368)     | 46,012                            | 27,428              | (45,928)            |
| Repayments on revolving line of credit              | (306,000)     |                                   |                     | (306,000)           |
| Borrowings on revolving line of credit              | 452,000       |                                   |                     | 452,000             |
| Repayments of long-term debt                        | (1,830)       | 589                               |                     | (1,241)             |
| Proceeds from issuance of common stock              | 2,291         |                                   |                     | 2,291               |
| Excess tax benefits from stock-based awards         | 1,313         |                                   |                     | 1,313               |
| Payment of financing costs                          | (416)         |                                   |                     | (416)               |
| Net cash provided by financing activities           | 147,358       | 589                               |                     | 147,947             |
| Effect of exchange rate changes on cash             |               | 33                                |                     | 33                  |
| Net increase (decrease) in cash and equivalents     | 3,514         | (17,321)                          |                     | (13,807)            |
| Cash and equivalents at beginning of period         | 9,087         | 19,319                            |                     | 28,406              |
| Cash and equivalents at end of period               | \$ 12,601     | \$ 1,998                          | \$                  | \$ 14,599           |

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Overview**

Central Garden & Pet Company is a leading innovator, marketer and producer of quality branded products. We are one of the largest suppliers in the pet and lawn and garden supplies industries in the United States. The total pet industry is estimated to be approximately \$36 billion in annual retail sales. We estimate the annual retail sales of the pet supplies and ultra-premium pet food markets in the categories in which we participate to be approximately \$13 billion. The total lawn and garden market in the United States is estimated to be approximately \$95 billion in annual retail sales. We estimate the annual retail sales of the lawn and garden supplies markets in the categories in which we participate to be approximately \$27 billion.

Our pet supplies products include products for dogs and cats, including edible bones, premium healthy edible and non-edible chews, ultra-premium dog and cat food, leashes, collars, toys, pet carriers, grooming supplies and other accessories; products for birds, small animals and specialty pets, including food, cages and habitats, toys, chews and related accessories; animal and household health and insect control products; products for fish, reptiles and other aquarium-based pets, including aquariums, furniture and lighting fixtures, pumps, filters, water conditioners, food and supplements, and information and knowledge resources; and products for horses and livestock. These products are sold

## Edgar Filing: CENTRAL GARDEN & PET CO - Form 10-Q

under a number of brand names including Adams, All-Glass Aquarium, Altosid, Aqueon, BioSpot, Breeder's Choice, Coralife, Farnam, Four Paws, Interpet, Kaytee, Kent Marine, Nylabone, Pet Select, Pre Strike, Oceanic, Super Pet, TFH, Zilla, and Zodiac.

Our lawn and garden supplies products include proprietary and non-proprietary grass seed; wild bird feed, bird feeders, bird houses and other birding accessories; weed, grass, ant and other herbicide, insecticide and pesticide products; and decorative outdoor lifestyle and lighting products including pottery, trellises and other wood products and holiday lighting. These products are sold under a number of brand names including AMDRO, GKI/Bethlehem Lighting, Grants, Ironite, Lilly Miller, Matthews Four Seasons, New England Pottery, Norcal Pottery, Pennington, Over n Out, Sevin and The Rebels.

In fiscal 2007, our consolidated net sales were \$1.7 billion, of which our lawn and garden segment, or Garden Products, accounted for approximately \$778 million and our pet segment, or Pet Products, accounted for approximately \$893 million. In fiscal 2007, our income from operations was \$99.4 million, of which Garden Products accounted for \$45.6 million and Pet Products accounted for \$94.3 million, before corporate expenses and eliminations of \$40.5 million.

## **Table of Contents**

### **Background**

We have transitioned our company to a leading marketer and producer of branded products from a traditional pet and lawn and garden supplies distributor. We made this transition because we recognized the opportunity to build a portfolio of leading brands and improve profitability by capitalizing on our knowledge of the pet and lawn and garden supplies sectors, strong relationships with retailers and nationwide sales and logistics network. Our goal was to diversify our business and improve operating margins by establishing a portfolio of leading brands. Since 1997, we have acquired numerous branded product companies and product lines, including Wellmark and Four Paws in fiscal 1997; Kaytee Products, TFH and Pennington Seed in fiscal 1998; Norcal Pottery in fiscal 1999; AMDRO and All-Glass Aquarium in fiscal 2000; Lilly Miller in fiscal 2001; Alaska Fish Fertilizer in fiscal 2002; Kent Marine, New England Pottery, Interpet, KRB Seed Company, (dba Budd's Seed), and Energy Savers Unlimited in fiscal 2004; Pets International and Gulfstream Home & Garden in fiscal 2005; Farnam, Breeder's Choice, Tech Pac, Ironite and Shirlo in fiscal 2006 and B2E Corporation, B2E Biotech LLC and DLF Trifolium Oregon (dba ASP Research) in fiscal 2007.

Virtually all of our sales before fiscal 1997 were derived from distributing other manufacturers' products. Since then, our branded product sales have grown to approximately \$1.4 billion, or approximately 84% of total sales, in fiscal 2007. During this same period, our sales of other manufacturers' products have declined to approximately 16% of total sales, and our gross profit margins have improved from 13.6% in fiscal 1996 to 32.0% in fiscal 2007.

### **Recent Developments**

#### **Goodwill**

We account for goodwill in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," and test goodwill for impairment annually, or whenever events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This assessment involves the use of significant accounting judgments and estimates as to future operating results and discount rates. Changes in estimates or use of different assumptions could produce significantly different results. An impairment loss is generally recognized when the carrying amount of the reporting unit's net assets exceeds the estimated fair value of the reporting unit. We use discounted cash flow analysis to estimate the fair value of our reporting units. Current accounting convention also requires a comparison of current market capitalization to book value.

Based on our most recent annual impairment test in fiscal year 2007, we determined that there was no goodwill impairment as of September 29, 2007. However, due to the continuing depressed stock price, as of December 29, 2007, shareholders' equity (book value) was approximately \$775 million and the market capitalization was approximately \$390 million. As a result, we concluded there was an indicator of possible goodwill impairment.

Accordingly, we updated our analysis and evaluation of goodwill for possible impairment as of December 29, 2007, which included a comparison of market capitalization to the combined fair values of our four reporting units. Based on our updated analysis and sustained decline in market capitalization, we determined that we were required to take a non-cash charge of \$400 million in the first fiscal quarter to recognize the impairment of goodwill, comprised of \$202 million relating to our Garden segment and \$198 million relating to our Pet segment. This non-cash charge of \$400 million reduced our net earnings for the six months ended March 29, 2008 by \$290.4 million, or \$4.07 per share. In the current quarter, we provided a valuation allowance of \$1.7 million to reduce deferred tax assets associated with the goodwill writeoff.

Notwithstanding the goodwill impairment charge, we believe the non-cash charge is not reflective of recent results or our long-range forecast, which continues to project growth and margin improvement, and consequently, does not by itself indicate impairment. However, according to current accounting convention, we are required to place greater emphasis on current stock trading values than on our forecasts in performing our impairment assessment.

#### **New Accounting Pronouncements**

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141(R) Business Combinations, which establishes accounting principles and disclosure requirements for all transactions in which a company obtains control over another business. This accounting pronouncement is effective for us in our fiscal year beginning September 27, 2009. We are currently evaluating the impact of SFAS No. 141(R) on our consolidated financial statements.

**Table of Contents**

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment to ARB No. 51. This standard prescribes the accounting by a parent company for minority interests held by other parties in a subsidiary of the parent company. SFAS No. 160 is effective for us in our fiscal year beginning September 27, 2009. We are currently evaluating the impact of SFAS No. 160 on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which provides companies an option to report selected financial assets and liabilities at fair value. SFAS No. 159 requires companies to provide information to assist financial statement users to understand the effect of a company's choice to use fair value on its earnings, as well as to display on the face of the balance sheet the fair value of assets and liabilities chosen by the company for fair value accounting. Additionally, SFAS No. 159 establishes presentation and disclosure requirements designed to simplify comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for us in our fiscal year beginning September 28, 2008. We are currently evaluating the impact of SFAS No. 159 on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The standard also establishes a framework for measuring fair value and provides for expanded disclosures about fair value measurements. SFAS No. 157 is effective for our fiscal year beginning September 28, 2008. We are currently evaluating the impact of SFAS No. 157 on our consolidated financial statements.

**Critical Accounting Policies, Estimates and Judgments**

There have been no material changes to our critical accounting policies, estimates and assumptions or the judgments affecting the application of those accounting policies, except for our estimates regarding the fair value of goodwill and other intangible assets pursuant to SFAS No. 142, as set forth in Note 2 to the consolidated financial statements, since our Annual Report on Form 10-K for the fiscal year ended September 29, 2007.

We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48) as of September 30, 2007. Upon adoption of FIN 48, we recognized a \$0.5 million increase to our reserve for uncertain tax positions and a cumulative effect adjustment to decrease retained earnings.

**Results of Operations**

**Three Months Ended March 29, 2008**

**Compared with Three Months Ended March 31, 2007**

***Net Sales***

Net sales for the three months ended March 29, 2008 decreased \$1.0 million, or 0.2%, to \$484.7 million from \$485.7 million for the three months ended March 31, 2007. Pet Products' net sales increased \$1.1 million, or 0.5%, to \$230.9 million for the three months ended March 29, 2008 from \$229.8 million in the comparable fiscal 2007 period. Garden Products' net sales decreased \$2.1 million, or 0.8%, to \$253.8 million for the three months ended March 29, 2008 from \$255.9 million in the comparable fiscal 2007 period. Our branded product sales increased \$5.0 million and sales of other manufacturers' products decreased \$6.0 million. While our branded Pet Products' sales were approximately the same as the prior year quarter, our aquatics sales decreased \$7.2 million due to continued softness in the category, which was offset primarily by increased sales in the dog, cat and small animal category. We currently expect aquatics sales to remain soft during the remainder of fiscal 2008.

***Gross Profit***

Gross profit for the three months ended March 29, 2008 decreased \$4.0 million, or 2.5%, to \$159.8 million from \$163.8 million for the three months ended March 31, 2007. Pet Products' and Garden Products' gross profit decreased \$2.2 million and \$1.8 million, respectively. Gross profit as a percentage of net sales decreased from 33.7% for the three months ended March 31, 2007 to 33.0% for the three months ended March 29, 2008 due primarily to rising costs.

***Selling, General and Administrative Expenses***

## Edgar Filing: CENTRAL GARDEN & PET CO - Form 10-Q

Selling, general and administrative expenses decreased \$2.4 million, or 2.0%, to \$115.2 million for the three months ended March 29, 2008 from \$117.6 million for the three months ended March 31, 2007. As a percentage of net sales, selling, general and administrative expenses decreased slightly to 23.8% for the three months ended March 29, 2008, compared with 24.2% in the comparable prior year quarter. The decrease in selling, general and administrative expenses is discussed below.



**Table of Contents**

Selling and delivery expense decreased \$3.5 million, or 5.8%, from \$60.8 million for the three months ended March 31, 2007 to \$57.3 million for the three months ended March 29, 2008. As a percentage of net sales, selling and delivery expense decreased to 11.8% from 12.5% of net sales due primarily to lower advertising and promotional costs.

Facilities expense was \$3.8 million for the three months ended March 29, 2008 and for the three months ended March 31, 2007.

Warehouse and administrative expense increased \$1.1 million, or 2.1%, to \$54.1 million in the quarter ended March 29, 2008 from \$53.0 million for the three months ended March 31, 2007. The increase was due primarily to the non-cash impairment charge of \$2.0 million taken against trade credits, partially offset by decreased third party provider costs.

***Net Interest Expense***

Net interest expense for the three months ended March 29, 2008 decreased \$2.9 million, or 23.3%, to \$9.5 million from \$12.4 million for the three months ended March 31, 2007. The decrease was due primarily to lower interest rates on our floating rate debt. Our borrowing rate for the quarter was approximately 5.6% compared to 7.4% a year ago.

***Other Income***

Other income decreased \$0.4 million to \$1.2 million for the quarter ended March 29, 2008 from \$1.6 million for the quarter ended March 31, 2007, primarily because of lower equity earnings from an investment now included in the financial statements on a fully consolidated basis.

***Income Taxes***

Our effective income tax rate was 43.0% for the quarter ended March 29, 2008 compared to a 38.2% for the quarter ended March 31, 2007. In the current quarter, we provided a valuation allowance of \$1.7 million to reduce deferred tax assets associated with the goodwill writeoff.

**Six Months Ended March 29, 2008****Compared with Six Months Ended March 31, 2007*****Net Sales***

Net sales for the six months ended March 29, 2008 decreased \$4.6 million, or 0.6%, to \$798.5 million from \$803.1 million for the six months ended March 31, 2007. Pet Products net sales increased \$0.5 million, or 0.1%, to \$432.6 million for the six months ended March 29, 2008 from \$432.1 million in the comparable fiscal 2007 period. Garden Products net sales decreased \$5.1 million, or 1.4%, to \$365.9 million for the six months ended March 29, 2008 from \$371.0 million in the comparable fiscal 2007 period. Our branded product sales increased \$6.3 million and sales of other manufacturers products decreased \$10.9 million. While our branded Pet Products sales were approximately the same as the prior year period, our aquatic sales decreased \$13.8 million which was offset primarily by increased sales in the dog, cat & small animal category. Sales of our branded Garden Products declined due primarily to weakness in pottery sales which were partially offset by sales from the launch of our Smart Seed line of grass seed.

***Gross Profit***

Gross profit for the six months ended March 29, 2008 decreased \$11.6 million, or 4.4%, to \$254.1 million from \$265.7 million for the six months ended March 31, 2007. Pet Products and Garden Products gross profit decreased \$6.6 million and \$5.0 million, respectively. Gross profit as a percentage of net sales decreased from 33.1% for the six months ended March 31, 2007 to 31.8% for the six months ended March 29, 2008 due primarily to rising costs. Our aquatic tank product margins continued to decline in an environment of weak tank sales. Also, the weighted average cost of grain in the first half of this fiscal year increased at over twice the rate, approximately 30% versus 15%, over the same period last year. We continue to pursue price increases to help offset the rising grain cost environment.

***Selling, General and Administrative Expenses***

Selling, general and administrative expenses decreased \$13.5 million, or 6.3%, to \$200.1 million for the six months ended March 29, 2008 from \$213.6 million for the six months ended March 31, 2007. As a percentage of net sales, selling, general and administrative expenses decreased from 26.6% for the six months ended March 31, 2007 to 25.1% for the six months ended March 29, 2008. The decrease in selling, general and

administrative expenses is discussed below.

Selling and delivery expense decreased \$3.3 million, or 3.0%, from \$108.4 million for the six months ended March 31, 2007 to \$105.1 million for the six months ended March 29, 2008. As a percentage of net sales, selling and delivery expense decreased to 13.2% from 13.5% of net sales due primarily to headcount reductions and lower advertising and promotional costs.

## **Table of Contents**

Facilities expense remained relatively flat at \$7.5 million for the six months ended March 29, 2008 and \$7.4 million for the six months ended March 31, 2007.

Warehouse and administrative expense decreased \$10.3 million to \$87.5 million in the six month period ended March 29, 2008. The decrease was due to gains of \$11.1 million from the sale of assets and a legal settlement. Decreased costs from headcount reduction and the reduced third party provider costs were partially offset by a non-cash impairment charge of \$2.0 million taken against trade credits.

### ***Goodwill Impairment***

We updated our analysis and evaluation of goodwill for possible impairment as of December 29, 2007. Applicable accounting standards require a comparison of the sum of the fair values of the reporting units to the current market capitalization when assessing goodwill for possible impairment. As a result, we recorded an impairment charge related to goodwill of approximately \$400 million, comprised of \$202 million in the Garden Products segment and \$198 million in the Pet Products segment, in the first quarter of fiscal 2008.

### ***Net Interest Expense***

Net interest expense for the six months ended March 29, 2008 decreased \$2.4 million, or 10.4%, to \$20.7 million from \$23.1 million for the six months ended March 31, 2007. The decrease was due primarily to lower interest rates on our floating rate debt partially offset by increased average borrowings. Our borrowing rate for the six months ended March 29, 2008 was approximately 6.3% compared to 7.4% a year ago.

### ***Other Income***

Other income was \$1.7 million for the six months ended March 29, 2008 and March 31, 2007. Other income is primarily earnings from investments accounted for under the equity method of accounting.

### ***Income Taxes***

Our effective income tax rate was 26.4% for the six months ended March 29, 2008 compared to 38.2% for the six months ended March 31, 2007. The fiscal 2008 effective tax rate was lower than in the prior year due primarily to the non-cash goodwill impairment charge in the first quarter of fiscal 2008.

### ***Inflation***

The results of operations and financial condition are presented based upon historical cost. While it is difficult to accurately measure the impact of inflation, we believe that the effects of inflation on our operations may be significant.

### ***Weather and Seasonality***

Historically, our sales of lawn and garden products have been influenced by weather and climate conditions in the different markets we serve. Additionally, Garden Products business has historically been highly seasonal. In fiscal 2007, approximately 62% of Garden Products net sales and 57% of our total net sales occurred in the second and third fiscal quarters. Substantially all of Garden Products operating income is typically generated in this period, which has historically offset the operating loss incurred during the first fiscal quarter of the year.

### ***Liquidity and Capital Resources***

We have financed our growth through a combination of bank borrowings, supplier credit, internally generated funds and sales of equity and debt securities to the public.

Historically, our business has been seasonal and our working capital requirements and capital resources tracked closely to this seasonal pattern. During the first fiscal quarter, accounts receivable reach their lowest level while inventory, accounts payable and short-term borrowings begin to increase. During the second fiscal quarter, accounts receivable, accounts payable and short-term borrowings increase, reflecting the build-up of inventory and related payables in anticipation of the peak lawn and garden selling season. During the third fiscal quarter, inventory levels remain relatively constant while accounts receivable peak and short-term borrowings start to decline as cash collections are received during the peak selling season. During the fourth fiscal quarter, inventory levels are at their lowest, and accounts receivable and payables are substantially reduced through conversion of receivables to cash.



**Table of Contents**

We service two broad markets: pet supplies and lawn and garden supplies. Our pet supplies businesses involve products that have a year round selling cycle with a slight degree of seasonality. As a result, it is not necessary to maintain large quantities of inventory to meet peak demands. Additionally, this level sales cycle eliminates the need for manufacturers to give extended credit terms to either distributors or retailers. On the other hand, our lawn and garden businesses are highly seasonal with approximately 62% of Garden Products net sales occurring during the second and third fiscal quarters. For many manufacturers of garden products, this seasonality requires them to ship large quantities of their product well ahead of the peak consumer buying periods. To encourage distributors to stock large quantities of inventory, industry practice has been for manufacturers to give extended credit terms and/or promotional discounts.

Cash flows for the six months ended March 29, 2008 were \$90.1 million of cash used in operating activities and \$6.1 million of cash used in investing activities, partially offset by \$82.7 million of cash provided by financing activities. Net cash used in operating activities decreased by \$25.7 million. The improvement in cash used in operating activities was attributable primarily to better working capital management. Net cash used in investing activities decreased by \$39.8 million from the prior year period due primarily to lower capital expenditures in the current year period, the absence of acquisitions, and proceeds received from sales of facilities, partially offset by the collection of a note in the prior year period. Net cash provided by financing activities decreased by \$65.3 million from the prior year period due primarily to the use of additional operating cash flow generated in the current year period that reduced our reliance on our revolving line of credit.

At March 29, 2008, our total debt outstanding was \$695.5 million compared to \$713.2 million at March 31, 2007, due to operating cash flows being used to pay down debt, partially offset by increased seasonal working capital requirements.

We have \$650 million in senior secured credit facilities, consisting of a \$350 million revolving credit facility maturing in February 2011 and a \$300 million term loan maturing in September 2012. Interest on the revolving credit facility is based on a rate equal to prime plus a margin, which fluctuates from 0% to 0.375%, or LIBOR plus a margin, which fluctuates from 0.75% to 1.50%, determined quarterly based on consolidated total debt to consolidated EBITDA for the most recent trailing 12-month period. Interest on the term loan is based on a rate equal to LIBOR plus a margin, which fluctuates from 1.50% to 1.75 % or the prime rate plus a margin, which fluctuates from 0.50% to 0.75%, at our option. The term loan is payable in quarterly installments of \$750,000 with the balance payable in September 2012. These facilities are secured by substantially all of our assets and contain certain financial covenants that require us to maintain minimum levels of interest coverage and maximum levels of total debt to EBITDA and that restrict our ability to repurchase our stock, make investments in or acquisitions of other businesses and pay dividends above certain levels over the life of the facilities.

In March 2007 and in August 2007, we amended the maximum leverage and minimum interest coverage ratios, amended certain defined terms and amended certain negative covenants and other provisions of our credit agreement. In the August 2007 amendment, we also made certain changes to the interest rate on loans to provide for a margin on loans when our leverage rates exceed 4.5x. There was \$247.0 million outstanding at March 29, 2008 under the \$350 million revolving credit facility plus \$15.9 million outstanding under certain letters of credit. The remaining potential borrowing capacity was up to \$87.1 million. Our borrowing capacity is also subject to compliance with the financial covenants in our credit agreement. Through the fiscal quarter ending in June 2008, our credit agreement requires a minimum interest coverage ratio of 2.5 to 1.0 and a maximum leverage ratio of 5.0 to 1.0. As of March 29, 2008, our interest coverage ratio was 3.13 to 1.0 and our leverage ratio was 4.47 to 1.0, and we were in compliance with all financial covenants.

We believe that cash flows from operating activities, funds available under our revolving credit facility, and arrangements with suppliers will be adequate to fund our presently anticipated working capital requirements for the foreseeable future. We anticipate that our capital expenditures will not exceed \$45 million for the next 12 months. The increase in expected capital expenditures, compared to our historical rate, is due to our implementation of a scalable enterprise-wide information technology platform to improve existing operations, to support future growth and to enable us to take advantage of new applications and technologies. We invested approximately \$32 million in fiscal 2007, 2006 and 2005 (on a combined basis) in this initiative and are planning to invest an additional \$10 million in fiscal 2008 for planned implementations. Capital expenditures for 2009 and beyond will depend upon the pace of conversion of remaining legacy systems. This initiative, when complete, will combine our numerous information systems into one enterprise system and create a common business model and common data, which should create greater efficiency and effectiveness.

As part of our growth strategy, we have acquired a number of companies, and we anticipate that we will continue to evaluate potential acquisition candidates in the future. If one or more potential acquisition opportunities, including those that would be material, become available in the near future, we may require additional external capital. In addition, such acquisitions would subject us to the general risks associated with acquiring companies, particularly if the acquisitions are relatively large.

**Off-Balance Sheet Arrangements**

There have been no material changes to the information provided in our Annual Report on Form 10-K for the fiscal year ended September 29, 2007 regarding off-balance sheet arrangements.



## **Table of Contents**

### **Contractual Obligations**

There have been no material changes outside the ordinary course of business in our contractual obligations set forth in the Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources in our Annual Report on Form 10-K for the fiscal year ended September 29, 2007.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We believe there has been no material change in our exposure to market risk from that discussed in our fiscal 2007 Annual Report filed on Form 10-K:

### **Item 4. Controls and Procedures**

(a) Our Chief Executive Officer and Chief Financial Officer have reviewed, as of the end of the period covered by this report, the disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) that ensure that information relating to the Company required to be disclosed by us in the reports that we file or submit under the Exchange Act, is recorded, processed, summarized and reported in a timely and proper manner and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based upon this review, we believe that the controls and procedures in place are effective to ensure that information relating to the Company that is required to be disclosed by us in the reports that we file or submit under the Exchange Act is properly disclosed as required by the Exchange Act and related regulations.

(b) *Changes in internal controls.* There were no changes in our internal controls during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

We are not currently a party to any material legal proceedings.

### **Item 1A. Risk Factors**

Except for the risk factors discussed below, there have been no material changes from the risk factors previously disclosed in our Form 10-K in response to Item 1A. to Part I of Form 10-K.

*Seeds and grains we use to produce bird feed and grass seed are commodity products subject to price volatility that has had, and continues to have, a negative impact on us.*

Our financial results depend on the cost of raw materials and our ability to pass along increases in these costs to our customers. In particular, our Pennington and Kaytee subsidiaries are exposed to fluctuations in market prices for commodity seeds and grains used to produce bird feed. Historically, market prices for commodity seeds and grains have fluctuated in response to a number of factors, including changes in United States government farm support programs, changes in international agricultural and trading policies and weather conditions during the growing and harvesting seasons.

To mitigate our exposure to changes in market prices, we enter into purchase contracts for grains, bird feed and grass seed to cover up to approximately one-third of the purchase requirements for a selling season. Since these contracts cover only a portion of our purchase requirements, as market prices for such products increase, our cost of production increases as well. In contrast, if market prices for such products decrease, we may end up purchasing grains and seeds pursuant to the purchase contracts at prices above market. In 2006, crop yields for grass seed and for the primary components of wild bird feed, notably milo, millet and sunflower were adversely impacted by drought conditions in key

growing regions of the United States. Supply has been further limited as more and more farmers shift to corn-based crops for the production of ethanol to meet increased demand.



**Table of Contents**

During the fourth quarter of fiscal 2006 and in fiscal 2007, prices for some of our key crops have increased substantially, and these price increases have continued in the first half of fiscal 2008. Our cost of goods for grain increased approximately \$30 million in fiscal 2007 over fiscal 2006. To date in fiscal 2008, the weighted average cost of grain increased at over twice the rate, approximately 30% versus 15%, over the first half of fiscal 2007. Although we have been able to negotiate price increases with our retailers, these price increases have not fully offset the rising costs. In fiscal 2007, the impact of these grain cost increases was only about half offset by price increases that we were able to obtain from our retailers. We can provide no assurance as to the timing or extent of our ability to implement additional price adjustments in the current context of rising costs or in the event of increased costs in the future. We also cannot predict to what extent price increases may negatively affect our sales volume. As retailers pass along price increases, consumers may shift to our lower margin pet bird feed, switch to competing products or reduce purchases of wild bird feed products.

*A decline in consumers discretionary spending or a change in consumer preferences could reduce our sales and harm our business.*

Our sales ultimately depend on consumer discretionary spending, which is influenced by factors beyond our control, including general economic conditions, the availability of discretionary income and credit, weather, consumer confidence and unemployment levels. We may experience declines in sales during economic downturns. Any material decline in the amount of consumer discretionary spending could reduce our sales and harm our business. Since substantially all of our sales are in the United States, a declining U.S. economy may have a greater impact on us than on our competitors, some of which may have a larger percentage of international sales.

The success of our business also depends in part on our ability to identify and respond to evolving trends in demographics and consumer preferences. For example, in the last year, the demand for aquatics products has declined significantly. Our failure to timely identify or effectively respond to changing consumer tastes, preferences, spending patterns and lawn and garden and pet care needs could adversely affect the demand for our products and our profitability.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table sets forth the repurchases of any equity securities during the fiscal quarter ended March 29, 2008 and the dollar amount of authorized share repurchases, remaining under our stock repurchase program.

| Period                               | Total Number of Shares (or Units) Purchased | Average Price Paid per Share (or Units) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|--------------------------------------|---|---|---|---|
| December 30, 2007 - February 2, 2008 |   | \$                                      |   | \$ 89,986,000   |
| February 3, 2008 - March 1, 2008     | 7,776*                                      | 4.79                                    |   | \$ 89,986,000   |
| March 2, 2008 - March 29, 2008       |   |   |   | \$ 89,986,000   |
| Total                                | 7,776                                       | \$ 4.79                                 |   | \$ 89,986,000   |

\* All shares purchased during the period indicated represent withholding of a portion of shares to cover taxes in connection with vesting of restricted stock.

**Item 3. Defaults Upon Senior Securities**

Not applicable

**Item 4. Submission of Matters to a Vote of Security Holders**

(a) The annual meeting of shareholders was held on February 11, 2008.

(b) The following directors were elected at the meeting:

William E. Brown

Brooks M. Pennington III

John B. Balousek

David N. Chichester

Alfred A. Piergallini

Bruce A. Westphal

**Table of Contents**

Set forth below is the tabulation of votes with respect to the election of directors at the meeting:

|                              | <b>For</b> | <b>Against/Withheld</b> |
|------------------------------|------------|-------------------------|
| <b>William E. Brown</b>      |            |                         |
| Common                       | 10,403,045 | 9,925,442               |
| Class B                      | 16,004,590 | 0                       |
| <b>Brooks M. Pennington</b>  |            |                         |
| Common                       | 13,627,281 | 6,701,206               |
| Class B                      | 16,004,590 | 0                       |
| <b>John B. Balousek</b>      |            |                         |
| Common                       | 18,933,134 | 1,395,353               |
| Class B                      | 16,004,590 | 0                       |
| <b>David N. Chichester</b>   |            |                         |
| Common                       | 18,933,134 | 1,395,353               |
| Class B                      | 16,004,590 | 0                       |
| <b>Alfred A. Piergallini</b> |            |                         |
| Common                       | 18,936,416 | 1,392,071               |
| Class B                      | 16,004,590 | 0                       |
| <b>Bruce A. Westphal</b>     |            |                         |
| Common                       | 15,632,271 | 4,696,216               |
| Class B                      | 16,004,590 | 0                       |

**Item 5. Other Information**

Not applicable

**Item 6. Exhibits**

- 10.1 Amendment No. 6 dated March 18, 2008 to the Credit Agreement, dated February 28, 2006, among Central Garden & Pet Company, the Subsidiary Guarantors and lenders thereto.
- 31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350.
- 32.2 Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunder duly authorized.

CENTRAL GARDEN & PET COMPANY  
Registrant

Dated: May 8, 2008

/s/ WILLIAM E. BROWN  
William E. Brown  
Chairman and Chief Executive Officer  
*(Principal Executive Officer)*

/s/ STUART W. BOOTH  
Stuart W. Booth  
Executive Vice President and Chief Financial Officer  
*(Principal Financial Officer)*