Company Name: Calavo Growers (CVGW)
Event: Stephens Annual Investment Conference | NASH2022
Date: November 17, 2022

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Okay, thanks. Good morning everybody. Thanks so much for joining us. I'm Ben Bienvenu. I cover the food and agro business sector here at Stephens. We have the team from Calavo today. Calavo is one of the largest packers of avocados in the U.S., and globally. They have a fresh cut fruit business and a guacamole business that really integrates nicely. The team has been in the midst of meaningful transformation at the company, making great progress, and we're glad to have from the team, Brian Kocher, CEO; and Shawn Munsell, CFO, to take our questions and talk about the business. This will be a fireside chat format. I'll lead the Q&A, but to the extent that folks want to chime in and ask questions, we'll certainly accommodate questions that you might have.

Brian, Shawn, thanks so much for being here. I appreciate it.

<<Brian Kocher, President and Chief Executive Officer>>

Thanks for having us. Really appreciate it.

<<Shawn Munsell, Chief Financial Officer>>

Yes, thank you.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

So, I think, maybe a good place to start is, is thinking bigger picture. And if you could just talk a little bit about the progress that you've made over the last year or so, in particular in the turnaround at Calavo, what excites you about the opportunity? What initially incentivized you to make the change, right, and come here? And then maybe talk about kind of what you see ahead for the company? What we should expect?

<<Brian Kocher, President and Chief Executive Officer>>

Perfect. So thanks again for having us and thanks for joining us today. So I joined in on February 1st, and I'd been in the industry for a while. I was with Chiquita for 10 years, managing their global business. I've been in Produce for 18 overall. And so, I knew Calavo a little bit when they started a CEO search. And I was excited by a couple of reasons. One, I'd love both of the categories, the significant categories that they're in. Avocados is a growing category. It's been growing for the last 15 years. It's predominantly been in a demand exceed supply position for the last 15 years. Now, that's not every week of the year, but in general it's demand exceed supply and consumption opportunities still exist in the U.S. as well as internationally. So I was excited about that.

I was also excited about what we've labeled the prepared segment, which includes both our fresh cut fruit, fresh cut veg, the formally known as RFG business, and our guacamole business, again because those categories are growing. If you look at grab-n-go convenient, ready-to-eat items, it's growing anywhere and has been anywhere from 10% to 25% on a volume basis. Over the course of the last five years, there's continued growth. We've seen channel expansion. So traditionally you'd see that that fresh cut grab-n-go items in traditional retail. Now it's in convenience channel as well and that brings 65,000 new distribution outlets to the United States alone. So predominantly, I was excited about the category. The second thing and it's not a surprise to anyone who's followed Calavo is Calavo was struggling when they look – were looking for a CEO, that's why they were looking for a CEO.

And because I was in the industry, I believe that that Calavo's challenges were eminently fixable. And those were the big reasons that I decided to join. If I look at my nine months, I'm excited about a couple of other reasons. One, we've been able to build a team. So every senior leadership position at Calavo has been turned over and I'm so excited to have the partners that we have, especially someone like, Shawn Munsell, who's been in big global businesses and managed big global portfolios and provide a big global financial advice to his business partners. So I'm excited to have our organization in place. They're new still. In fact, we just had our first face to face team meeting two weeks ago. So that's how new we are in terms of building the team. But I'm really proud of the team that we have that that I think allows us to fight above our weight class. There's nothing too big for this team at Calavo.

The second thing is, I've been excited about the progress that we've been able to make, and we try to keep things simple at Calavo. We just want to get better every day. If we get better today, better than yesterday, better tomorrow than today, we're going to be fine 365 days from now, right? And better means drive better profitability, drive better cash flow, drive growth, that's what better means in our scenario. So if I look back at how did we get better over the last nine months and one thing we should say is we're in this little funny period. We published our third quarter results. Our year end was October 31st, and yet we haven't released our year end results.

So we're – the financial figures that you'll hear is state today are our third quarter, which was our quarter that ended July, July 31st, so just for your information. But if I look at that, we've got an avocado business that that we're really managing with a minute by minute, hour by hour intensity. And that's the way you have to manage a commodity. You can't look at the end of the month and see, how did I do on this commodity? You've got to look at it every single minute and hour. And I think proof of that is our grown business through the first nine months of the year, which is predominantly avocados, we have some tomatoes and papayas, but our grown business is – has improved profitability slightly but did that in the face of a demand constraint where volume was off 16%, 17%, 19% in the third quarter alone and somehow we still managed to overcome volume constraints and deliver a slight increase in gross margin in that category.

So I'm proud of the kind of day to day, hour by hour mentality we've installed. And then of course, I'm proud of the work that we've done at what was formally RFG in our prepared fresh cut segment. Here's a business that in the fourth quarter of 2021 had 0% gross profit, 0%, was filling orders at about a 70% clip. So if someone ordered a hundred items, we were getting them

70 and had about 70% of their day to day production roles filled at any one time. Fast forward that to our third quarter, we're up to 7.7% gross margin on our path to kind of 10% to 12% by the end of our fiscal 2023. We are filling 99% of our orders and we've got 94% of our production roles filled every single day. So I'm proud of the improvement. And again, when you combine stability and operations with categories that are growing, that's our opportunity to grow as well.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Can you maybe back up a little bit and talk about how Calavo got to where it was for some context as you think about the opportunities that you guys are now executing against?

<<Brian Kocher, President and Chief Executive Officer>>

Yes, I think, it's hard – a little bit hard for Shawn and I to go deep into how they got in, but I think it was a culture that was particularly on the prepared side. So if you look at that former RFG business, it was based on a culture where growth and revenue growth was fine and good and encouraged, but I'm not sure profitability was encouraged. So when we came into the organization, we did things like for the first time ever RFG has shop floor metrics. So we know on an hourly basis our productivity on the shop floor that was never around. For the first time ever we put a transportation RFP in place. So the first time in 98 year history of Calavo, we have now a transportation RFP and we're probably one of the few companies that you follow or invest in that had year-over-year transportation decreases this year.

So that is some of that kind of – I'd say, that's what we did to address what we thought were some of the reasons why we were generating 0% gross profit. The next phase though is we have to grow and we want to grow and we're investing in our sales resources, but we're investing in the mentality of growth and just get better every day. Our – I tell our salespeople all the time, just sell one more, one more case of avocados than you did yesterday. I'm not asking you to sell all of Europe tomorrow, but just sell one more and we'll start there.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

That's great. Okay. Could we maybe shift gears a little bit and look at the specific business segments, and if we could start with the avocado business and maybe you mentioned kind of the environment we've had year-to-date, which has been one of volume declines. We've seen a reversal on that dynamic. Can you talk about what's going on there on the supply side? Maybe touch on demand as well. And then if you think about kind of the forthcoming potential recessionary backdrop we might have, can you talk about how avocados are positioned within kind of the consumer basket and how you think demand might fare in that environment?

<<Brian Kocher, President and Chief Executive Officer>>

Yes, let's address the last one first, Ben, if it's okay. I am very excited about the inelastic demand of avocados. Think about this, in the middle of this year, avocados were twice as much on the retail shelf as they were in the middle of 2021 and yet demand was still unfulfilled because of our supply constraint it's unfulfilled. So I am sure there is a threshold where we start to see some reaction in consumption and penetration, but right now we haven't seen that. And we didn't see it at prices that just from a case level went from $35 a case to $70 a case. So that's a good sign to me that in a growing category where demand typically has exceeded supply, we still have inelastic demand and so I'm excited about that. We have seen prices normalize. And maybe Shawn, if you wouldn't mind just talking a little bit about how we see that coming in the course of the fourth quarter, because we foreshadowed a little bit of that in the third quarter.

<<Shawn Munsell, Chief Financial Officer>>

Yes. And just to build on the prior point too, keep in mind in the summer not only were prices elevated, but as a consequence you had retailers pulling back on promotions and features. And again, we really didn't see any signs of demand destruction. But as far as the outlook is concerned for supply, first off prices have fallen quite a bit since the summer and in particular that's beneficial to us and we expected to see prices decline. It was a little slower. They've sort of remained stubbornly high in August, but it was a little slower than we anticipated, but we started to see prices come down, and that gave us relief for a prepared guacamole business.

And so as a consequence of those softening prices, margins in our prepared guacamole business are – have normalized. And that business had really been – margins had really been under pressure frankly since the second quarter because of those higher input costs. But looking ahead, the expectation is we're going to see a fairly strong supply out of Mexico next year. We expect that depending on who you asked, you could see supply coming out of Mexico. That's, call it, 20% more than what we saw in fiscal 2022. And that's partly just the nature of the crop. You have a strong crop and a weak crop every other year, so we expect to see a pretty solid crop next year and that's going to be great for throughput.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

If you think about the supply, you talked about that kind of alternate bearing dynamic as more production comes on globally and I know it's slower, Mexico is still the 800 pound gorilla in the global avocado market. I would assume that dynamic should smooth because, I think, looking at Calavo's business or anyone that's packing avocados, sometimes it could – last year it would be a misnomer for the underlying secular growth of the business.

<<Brian Kocher, President and Chief Executive Officer>>

It would be.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

I would think as that supply smooths, that starts to separate the signal from the noise potentially.

<<Brian Kocher, President and Chief Executive Officer>>

Well, I think that will help. You certainly have production that's come online and continued to grow in Peru, we've grown in Peru. In fact, for this year, we probably have increased our supply from Peru during their season by 60%. We've grown in Columbia. I'm a big fan – and just as a reminder, I think, it's for those of you who are maybe new to Calavo or potentially haven't followed in a while, we are a marketer of fruit. So we buy every day and we sell every day, and we price on both sides every day. And then we – obviously we have an inventory position in there that we're taking, but that gives us a chance to move rather rapidly in the market. And when you're buying and selling a commodity every day, I'd love optionality.

So Shawn mentioned that that the alternate bearing side of Mexico, the other structural difference is Mexico has opened a whole new state of production. The USDA has allowed Mexico to open a whole new state of production for avocado import into the U.S. So the State of Jalisco is now authorized to import product into the U.S. The State of Jalisco alone is the size of the California avocado crop. So we have more options now, right? So we've got more optionality in Mexico. We're growing Peru for more optionality. We're growing Columbia for more optionality to set expectations appropriately. Mexico and the State of Michoacán in Mexico is still 10 times the size of any of those markets that I mentioned, but the more optionality we have and the more they grow, I think you'll see long term more of that that smoothing that you talked about. In our environment, it gives us more chance to arbitrage. So we need the chance to arbitrage on the buy side, and then our job is to grow more customer distribution points on the sell side, so we have chance to arbitrage on the sell side too.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

You touched on Jalisco. Can you talk about the facility that you'll have there, kind of how it's historically been utilized, given that that dynamic around the prohibition of avocado imports from that state into the U.S. and then talk about kind of the opportunity that exists for you all specifically with respect to Jalisco.

<<Brian Kocher, President and Chief Executive Officer>>

Yes. So, we've had a presence in Jalisco for seven years now. We put a packing house in Jalisco in anticipation of that – that market being opened to the U.S. in 2015. And the one thing you'll get with Calavo is transparent leadership. So when you ask how that facility has been utilized, Ben, I would say poorly, poorly utilized. We did a couple of international loads a week out of there to try to keep staff there and the facility going. What's happened since July 29th though is that's totaled somewhere in the range of 15% of our overall sourcing from Mexico now. So we've really pushed through with some relatively small investments. We can double that capacity in that packing house. We've got the opportunity to add a second shift. Again, why is that important? We've got a big Michoacán packing house.

Now we have a Jalisco packing house to the extent that there is a little variation in the field price. We can swap more volume from one to the other. Let we – we calculate how we're going to leverage fixed costs and we make that decision every day. Every day at four o'clock, we're placing an order for how much volume we want. And now we're placing an order that says, well, I want two loads in Michoacán and 20 in Jalisco or vice versa when it benefits us. And as you know, this is a penny, nickel and dime business. So if you can find a dime somewhere by arbitraging between Jalisco and Michoacán, it's really good.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Okay. That's a great segue into – I wanted to ask about just profitability perhaps you talked about kind of changing the mindset to managing the business like a commodity business minute by minute. What is the output of that? Is it margin improvement? Is it volume or capacity utilization improvement? And how do you guys think about the margin opportunity or profile of the margins in the fresh business?

<<Shawn Munsell, Chief Financial Officer>>

Yes, I'd say that, our – what we call our targeted margin in the grown business, specifically for avocados is about $3 to $4 a case. And what's interesting is this year through the third quarter, our volume is down, call it, 15%, primarily because of the weaker crop in Mexico versus the prior year. But despite that our gross profit in that business is about in line with the prior year because we were able to expand the margin. And so we were toward kind of the higher end of that range of $3 to $4 per case. We certainly saw that play out in the third quarter. Although that's when we really saw some volatility kick in where our margins were really strong in May, but by July those margins had compressed. But over the course of the entire quarter, it was really right in the middle of that targeted range. But as we look ahead, I think it's going to be a combination of like Brian said, it's going to be a combination of volume growth, taking advantage of the assets that we have today, and just that constant buying and selling mentality to ensure that we're getting both the volume growth, but we're doing – we're growing profitably in that business.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Shawn, you touched on – if we could pivot a little bit to the guacamole business, you talked about how – having seen prices normalized for avocados that that pretends margin improvement, normalization in your guacamole business. Can you talk about the opportunities that exist there more broadly as well?

<<Shawn Munsell, Chief Financial Officer>>

Yes, sure.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Maybe – be the margins or the opportunity to continue to grow that business.

<<Shawn Munsell, Chief Financial Officer>>

Yes, absolutely. So, first off, the business, and I alluded to this earlier, the business suffered this year. Margins were pressured because of those high input costs. And we took price against the high input costs, but it ran up much faster than we were able to take price. I think we took price something like four times this year and it wasn't quite enough. And in the summer, we certainly expected prices to come off. Like I said, it took a little longer for us to see some of that pricing relief, but we absolutely did see it. And it certainly did yield margins that I'd say are consistent with what we consider to be the normalized range in the fourth quarter.

But as far as opportunities for that business going forward, we've got a team right now that, that's focused on operational improvements to that manufacturing facility in Mexico. We're investing capital. We've made some changes with respect to the management team. And we think that there's going to be a few points of improvement that we're going to be able to realize come fiscal 2023 from some of the operational improvements that are underway now. Beyond that we're absolutely focused on growing volume. We're probably underpenetrated from a retail perspective in the Midwest, in the Northeast, and there are absolutely some opportunities for us to grow that business internationally. So that's really where we're focused.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

How sensitive is the demand for that product profile? You mentioned very resilient demand for avocados. When you start to think about prepared products, is it similarly defensive? And how do you guys think about positioning around price kind of two parts, one, when perhaps the consumer is under a little bit more pressure, and then two, when the costs have come down quite a bit too, I don't know how dynamic the costs are on that – or the prices are on that side?

<<Shawn Munsell, Chief Financial Officer>>

Yes, I'd say, the great thing about that business, and again, this is true of a lot of the products that we participate in is, it certainly has some demand tailwinds, right. It's growing and that's helpful. But absolutely as prices have come down, our – we've seen margins widened out. And the expectation is that we're going to continue to run that business within – at margins that are consistent with that normalized range, which for us would be, call it, 20% to 25% gross margin.

<<Brian Kocher, President and Chief Executive Officer>>

And Ben, I think, it's also fair to say, I don't see demand being impacted by the retail price or really even the consumer and recessionary pressures. If you're going to a football party or a Super Bowl party or – and you want to bring guacamole, you're going to go get guacamole, right? I don't see that changing. We do see a little interplay if the cost of raw product of the whole avocado comes down significantly, there may be a little bit of trade off between prepared and they just say I'll make it myself. The fact of the matter is people don't make guacamole very well. So that kind of help – that kind of helps us in that regard.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Okay, that's great. Can you talk a little bit about kind of the mix of the business pre- and post-COVID? And if you could compare contrast kind of the two end markets be they either profitability differences or penetration growth and kind of the health of each end market, that'd be helpful.

<<Shawn Munsell, Chief Financial Officer>>

Yes, sure. So I'd say, I mean, the primary difference within prepared guacamole between food service and retail is it's really the packaging format. You're selling the prepared guacamole to food service in – really in bulk form and pouches whereas you're selling it in much smaller serving size for retail. And I'd say that as a consequence of that, you do tend to see that food service business has modestly more attractive margins. But, like I said earlier, as far as where we're going to grow the business, we'd be looking to more retail in the Midwest in the Northeast to further penetrate the presence that we already have there today and then adding some international growth. And we sell internationally today. But I think we're, as far as the growth in that business is concerned, I would call it a more deliberate effort to actually grow the volume than perhaps we've had historically. And I think that's really the difference maker for us. I think that historically that business has been sort of we had excess fruit available to us that we couldn't use in retail. And so, as a consequence, we push it into to make Prepared guacamole. So I think that just overall it's more deliberate effort operationally as well as growing the volume.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Okay. I still have the muscle memory of fresh foods and RFG. Can you talk – you kind of triggered this question in my mind. Can you talk a little bit about the decision to change it to Grown and Prepared and how that either organizationally or operationally, if at all changes the way those businesses operate next to one other?

<<Brian Kocher, President and Chief Executive Officer>>

Sure. Yeah. Thank you for that question. So in April, we changed three reporting segments. We had a fresh reporting segment, which essentially was just renamed as Grown. Fresh was avocados, tomatoes, and some small papaya business that was renamed as Grown. We then combined the RFG segment with our foods, which predominantly guacamole product into a Prepared segment. A couple of reasons that we did that. We found we were not taking advantage of the leverage on the go-to-market strategy between our guacamole products and our fresh cut products. We were calling a lot of the same buyers in our retail or food service customers. We were approaching the category the same way we were approaching the sales process the same way. So we believed there was an inefficiency in our go-to-market strategy that we weren't capturing.

The second thing that we wanted to manage is on the highest level, they have similar attributes. You want volume, you want manufacturing efficiency, and you want customer service that allows you the right to go ask for more business. And we were sort of as Shawn mentioned, I think we were managing our guacamole business sort of as well. We produced guacamole, so let's sell guacamole and we needed to be more aggressive at that. So combining that under one leadership role, and we hired Helen Kurtz, who has some General Mills experience. She has some Foster Farms experience in growing categories, growing labels. And we combined that under her leadership, so we could get the synergies and go-to-market and some back office synergies.

The processing plant is different. We produce guacamole in Mexico. All of our fresh cut are in our five facilities in the U.S. So there's not a lot of synergy between those six facilities, but standardization of how we manage labor, standardization of how we source raw products, the process around there, we've already seen some efficiencies in there.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Okay, great. Maybe shifting over to the fresh-cut fruit business, the legacy RFG business. Can you talk about what long-term demand looks like for that business? And I think historically there's been a lot of saying yes to new business and new facilities that have opened and they've been operating at kind of suboptimal capacity utilization levels. You have done a lot to bring efficiency to that business. But can you talk too about the opportunity to grow it and optimize capacity utilization kind of in the intermediate term, kind of in the backdrop of this bigger picture demand backdrop?

<<Brian Kocher, President and Chief Executive Officer>>

Yeah, sure. Sure. So let's talk about bigger picture demand. If you look at this ready-to-eat convenient product, and that's really what we're talking about in our fresh cut area. We're talking about pineapple spears. We're talking about cut watermelon, cut strawberries, potentially diced onions, diced squash, so that you can buy at the store, and then just throw in your recipe. These are convenient ready-to-eat items. If you look at those categories, they're growing sort of depending on the category and depending on what research firm you look at, they're growing in the 10% to 25% range annually, volume wise. Dollar wise is a little different, but volume wise, they're growing.

So we're in a growing category. I mentioned to you already the focus that the convenience channel has on fresh ready-to-eat products. And if you've been into a Speedway, a Circle K, a 7-Eleven, you see the little destinations that they've created, either in a cooler or an island in the store where you can buy sandwiches, you can buy hummus mixes, you can buy those. So we see that growth.

So I think we're in a category that's growing overall. So part of our growth is the category is growing and we should demand and get our fair share of the category growth. I think the other thing that you'll see for us is our customer base has lent us to develop an expertise in what we would rephrase as deli type items, sandwiches, pinwheels, party trays, these types of things that might fold right into a deli or a convenience destination spot. And I think we're seeing more and more growth come from that. We've got to go out and win that business. We've got to go out and make sure we're demonstrating our value and our value is in service, it's in innovation, it's in quality, it's in value. But I think over the course of the next several years, you might see us growing in that particular portion of our fresh cut business, maybe disproportionately to anywhere else.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

And if we think about kind of where utilization is today and where you think it can get to in some reasonable timeframe, how do you think about kind of that critical path?

<<Brian Kocher, President and Chief Executive Officer>>

I think we – so going back in time, Calavo closed a processing plant in Florida in December of 2021 I think. Something around there, in November, December of 2021, and consolidated that business in the other facilities, that still left us with extra capacity at each of our facilities. All right. I think we've got a path to grow 10%, 20% without significant CapEx. We're not talking about adding a new facility there. There might be equipment and machinery automation that we'd find in CapEx, but without significant CapEx. To the extent that, we win big customer accounts, and by the way, I hope that's a big problem that we have. Then – and we reach that capacity, we still have things like expanding shifts that we could add capacity before we need to invest in another plant. So we've got room to grow, is I guess what I'd say.

<<Brian Kocher, President and Chief Executive Officer>>

Okay. Is that fair?

<<Shawn Munsell, Chief Financial Officer>>

Yes.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

You talked about the margin improvement there, which has been very notable and kind of demonstrated in the last quarter. You've worked through a number of different things, some of which you talked about SKU rationalization was another one. Maybe rewind for us and tell us what you found when you got there, where you are today and what's left around the margin opportunity to get to that kind of I think you talked about 10% to 12% next year?

<<Shawn Munsell, Chief Financial Officer>>

Yeah. So, for perspective, like Brian said, we've made some real strides in that fresh cut former RFG business. And frankly when we talk about the underperformance the company over the last couple of years, that's really where it's been concentrated. and so that business in Q1 was essentially a break even business. I think we lost a little bit of money in Q1. Fast forward to Q3 and we put up a 7.7% gross margin, and you compare that to the prior year, third quarter, when we lost about, I think it was minus 3% gross margin. So all in Q3 it was about a $14 million, $15 million improvement year-over-year in gross profit in that business.

And a lot of those improvements are being undertaken in what we're calling Project Uno. And so Project Uno that's just – there's a number of different initiatives. The biggest piece of that is in fact pricing. But think about it as operational improvements, labor optimization, SKU harmonization, that includes the impact of the closure and consolidation of the plant in Florida. So a number of different operational improvements that are underway. And that's what's contributed to the improvement to get to 7.7% in Q3. Long term, by the end of FY 2023, we'd like that business to be on a run rate of 10% to 12%. Now, keep in mind, there's some seasonality. There's seasonality in Q4 that seasonality is especially pronounced in Q1.

But as we finish up those initiatives over the course of call it the next 12 months, that's what's going to deliver that run rate the 10% to 12% targeted run rate. And if you think about the places where we still have room for improvement, those initiatives where we're still not finished, certainly, there's still room for more pricing, but it's going to be incremental benefits from SKU harmonization from labor optimization. We're still not done with transportation and warehousing improvements. Brian said that we had our first RFP for transportation in the company's history. That was really just step one with respect to transportation. There's still a lot more that we can be doing. And so, the culmination of that will be a higher margin in that business.

And what we want to get to what we're trying to get to is a place where we're not undertaking these initiatives as part of some one time program. We're really trying to institutionalize that. We want it to become just a reflex for us. So it's a practice or a process that we have. We have a revenue management process today, that's still frankly, in its infancy, but we didn't really have a revenue management process before, aSKU optimization process. Likewise, it's still in the early innings, but that's not something that we had before. But it's going to be an ongoing process for us in the future.

You think about simple things in my world, like working capital management. If you look at the cash flow statement, you look at the balance sheet, you'll see that we freed up a lot of cash this year from management of working capital. Well, we really didn't have a deliberate working capital management process historically. So those are the types of things that are going to help to improve the business, and it's going to be gradual. And like I said, there's some seasonality in the business, especially in Q1, but we know the areas that we need to tackle and we just need to keep chipping away.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Yeah. I'm glad you made that point, it's easy to think in these turnaround processes of like SKU rationalization as like a one and done sort of thing, versus like managing efficiency, making that a part of the operating culture of the business. I want you mentioned labor, the fresh-cut fruit RFG business is probably the most labor intensive business in your portfolio. Could you talk about where things are with labor kind of from an external environment? You mentioned some of the labor efficiency things you're working on. Could you talk about what those are? And then I have a follow-up questions just about costs.

<<Brian Kocher, President and Chief Executive Officer>>

Yeah. So, I would say labor is easier, but not easy. Labor is easier than a year, a year and a half ago, but not easy. Also, remember, we made significant investment in labor rates. So when I talk about the net, the productivity that we're generating in labor, that's net of somewhere in the range of 12% to 15% hourly rate increases. So we've been able to get 10% to 12%, 12% to 15% hourly rate increases. And then productivity that not only offsets that, but yields efficiencies to the bottom line.

Our strategy is one of engagement. I think you've got to be priced right in the market. If you're not priced right in the market, you're not going to get the labor. But once you get the labor, you've got to make sure that they're onboarded correctly. You've got to make sure that they have buddies that they can talk to and work you've got to make sure that they have training. We have launched a training program that starts with our plant managers and goes all the way down the supervisors where we're actually prescribing not only how we want the culture to do and how we want them to lead, but how we want them to react when they see certain trends going on in the business. If line one is way ahead of schedule on at 10 o'clock in the morning, we've given them options. They've got a playbook now, and they can go, well, I need to check line three and then line five to see how that's doing. So all of those things are helping us be more productive and layer into what I call labor strategy.

The key component, if there's a theme with labor strategy, and this isn't sexy, but is treat people well, treat people with dignity and respect. And it doesn't mean lay down on the job, but we treat them right. We communicate right. We have communicated, we do probably 10 to 12 town halls a year. We're actually increasing that next year. We do simultaneous translation so that, that our team members that have Spanish at a native tongue and feel more connected. Those are just simple things that we're doing that don't show up in the hourly wage rate, that don't show up in some OSHA document. But ultimately, we believe contribute to our labor strategy. And particularly at RFG, as I mentioned before, go back a year ago, August, September of 2021, they had 70% of their frontline production work roles filled every day. Today, we're at 94%.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Yeah. Okay.

<<Shawn Munsell, Chief Financial Officer>>

Yeah. And incremental automation too is helping our labor strategy. And so it's obviously a lot easier to justify automation when wages are higher and labor's just in short supply?

<<Brian Kocher, President and Chief Executive Officer>>

And I think, that's a great point, Shawn, but think about how we sell that to employees. We don't go to employees and say, we're automating to eliminate your job. We're automating legitimately to redeploy them to somewhere else. So when we automate, we've got other holes that we're filling. That's why I said labor is easier, but it's not easy. Every day we go to work figuring out how to get better at labor.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

And is that automation to make their lives easier, to make it such that they're in higher value roles? Is it to address issues of particular kind of acute challenges? And I would assume that reduces turnover when you make their roles more fulfilling or easier.

<<Shawn Munsell, Chief Financial Officer>>

Yeah, absolutely. The automation tends to work best in those repetitive tasks. That certainly when you add automation there, it – I think it improves the welfare for the employees.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Okay. You touched on labor. Can you talk through the other kind of big cost buckets in that business? And when you think about having gone from Shawn, you said a year ago, negative gross margins crossing the equator and getting to where you were in this last quarter, to the extent you can kind of unpack the kind of cost components, efficiency components and how we should think about that outlay as we go forward?

<<Shawn Munsell, Chief Financial Officer>>

Yeah, sure. So you think about that swing from Q3 of last year to Q3 of this year. You know for sure the biggest component was price under a revenue management system, price and mix optimization. I'd say that, right? But we also saw a component of labor optimization, throughput per man hour had improved, but that's also a place where you saw the benefits from the transportation and warehousing initiatives. And then the other piece is just the benefit coming from the consolidation of that Jacksonville facility, into the Atlanta plant. And so that on an annualized basis that's call it $5 million. So, like we said that we're not done with respect to those initiatives, but those are the principal drivers of improvement today.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

Okay.

<<Brian Kocher, President and Chief Executive Officer>>

I think the other thing that's helped us and this is relates to raw product management, and particularly in that former RFG business is we now have a strategy on all of our significant commodities for raw product sourcing. So we've got a strategy for strawberries, watermelons, meat, cheeses. We have 93% of our input costs are now contracted. It doesn't mean we're susceptible to inflation, but every one of them went through – it doesn't mean we're not susceptible to inflation. Every one of them went through a RFP process. We managed to mitigate some, we switched some vendors where we could. So I think if I remember right through the third quarter, we had about 4% increase in raw material costs in our raw – 4% when you think of inflation in the other areas. And part of that was even offset by yield.

When you have more employees, they're better trained. Now all of a sudden your yield is better as well. So I think net-net, our raw product increase in the third quarter with something like 2%, which is nothing in this environment. But again, we went from zero to 7.7%. Getting from 7.7% to 10% to 12% is harder than getting from zero to 7.7%. So we've got some work to do and let's just keep this simple, get better every day, right. Just keep getting better every day. And I love the term grinding. When you come to Calavo, you come to grind, right. That's our job. We grind every day. We get pits in our stomach at night, and then we come back and grind the next day. And that's the only way I know how to run these businesses is an hour by hour, day by day intensity.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

One quick question on capital allocation and then kind of a bigger concluding question. What are your priorities around capital allocation and then on the leverage profile, historically, the company has been kind of debt averse. Shawn, how do you think about optimizing the balance sheet and where you'd like leverage to reside kind of on a steady state?

<<Shawn Munsell, Chief Financial Officer>>

Yeah, sure. So, our priorities, as you've seen, our top priorities really investing in the business organically. And so we've been making strategic investments in CapEx. And then any remaining discretionary cash flow we've been using to pay down debt, strengthen the balance sheet. We paid down about almost $40 million worth of debt from the end of the first quarter to the end of the third quarter. So the balance sheet is in a good place, but we have options. We have flexibility. I wouldn't say that we're averse to debt. That's – but we're going to be – we're going to be strategic. We're going to be disciplined with respect to capital allocation and capital deployment. But for the time being, we've really been focused on improving the business, making incremental investments where it makes sense, where we have solid returns and we've got a nice pipeline of projects that we're implementing now. And we've got the right team in place to execute those projects. And so it's not just having the dry powder from a capital perspective, but making sure you've got the teams that can execute and deliver the benefits that you modeled out.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

We've talked mostly today about transformation and efficiency. When we're sitting here at this conference next year, what do you think we'll be talking about?

<<Brian Kocher, President and Chief Executive Officer>>

I think we're going to be talking about growth. We've stabilized, think of it in this, it was tough for us to go talk to customers about growth when you're filling 70% of their order, right. That's just a fact of the world we were living in. But we've stabilized our operations. I think we're bringing optionality on the commodity side so that our Grown business can grow and grow profitably. We've stabilized our operations on the processing on our Prepared side, both in formally RFG and in our guac business. And now we have a chance with the way we've serviced, we have a right to ask for more business.

So our focus now, and every day when I'm in the office, I walk around the sales department. I don't know if they like that or not. But every day I walk around, where are you growing? Who is the next customer you're going to call? Who is the next customer you're going to call for an extra DC. Hey, we've just done a hell of a job this last year in delivering 99.7% of their orders. Why aren't – why don't we have this DC in the northeast or this one in Florida? Now that I think of it, I know that they don't like it when I come walk around. But that's the mentality we've got on our organization that's kind of switched from, let's take the orders as they come into. We've got now confidence that we've got an operating structure that can deliver, that can deliver successfully, that can deliver high quality and could deliver the right profit profile. Now we need to grow.

<<Ben Bienvenu, Analyst, Stephens Inc.>>

That's great. That's a great place to leave it. Brian, Shawn, thanks for your time.

<<Shawn Munsell, Chief Financial Officer>>

Thank you.

<<Brian Kocher, President and Chief Executive Officer>>

Thank you all for your time.