

The Scotts Miracle-Gro Company

NYSE:SMG

FQ4 2021 Earnings Call Transcripts

Wednesday, November 03, 2021 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2021-			-FQ1 2022-	-FY 2021-			-FY 2022-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS
EPS Normalized	(0.86)	(0.82)	NM	(0.53)	9.17	9.23	▲0.65	8.54
Revenue (mm)	695.38	737.80	▲6.10	632.15	4873.92	4925.00	▲1.05	4780.62

Currency: USD

Consensus as of Nov-01-2021 12:41 PM GMT

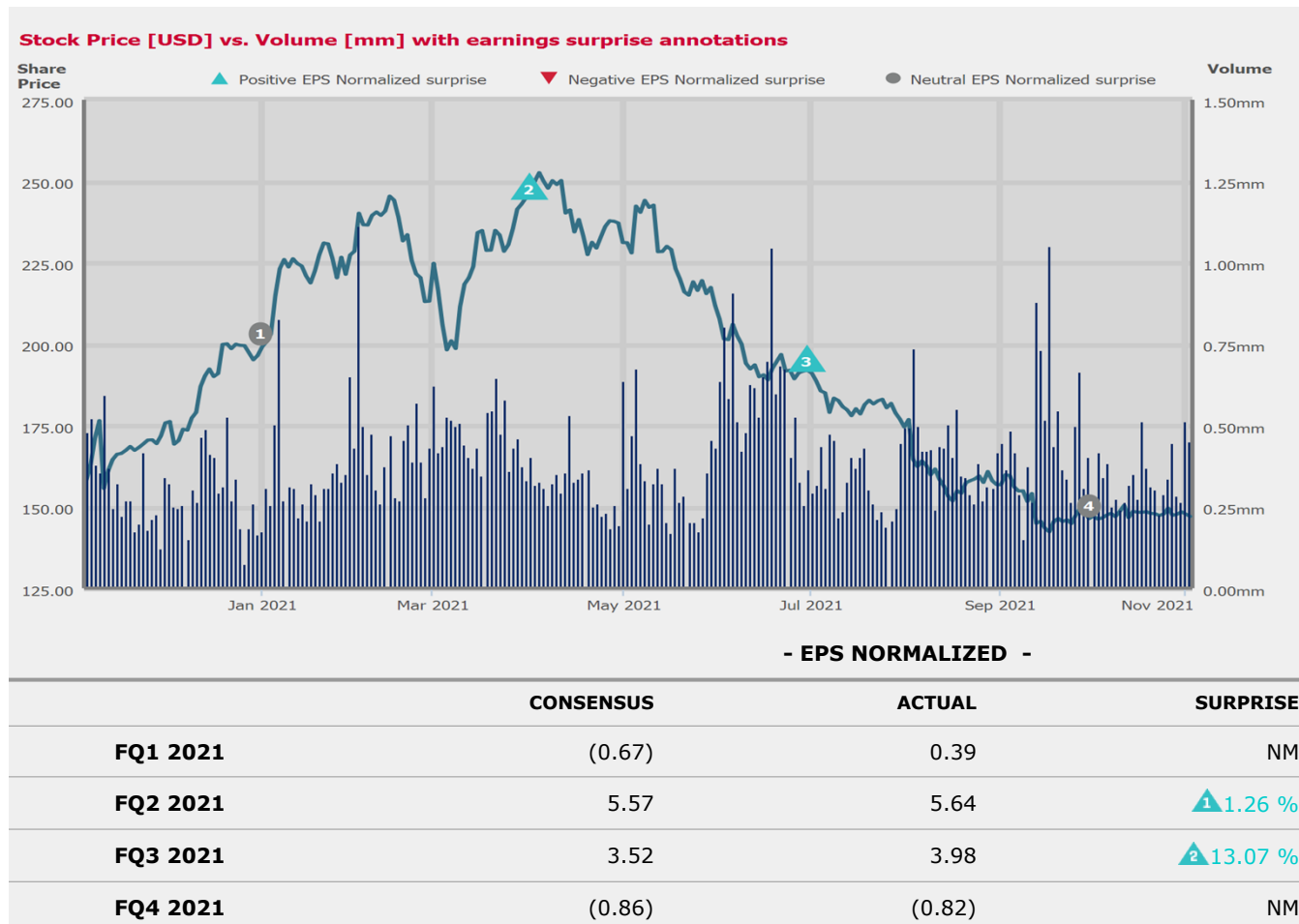


Table of Contents

Call Participants	3
Presentation	4
Question and Answer	13

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Presentation

Operator

Good day, and welcome to The Scotts Miracle-Gro Company's Fourth Quarter Earnings Conference Call. As a reminder, today's call is being recorded. At this time, I would like to turn the conference over to Jim King. Please go ahead.

James D. King

Chief Communications Officer, Executive VP and Senior VP of Investor Relations & Corporate Affairs

Good morning, all of you, and welcome to The Scotts Miracle-Gro Fourth Quarter Conference Call. By now, you've likely seen our fourth quarter and year-end press release, in which we announced record full year results as well as our initial guidance for fiscal 2022. We have a lot of ground to cover this morning with prepared comments from Chairman and CEO, Jim Hagedorn; CFO, Cory Miller; as well as Hawthorne Division President, Chris Hagedorn.

After their comments, we'll take your questions. And for the Q&A session, we'll be joined by President and COO, Mike Lukemire. In the interest of time, we request that you ask only 1 question and 1 follow-up. I will be available after the call and throughout the days ahead to answer any questions that we don't have time to address or need further follow-up. I want to remind everyone that our comments today will include forward-looking statements, and so our actual results could differ materially from what we discuss.

I'd refer you to our Form 10-K, which is filed with the Securities and Exchange Commission, so that you might familiarize yourself with the full range of risk factors that could impact our results. This call is being recorded. And an archived version of the call will be stored on the Investor Relations portion of our corporate website, scottsmiraclegro.com.

Without further delay, we'll get started, and I'll turn the call over to Jim Hagedorn to begin. Jim?

James S. Hagedorn

CEO & Chairman of the Board

Thank you, Jim, and good morning. For the last month, I've been thinking about the key themes I wanted to cover today, and I also spent a lot of time thinking about who exactly I wanted to target with my remarks. I won't spend a lot of time focusing on the quarter or the past year but it is worth pointing out that we've just finished our third straight record year, and remain extremely optimistic. And it's worth pointing out that our 11% growth in U.S. consumer was against a 24% comp, and a 39% growth in Hawthorne was against a comp of 64%.

I know there are obvious questions to address. Our stance on pricing, the commodity outlook, excess inventory in the cannabis market, and our thoughts about capital allocation. We'll cover all of these topics as well as share our thoughts about fiscal '22. But I've been a public company CEO for 20 years now. And too often, I've seen the markets focus with short-term issues overwhelmed the bigger picture. So I want to spend most of my time focused on more than our current results.

Frankly, there are a lot of great things happening at the company right now. Some of them I can't share with you, but they're very exciting. Our business is in important inflection point, 1 that could transform what we look like 5 years from now. We have the opportunity to make this company stronger to make the moat around our business wider and deeper, and to empower a new generation of leaders to shape it through their eyes, not just mine or my executive team.

We also see the current volatility in the market as an opportunity. If you're willing to lean in during times like this, there is potential to capture opportunities that others can't and an opportunity to further strengthen your competitive advantages, and leveraging those advantages, it's what drives long-term shareholder value.

So I want the real takeaway from today to be a better understanding of the journey we're on. And I'll be honest, my target audience is pretty narrow. To our sell-side friends, I appreciate the need to get your models refined and to share that information with your clients. We're committed to giving you what you need, but my comments are not aimed at you. My comments are also not aimed at short-term investors. I'm not going to get pulled into a rabbit hole about our quarterly splits to spot market price of commodities, or a bridge to year-over-year SG&A.

I do, however, want to speak to those investors who see the long-term opportunity in SMG shares. I want you to know where we're headed, and why we're confident that our efforts will create shareholder value. I won't ignore the key questions about fiscal '22, but weave them into a broader context of how we're operating the business rather than the confines of how it impacts the P&L.

In order to look ahead, I need to look backwards for just a moment. For the 5-year period, we've completed on September 30. Our strategic plan assumed a relatively mature core business, and enterprise growth of roughly 4% to 6%, driven by the higher growth at Hawthorne. We sought to achieve a consistent shareholder return of 10% to 12% by leveraging the P&L, repurchasing shares, maintaining a roughly 2% dividend yield.

We also set a 5-year target of cumulative free cash flow of \$1.5 billion. We exceeded each of those goals. While we are proud of the achievement, we know that the strategy has run its course because the opportunities are different now. And we're different, too. And so the next step in our evolution will reflect these realities. We have defined 5 distinct pillars of growth for the next 5 years. 3 of the 5 pillar related to the U.S. consumer business, the other 2 are related to Hawthorne.

First, we see a higher level of sustainable growth with our existing brands in our core business based largely on our ability to reach a new generation of consumers. Second, further growth of our direct-to-consumer efforts is there for the taking, if we invest in people, brands, partnerships and infrastructure. Third, live goods remains a meaningful growth vehicle and a gateway for a more direct relationship with gardeners. Our goal remains the same for consumers to see us as a gardening company, not a gardening supply company.

Fourth, to support Hawthorne's future growth, we must continue to put the commercial grower at the center of everything we do. This means further strengthening our model driven by innovation and technical solutions. And fifth, there is no doubt the cannabis industry will continue to evolve and grow. And there's little doubt that those companies, creative and courageous enough, to wait until that pool early, have the potential for a first mover advantage. We've shown our willingness to do this when we created Hawthorne. And as I'll describe later, we intend to do it again.

As we pursue these pillars, we are strengthening our team. Focusing on succession planning, and ensuring our ESG efforts, are embedded into our operations, and also better understood by our key stakeholders. We debated as a team and with our Board whether to pursue all of these opportunities at once. We all agreed we had to, but we recognize that succeeding against all these pillars requires us to reorganize and empower a new generation of leaders. While there are no plans for me or any member of the current team to step away, nearly every member of my team has made changes to their organizations.

The level of oversight needed to succeed against these efforts requires Mike Lukemire to spend more of his time on the strategy and implementation of the fastest-growing areas of the business. He has reshaped this organization so that each of these pillars reports directly to him. Therefore, he's given up most of his day-to-day responsibilities in the U.S. consumer segment to Josh Peoples and Dave Swihart, who will effectively serve as co-leads of that business.

On the corporate side, Cory has fortified his leadership team with an infusion of outside talent. And Denise Stump and Jim King have realigned their teams to better meet the needs of the business.

In addition, most of the M&A opportunities we're pursuing includes a management team that can further strengthen our own. If every opportunity we see manifest itself, we could double the size of Scotts Miracle-Gro within 5 years. That's not the goal necessarily. We want smart growth, not growth simply for the sake of it, but the magnitude of the opportunity could be game changing.

Let me briefly tell you how we expect to execute against these pillars, or I can, I'll talk about them in the context of our expectations for next year. Between the first 2 pillars, we believe the U.S. consumer segment can achieve sustainable long-term growth of 2% to 4% annually. Our previous strategic plan assumed growth of 0% to 2%. If we can sustain growth at this higher level, those added 2 points carry significant P&L leverage and improved cash flow.

It's worth noting that the guidance we set for next year assumes flat to slightly declining growth in the U.S. consumer segment. This is based on an assumed reset of the business in a post-COVID world. Specifically, we're planning for a decline in unit volume offset by pricing. You'll remember from our Q3 call that we took roughly 5 points of pricing, effective in August.

In recent weeks, we've communicated to our retail partners a second price increase effective in January. This more targeted increase will range from mid-single to low double-digits depending on the product line. In total, we now expect pricing in '22 to be on the high single-digit side with the goal of covering commodity prices. While we believe our sales assumption for '22 is a prudent way to plan, the trends suggest a better outcome.

Here's why. Consumer POS, in units in fiscal '21 was 6 points higher than in 2020. More importantly, it was 21 points better than fiscal '19 and actually got stronger later in the year. Consumer volume during the fourth quarter of fiscal '21, while down 7 points from last year's record performance was 35 points higher than the same period in fiscal 2019.

Consumers are showing us that lawn and garden is an essential part of their lives. Every cut of the data tells us they have stayed with the category and our brands throughout this past season. Those trends have continued in October. While it's a relatively small month, it's an important conclusion to the season, especially in the Midwest and Northeast. POS and units were up 4% in October compared to last year's record result and up 42% compared to fiscal 2019.

As we enter the off-season, the POS numbers won't tell us much until February. And obviously, we won't know until next summer, how much of the COVID bump we've retained. But I'm confident we'll have a significantly higher base to grow from. We continue to invest with that in mind. Millennial homeowners clearly have become a demographic tailwind, and are more than offsetting baby boomers who are leaving the category. This group of consumers care more about gardening than their parents, and see the categories more rewarding and purpose-driven as well.

A 30-year-old couple buying a home today and entering our category for the first time has the potential to stay with us for 20 years or longer. We must operate with that time frame in mind. We don't want our marketers to worry about hitting a target for Wall Street. Their job is to drive consumer engagement, brand loyalty, and market share. And we're going to give Josh Peoples and his team the tools to get that done. The same holds true for our direct-to-consumer pillar. This area is approaching 10% of our U.S. consumer sales and will only grow higher.

When we think about direct-to-consumer, it goes well beyond selling items on our website. It also means collaborating closely with our retail partners to support their online efforts. It also means finding new partners who can help us boost the appeal of gardening and have their own digital platforms that we leverage. Patti Ziegler is 1 of our brightest and most creative leaders, and directs our direct-to-consumer effort.

In addition to the efforts I've already mentioned, she and her team have launched native online brands like [Green Digs, knock-knock, and instead]. But 1 of their greatest successes has been with AeroGrow. Thanks to Patti's leadership and with the infusion of our R&D and marketing capabilities, we took a declining business, and tripled its sales since 2019 to nearly a \$100 million. Patti has been a champion for the potential of our direct-to-consumer platform since day 1, and continues to reimagine the future of this business.

Succeeding in our direct-to-consumer effort also requires improving our IT and supply chain infrastructure. Dave Swihart, whose role has recently been expanded to lead both supply chain and R&D, is driving toward that goal. We need to improve our ability to ship directly to consumers, especially in categories like

live goods, which has significant online potential. Until recently, our direct-to-consumer efforts didn't want your attention, but that's changed. While it remains too early to gauge the ultimate potential of this pillar, it will be a significant contributor to growth as we go forward.

I'm equally convinced our third pillar, live goods will be even more important. Live goods are the gateway to lawn and garden category, but historically have been highly regional, poorly marketed, and highly commoditized. We believe, we can do better. We've got a great start with Bonnie and its leader, Mike Sutterer, and we're working with Bonnie's other owner, Alabama Farmers Coop or AFC, to pursue other growth opportunities that holds significant potential. Like us, AFC has a vision to create a national branded business across several categories of live goods.

Together, we believe we can better meet the needs of gardeners and our retail partners through innovation, marketing, and supply chain. We've already made tremendous progress improving the Bonnie business. And even there, we've only scratched the surface.

The other 2 pillars are related to Hawthorne. Chris will spend more time discussing the current environment, but I want you to know I'm not obsessing about the sales in Q4 or what we think about Q1. I believe Chris and his team have a good handle on the current environment. More importantly, I believe they're navigating the choppiness in the market, while keeping their eye on the long-term opportunity.

If the market is challenged for a couple of quarters, expect them to take advantage of it. We won't chase sales but we will take an aggressive stance to further solidify Hawthorne and strengthen its market position. So expect us, for example, to further enhance our innovation efforts. I finally visited our new R&D facility in British Columbia last week. It's amazing. I've recently visited field stations in Oregon, Florida and, of course, Ohio. What's been the takeaway, that the work we're doing on hemp and cannabis research, is changing the industry. From lighting to nutrients, to growing media, our research is not just focused on continuing to improve our product offerings but more importantly, to help growers get a better and more cost-effective outcome.

Our unique understanding of plant science and the nuances of indoor cultivation is unmatched. Not only is no 1 in the industry doing, what Hawthorne is doing, Our competitors can't even try to replicate that model. I think you should keep that in mind.

We also are likely to use this period as an opportunity to step up our M&A efforts. We continue to be disciplined in our M&A efforts but the economics of some of our deals have become more attractive recently.

The final pillar of our strategy is embedded into the recent creation of a new subsidiary called the Hawthorne Collective. I've been alluding for months about the opportunities to invest in emerging areas of the cannabis industry, but this is my first opportunity to discuss the effort in detail.

It starts with our recent investment in RIV Capital, a Canadian-based publicly traded company, that owns or invest in a series of cannabis-related businesses. We share a common vision with the other major investors at RIV, to create a fully integrated business, based on the acquisition of licenses for cultivation and distribution. From there, Roof, can partner with some of the most well-managed brands in the cannabis industry.

There's a lot of speculation regarding the potential for new brands to prosper, as the market expands in the categories like beverages. However, too few people are focused on existing brands in traditional categories. This is already a multibillion-dollar market, with brands operating in the silos of individual states.

We're convinced there is tremendous potential for some of those brands to flourish more broadly as the market expands, and our investment in RIV reflects that belief. We believe that our unique level of expertise in the cannabis industry, gives us the right to win in areas beyond our existing portfolio. However, today, we cannot make direct investments in those areas. In fact, we can't even have a direct ownership stake in a company that does, but we can create an ownership option, which is what our convertible loan to RIV Capital reflects.

In the near term, we do not expect to see an impact from the investment in RIV on our P&L, and the amount of capital we've employed \$150 million does not impact our ability to invest in other areas, or return cash to shareholders. In the intermediate term, it is possible RIV may seek further capital infusions. We could be interested depending on the opportunities I'm not going to speculate on how much we might invest. The honest answer is it depends. But just as we did when we purchased General Hydroponics, Botanicare, Gavita and Can-Filters, we're willing to make investments others might avoid, until there is more clarity about the future. If you're a short-term investor, you may not like it. That's fine. But the long-term potential is real and is significant.

Ultimately, if we convert our financial interest in RIV into equity, which is definitely the goal, it may prompt us to reassess our current capital structure. Many of you have asked if we break Hawthorne off as a separate company. I've said we'd only consider doing that for strategic reasons, and not to chase valuation, and that's still true. Over the past year, we've worked to understand what a potential separation would require, and I believe we're capable of pulling trigger on such a move if we decided, it made sense.

Let me be clear. We have no near-term plans to do this. But could it become a viable option? I think the possibility is growing. As I transition to Cory, I want to emphasize that I'm just as confident about our near-term plans as I am about our long-term strategy.

The U.S. consumer business is performing well, and our consumers continue to demonstrate how important they see this category in their lives. At Hawthorne, while we continue to expect top line pressure through Q1. I'm confident in our team's ability to power through it, and we still expect sales growth on a full year basis.

I appreciate your patience this morning as I know my prepared remarks are longer than normal. Are there more challenges out there right now than a year ago? Yes. Am I thrilled with the equity price right now? No. But we're on a path to build a better, and stronger business, and we won't be distracted by the noise around us.

I mentioned earlier that we exceeded all the financial targets that we set with our previous strategic plan. And the goal is to remain on a path that allows shareholders to continue benefiting from the opportunities, I outlined in our new plan, and the pillars that I've discussed.

The confidence we all have is part of our decision to increase our share repurchase efforts. I told you last quarter, we had allocated \$250 million for that purpose.

We now expect to add another \$100 million to that total, and we hope to acquire as many of those shares as possible in the next 2 quarters. There's still a lot to cover this morning, so I want to step aside for now.

Cory, why don't you pick it up from here?

Cory T. Miller

Executive VP & CFO

Thanks, Jim. I'm going to spend a few minutes on the big themes from our Q4 results, especially around sales and gross margin. I'll share some thoughts about the guidance we've provided this morning for fiscal '22. And in between, I'll turn things over to Chris to provide some color on Hawthorne.

Starting on the top line, you saw this morning, company-wide sales growth for the full year was 19%, which was in line with the updated guidance we've provided a few months ago. U.S. consumer sales did better than we expected, finishing up 11% compared to the 7% to 9% growth we expected. At \$3.2 billion, sales grew by nearly \$900 million in the last 2 years. The supply chain team deserves a lot of credit for their ability to deliver this growth. The targeted investments we have made and will continue making in this area will prove to be key.

Consumer engagement remained extremely strong through the fourth quarter, and that kept our retailers equally engaged. Although U.S. consumer segment, sales declined 28% in Q4, we were up against a plus 92% comp. Also, remember that Q4 had 6 fewer days this year than last year. Adjusting for that, sales in the quarter would have declined 23%.

At Hawthorne, the calendar shift cost us 7 points for the quarter. While year-over-year sales declined 2%, the segment would have been up 5% on an apples-to-apples basis when adjusting for the calendar. And the U.S. Hawthorne business, grew by over 10% last year in Q4 given the same comparison.

Finally, recall that Hawthorne was up against a plus 64% comp in the same period a year ago. On a full year basis, Hawthorne grew 39% to \$1.4 billion. I'll remind you that number was \$640 million in fiscal 2019. We have more than doubled the sales of that business in 2 years and all of that growth was organic.

On the segment profit line, Hawthorne earned \$164 million in fiscal '21, for an operating margin of 11.5%. The profit was up 46% from last year and more than 200% from 2019. We've said repeatedly that we're trying to strike a balance between growth and improved profitability. I think the results speak for themselves.

As many of you know, I served as a finance lead at Hawthorne, almost since the inception of that business, before joining the corporate team as CFO. As you look at the [Hawthorne] results, I encourage investors to look deeper than the numbers. While the growth and profit improvements have been impressive.

The improvements we've made to how the business operates tell an even better story from the integration of 7 separate businesses to the implementation of SAP, the revamping of our sales force, and the creation of the world's only cannabis-focused R&D program, the efforts of this team have been outstanding.

I know all of you want to know more about the current state of the business. So let me take a pause here, and turn the call over to Chris Hagedorn for a few minutes.

Christopher J. Hagedorn

Division President

Thanks, Cory. I'll leave the details around the numbers to Cory, but I know you guys are wondering about the current state of the industry, and how we're navigating it. So let me address that for a few minutes.

We're obviously seeing some disruption in the market right now, but we expect it to be temporary. Our field sales team, began seeing the signs of potential slowdown in late June. We got smarter about the issues in July, and that allowed us to share some of those insights on our third quarter conference call in August. That's when we caution that the growth will be significantly slower in Q4 than we've seen for the rest of the year.

Since then, many of you have been asking whether this will be a replay of 2018. We don't see it that way at all, and we're not alone. Some of you were in Las Vegas a couple of weeks ago for the MJBiz conference. It's the largest cannabis trade show in the world. And if you were there, you saw firsthand, that this is not an industry that's [threatening] about the future.

Consumer demand for cannabis products continues to grow, and the market continues to expand. As it relates to the current environment, what was clear to me in Vegas, was the industry is becoming increasingly adept at navigating the chopiness that's inevitable in a market like this.

What's happening right now is actually pretty straightforward. In California, there were simply too much cannabis harvested in the past few months, especially from outdoor growers in the northern part of the state. On top of a strong harvest from the first turn of crops earlier in the year, many growers harvested their second crop of cannabis earlier this season due to concerns about wildfires drought, and in the case of the legacy market, fear of increased enforcement efforts. The combination of too much product and relatively poor quality has put downward pressure on wholesale cannabis prices.

However, that issue should solve itself once the current supply makes its way through the marketplace, because the legacy market remains a big part of what's happening in California, the available data isn't great. So that makes it hard to give you a precise answer on how long it will take for the current oversupply to work itself through the market. That's why we're currently forecasting Hawthorne sales to decline in the first quarter.

That said, the single most important fact is the end market for cannabis continues to expand, and we expect to start seeing growth again in the new calendar year. And virtually no 1 is expecting that fact to change for the foreseeable future. In fact, many high-end growers have told us that current market issues are not impacting them at all, and they continue to flourish.

Another important fact to remember is that unlike in 2018, there are no regulatory issues getting in the way right now. 3 years ago, California badly boxed the rollout of the recreational marketplace. That overwhelmingly was the issue that impacted the market back then. It was nearly impossible to get a license to operate legally, regardless of whether you were a cultivator or a dispensary. While the current marketplace in California remains more expensive and bureaucratic than other states, it is vastly improved from what we've seen in the past and the legal market there continues to grow.

Some of you are also wondering whether the current situation will result in some consolidation. The answer is pretty simple. Yes, of course, it will. But those kinds of ebbs and flows are exactly what we expect to happen. It's what happened in Colorado back in 2015, it happened in Oregon when it went legal, and it's likely to happen in California to some degree. In fact, that's also what we're seeing right now in Oklahoma.

Like many new markets, Oklahoma, had explosive growth out of the gates and probably got a bit overbuilt. So we expect to pause there before growth resumes. We have told you repeatedly over the years that this industry is likely to be choppy from time to time. This is not the first time the industry has seen an oversupply of cannabis and just to be clear, it will not be the last.

What's important for Hawthorne as we keep running our play. The growth will be there in the long term. I'm not worried about that. Instead, I want to make sure that we're doing everything we need to distance ourselves from the competition. Jim has already told you that we won't slow down on our innovation efforts, which, by the way, go much further than just new product development, which brings me full circle to the MJBiz conference a couple of weeks ago in Vegas.

Like most major trade shows, MJBiz, was canceled last year due to COVID. So we haven't seen the industry all in 1 place for over 2 years. What was clear to us and frankly, nearly everyone we interacted with is how far Hawthorne has come in those 2 years and how much we've distanced ourselves from the competition.

We have fundamentally changed our approach to selling, and that transformation is continuing. We've brought new products to the market that have improved the results for growers, by both increasing the yields and lowering their operating costs. And we've used the innovation to help us in more qualitative ways, like the establishment of the Hawthorne Social Justice Fund, within our corporate foundation.

While I understand the questions you all need to ask about the step down in our growth rate, I would urge you not to lose sight of the bigger picture. There is no doubt that we're the clear leader in the industry. There is no doubt that our competitive advantages are unique, and there's also no doubt that the cannabis industry still has miles of runway ahead of it.

So looking ahead at fiscal '22, I'm not worried about a few speed bumps. Rather, I'm excited to see how much further we can push this business, and continue to lead the way in an industry, that remains poised for years of growth.

With that, Cory, let me turn it back to you.

Cory T. Miller
Executive VP & CFO

Thanks, Chris. Let's move down the P&L now to the gross margin line. Like nearly all other CPG companies, we've continue to see pressure from higher commodities and distribution costs. However, the year-over-year change in the margin rate during Q4 require some additional context.

In Q4 of fiscal '21, the adjusted gross margin rate was 17.4% compared with 24.3% in 2020. Company-wide sales in Q4 of last year were up nearly 80%. So the fixed cost leverage in a relatively small quarter

drove a massive improvement in the margin rate. If you compare the Q4 gross margin rate in '21 versus '19, you'll see the difference is only a 100 basis points, and that difference is a combination of segment mix and higher commodity costs.

On a full year basis, the gross margin rate declined 270 basis points to 30.3%. The year-over-year increase in commodity costs of about \$85 million nearly all of which was on plan, was the primary reason for the decline, followed by higher distribution costs. As you know, we did not adjust our prices this year until August in the U.S. consumer business.

So we had limited ability to offset the commodity inflation during the first 3 quarters of the year. That story will change significantly in fiscal '22, which I'll explain further when I cover our guidance for next year. Higher volume was able to drive improved fixed cost leverage, and conversion, to help offset the commodity cost increases.

SG&A came in 2 percentage points lower in fiscal '21 at \$743 million. It declined 21% in the quarter to \$161 million. Lower variable compensation was the main driver. Also, in Q4 of 2020, and we used some of our strong earnings upside, to significantly increase our annual contribution to The Scotts Miracle-Gro Foundation, which we did not repeat in fiscal '21.

Interest expense was \$5 million higher in Q4 compared with a year ago. but essentially flat on a full year basis. Remember, we issued \$900 million of bonds in the second half of the year, which drove an increase in the quarter.

On the bottom line, adjusted net income, which excludes restructuring, impairment, and onetime items, was up 28% to \$528 million or \$9.23 a share. That's just \$0.01 shy of a \$2 per share increase in a single year and more than twice the \$4.47 a share we earned in 2019. The EPS number is on the high end of the revised range we've set in early June, and is a major accomplishment given the difficult comps, and some of the cost hurdles we've had to clear in the second half of the year. We're obviously glad to answer any of your questions regarding our Q4 or full year results. But instead of spending more time on those details, I want to switch gears and share our thoughts about Goal '22.

As you saw in the press release this morning, you see company-wide sales next year of about flat to plus 3%. This assumes the U.S. consumer segment is flat to minus 4%, and that Hawthorne grows 8% to 12%. None of those ranges assume the potential impact from acquisitions.

In U.S. consumer, we are going into the year with the assumption that unit volume will decline high single digits. Roughly half of that decline is expected from lower shipments in the first half of the year. Remember that last year's Q1 was up nearly 150%, as retailers worked hard to remedy depleted inventory levels. Since current retail inventory levels remain higher than a year ago, we likely won't see a repeat of that kind of initial load-in.

We're also for planning purposes, assuming modest declines in consumer takeaway in fiscal '22, mostly driven by the difficult comps we've faced in the first half. As Jim already indicated, consumer POS has been stronger than we expected in recent months, and has actually been positive for the fall season. It's easy for us to lean in to meet the higher consumer demand if it comes, but the prudent play is to assume a slight decline.

Most and perhaps, all of the planned unit volume decline, should be offset by pricing. You should see some benefit from pricing in Q1 from the August price increases, and the balance will begin during our Q2. As it relates to Hawthorne, we're planning for 8% to 12% growth on a full year basis. As we expect to see continued pressure in Q1. As Chris said, it's hard to be precise regarding the current inventory supply issues in the industry, but we're hoping to see a return to growth sometime in Q2.

Let's move on to gross margin. We expect to see gross margin rate decline by 100 to 150 basis points on a full year basis. We are cautiously optimistic that our pricing moves will offset expected commodity pressure. That said, we expect about 65% to 70% of our costs to be locked in by the end of the calendar year. So we'll still have some exposure if costs move higher than the planned increases we are assuming.

The 2 biggest pressures on the rate next year, will come from lower fixed cost leverage and segment mix. We would expect some leverage out of SG&A, meaning this line can range from a 6% decline year-over-year to a slight increase, maybe 2%. There are no major moving pieces in SG&A, and we remain committed to investments, we believe will drive the business, not just in fiscal '22, but the years to follow.

Below the operating line, interest expense should be roughly \$25 million higher, based on the full year impact of our recent bond offering. Our guidance also assumes no offsetting earnings impact from acquisitions, which is a pretty conservative starting point.

All of this rolls up to a guidance range for adjusted EPS of \$8.50 to \$8.90. I also want to talk about cash flow for a moment. For the year we just completed, free cash flow, that's operating cash flow minus CapEx, came in at \$165 million. While that is low from historical standards. There are 3 main reasons behind the year-over-year decline. First was variable compensation that was earned in fiscal '20, but paid out in fiscal '21. That was about a \$60 million impact. Second, we increased CapEx by about \$45 million. Third, inventory levels were up \$500 million from fiscal '20. While most of this increase was paid during the year, we did lean on our vendor partners more than in the past to achieve extended payment terms.

As we look to fiscal '22, we're aiming for free cash flow of up to \$300 million. We expect CapEx to increase again, and we also expect inventory levels, while flat on a unit basis to be higher overall because of the increased cost. These investments are necessary to continue meeting the required service levels to our customers, which is the higher priority. But as it relates to inventory, we find ourselves in a very good place right now.

In both U.S. Consumer and Hawthorne, we believe some competitors will have a hard time meeting demand. And in the consumer business, we expect the market to see shortages of grass seed and [sphagnum peat moss]. The key ingredient used in growing media. We do not expect to be impacted by those issues, and we do not expect to have any problems getting our customers at the appropriate inventory levels either. Before we open the call for your questions, I'll offer a final bit of commentary. I agree with Jim's assessment. We've got a lot of moving pieces right now and several active initiatives that could require us to update our outlook as we move through the year. But even in the unlikely event that none of those efforts come to pass, I believe the business is in a great spot.

The challenges we're seeing on the cost of goods line are pretty consistent with what you've been hearing from other companies over the past 2 weeks. And just as we said we would, we've taken aggressive action to stay ahead of all those challenges, and protect the profitability of the business.

When I think about how far this business has come in such a short period of time, it's hard not to feel good about where we sit right now.

And so with that, let me turn things back to the operator so we can take your questions.

Question and Answer

Operator

[Operator Instructions] We'll go ahead and take our first question from Jon Andersen with William Blair.

Jon Robert Andersen

William Blair & Company L.L.C., Research Division

Lot of different questions, but let me start with Hawthorne. Understand the situation in California, and thank you for the color on that. I'm wondering, like you to comment on what you're seeing in some of the newer states, really over the last year, a number of things have legalized adult-use cannabis, and yet in some of those states are quite large, such that the total population or living in states with adult legal has risen quite a bit.

My sense is that you haven't really seen demand from those newer states yet. Could you provide kind of an update on that? And when you expect that to kind of kick in?

Christopher J. Hagedorn

Division President

Jon, yes, it's Chris. You're absolutely right. We saw a lot of states. And when you talk about high population states that have seen adult use pass, I assume you're talking about states like New Jersey. We've always liked to give you guys, and ourselves, frankly, sort of a year, we think, from passage of law, that's when we expect the market to kick in. And while I think that's a reasonable estimate in most states, you do have to couch that with the reality that this is depending on state legislatures, getting the regulatory frameworks for these markets setup. And that's something in the state like New Jersey has taken a lot longer than expected. As an example, New Jersey had a big slate of social equity licenses, adult-use grow licenses that were supposed to be granted back in 2019. Those licenses were just granted 2 weeks ago.

Just an example of how slow that state has moved to actually approve what the voters have asked for. And in that state, those adult-use licenses will not actually be able to sell into the adult-use market for a year after they've been operational under medical. So those guys who have to build out their medical grows, start operating, for at least a year before they're eligible for adult-use.

So even when they passed adult-use, we've seen some regulatory hurdles that just really stretch that time line out for us. So we expect New Jersey, to start kicking in. We're seeing some really early results, but it's still a very small state for us.

So again, it's a year has always been our kind of our number, but it looks like that may be a little optimistic in some of the Northeastern states that have kind of no existing framework, and they're kind of figuring out the live.

Jon Robert Andersen

William Blair & Company L.L.C., Research Division

Great. That's helpful. Appreciate that. And just as a follow-up. Maybe I'll stick with something bigger picture. So Jim mentioned live goods several times as a gateway to lawn and garden. It's 1 of the 5 pillars, that you outlined of growth for the next several years.

So what can you just let us sell -- what have you done and accomplished so far in live goods, A little bit more color around that?

And when you look forward, what is it that you haven't done that you want to do in live goods that would be accretive to your growth in earnings, whether that's more with Bonnie, whether it's broadening the relationship with [AFC], et cetera?

James S. Hagedorn

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CEO & Chairman of the Board

All right. I think I'll start, and then hand it to Mike, who I view is really sort of the author of the strategy, which I'm totally behind. I'll just hit with what have we done. And we -- I think this year, we've stepped in, or [privates] a little bit and learned a lot. And I can let Mike talk about that because I think that's what are we going to do. But let's start with what have we done? I think we bought the -- or partnered with AFC on the finest brand, really the only brand that's national in live goods and that's Bonnie, and worked with them to really begin to professionalize.

And it's not that they were unprofessional, but I think we've learned a lot of how we want it to be, Mike, has really led that from our side. And if you say where we want to go, is we want to participate in the other categories under the same kind of idea of branded, national, the ability to use scale.

But let's just remember what was our original interest. And we're saying now and it's true. That we just don't want to be kind of a lawn and garden [cannabis] company, that people garden really, and it starts with plants, and the psychology of why people want a garden. And there's a lot of really good stuff for us, sort of in that. But we want to play in plants, and we view basically is a high-growth area.

So if you -- even if you look at what we're seeing now, which is, we believe, based on younger people, people wanting to own homes, very different than probably 5 or 6 years ago, when we were saying people are going to want to move to the city, and have a condo and not have a yard. I think we feel very differently than that now. And young people want their own homes, there's a gigantic bubble of kind of our kids, who are at that phase now where they're buying homes and having kids, and the dog or whatever. And that data we talked about a little bit, they want to garden.

And so if you look at our core and you say, we think we can kind of double that, which is, I don't know, not saying a lot. I think Mike and I struggle with that to [0% to 2%, 2% to 4%]. But we're seeing a growth rate in live goods that's at least 2x that. And so that was the attraction to the business plus this idea of getting involved more in sort of the basics of gardening, and the brand side of it, which Bonnie brings to us.

So the question of it is like what have we learned, and kind of Mike, what's your addition to the craft?

Michael C. Lukemire

President & COO

Well, I think having a national network is -- that's what Bonnie brought but the sophistication. There are really -- other than Bonnie, there's no other national brand. There's all kinds of really cool genetics, and activity, that we can bring to the market, and we look at it as tying the solution for the consumer, with our other products, to actually give the consumer a better opportunity to have success and enjoy gardening.

So we're tying it all together. We're looking at succulents. We're looking at -- we're actually doing succulents, and we've expanded and doing some color, Miracle-Gro flowers are in Lowe's. And so we look at providing that national network and supply chain infrastructure, which is probably the weakness of every growers being able to supply nationally those products. And then expand also in direct-to-consumer and get those products there.

James S. Hagedorn

CEO & Chairman of the Board

So how much of your time is going into that, Mike? Sort of the supply chain of getting that where you want it?

Michael C. Lukemire

President & COO

It's probably 25% right now. So there really no -- I mean, we've integrated companies. We got to integrate those systems. And if you remember where Scotts was for me 26 years ago, it really was an isolated supply chain. This is really nationalizing the supply chain of the live good companies, and really

making it more effective. And so, and the branding, and the marketing. And I would say indoor is actually a huge opportunity. That is really underdeveloped. And so we want to simplify that for consumers.

Operator

[Operator Instructions] We'll go ahead and take our next question from Peter Grom with UBS.

Peter K. Grom

UBS Investment Bank, Research Division

So just a few questions on Hawthorne for me. Maybe just to start, Jim, you alluded to a greater willingness to separate Hawthorne from the legacy business, and I know you said that it's not that what you expect in the near term, but could you maybe help us understand what is driving that growing confidence, that this is something you may consider?

And then what could actually push you over the line to actually making that happen? I'll stop here.

Cory T. Miller

Executive VP & CFO

Dude, I could go on for an hour on that 1. Let me start with how welcome Hawthorne is within sort of the SMG world. And that I think I probably told you guys this before, I think Chris is, I think it was always a kind of a reluctant partner. And I think it's -- I don't know how long, Chris, you've been in this job now how long?

Christopher J. Hagedorn

Division President

7 to 8 years, [indiscernible]

Cory T. Miller

Executive VP & CFO

[indiscernible] [Higher dog life]. The -- I think if you look at what we're doing with supply chain, innovation, we're not really advancing sort of science. The stuff that we -- plus also being a buffer when they've had issues like in 18, where the largeness of Scott's really helped. So I think it's very much a virtuous place for Hawthorne to be and it's -- I'd call it probably highly synergistic.

So when we get into this question of separation, the question is, I'm not saying you would suffer dissynergies, but I think it would have to be strategic enough that -- well, Chris is nodding, there would be. But I think there's arrangements that could be made to sort of minimize that.

Why would I do it? Because I think there's opportunities out there with like-minded partners, that is big. And I don't know, Peter, I don't think we've met. I don't -- if we have, I apologize. But let's just say maybe you don't know me that well, I'm just not that good as minor partner. I think we've been doing deals here where we're -- what we call it as a respectful minority interest because that's kind of what people are willing to tolerate.

A lot of the people we're dealing with on a future basis, this is now sort of confidentially talking down the road, I think they don't want to sell their businesses. Would they participate in something that added a lot of value and became something important? I think the answer is yes. Would they sort of join the Allied Military, whatever you want to call it? The answer is yes, they would. And -- If you look at the dollars involved, I think it would be challenging to do this on the long term, where we are a relatively small partner.

I think what we have to offer, beyond sort of what Hawthorne is, is management structure capital access to the public markets, both equity and finance. There's just a lot of things that we have to offer, and to sort of have a real seat at the table, in my view, is the big dog in the room, in the industry, is Hawthorne, for the right structure. I'll speak for myself because I have a management team that are my partners.

I got a Board of Directors, that I have to sort of work through my family, I think I could see a contribution of Hawthorne in spite of sort of how welcome it is here, to put together the right structure. And I think that, what that offers, and I don't think we've suffered as a result of saying, it's not super clean that you have this sort of cannabis business stuck into a consumer lawn and garden market or business.

I think especially when the stock price was higher, I thought it was properly valued of, Hawthorne's value, Scott's value combined, it felt better than it does right now. But it felt right. And I didn't think it was disadvantage to us at all. I do think that there are people who would make an argument, and I'm sympathetic to the argument that doesn't mean I completely agree with it. Let's say, it's cleaner to have people who want to make investments in sort of the cannabis business, especially if something was this strategic, as what I envision, and not have that mixed into the sort of lawn and garden business, which is a slower growing, probably more cash flow positive business.

So I could make an argument that, that, that would be the right thing or could be. We've also spent at least, I'm going to say, the last 18 months, making sure that we have [severable] financials, that sort of are financeable in a sort of public way. And we are -- I don't know, I was talking to Ivan Smith, a week, 2 weeks ago, and said we're there, right? We're there from a financial and legal point of view, where they're severable. And I think what he said is within a month or 2, I think that's correct.

So again, there's no rush to it. But I do think that -- and this question that came up about sort of the East Coast in Jersey, I think these are very valuable opportunities. And I think the dollars -- and remember, these are I'm not going to get critical to the United States government, except to say [indiscernible] is a piece of ship. It's ridiculous that the United States government makes more in public marijuana, than the owners of the businesses, that have invested behind them, and it has to be fixed. And we're involved in D.C. solving that. But on a before tax basis.

These are significantly profitable business in their early years. And so I think that if you look at the value of these businesses, you can get to the point where you're getting into real money, and to sort of deal with balance of power issues that's where I get to saying, Hawthorne really has to be a part of that.

And so I -- hopefully, that answers the question of -- but I don't think we're on the cusp of a deal. But if you were 1 of my brothers, sisters and they said, when do you think this could happen, I would say a year or 2 years, something like that, I wouldn't be surprised.

And 1 last thing, I'm not sure I've actually done a call where my son had a speaking part. I will say as dad, I'm pretty happy, and proud to be sitting here with my elder son at the table. And if I was representing to you guys, I would say, he's ready to run things. He's maybe better than I am.

So I do think that -- the biggest thing we're working right now is just make sure we understand kind of the map that we're developing with some other people on how this thing progresses, and then putting the management team together to actually support that business.

And Mike, and I, and the Board, are spending a lot of time on that. So that's a pretty open answer and truthful, okay?

Peter K. Grom

UBS Investment Bank, Research Division

No, that was really helpful. But I guess maybe for Chris, I was hoping to get your view on the cadence of Hawthorne as you look out to fiscal '22. Can you maybe just help us understand the magnitude of the negative pressure you kind of expect in Q1? What gives you confidence that it will snap back so aggressively to kind of to hit this high single-digit, low double-digit target for the year.

Is there enough conservatism in your guidance? Like should this, the underlying trends take longer to improve? And then just -- I know there's a lot here, but just the Oklahoma comment. Can you maybe help us understand how big Oklahoma is for Scotts or the broader industry?

Christopher J. Hagedorn

Division President

Yes. No problem. So Oklahoma is has become a somewhat material state for us. It's -- we saw a kind of 1,000-plus percent growth over there in that state over the past couple of years. And candidly, it was a state that we've been talking internally about that we need to prepare ourselves for a little bit to fallout in Oklahoma, just because you can't see that kind of growth forever. And you saw a similar growth in states like Oregon, back in 2017, which led to kind of end product saturation in those states, and the resulting a kind of fallout that we dealt with a few years ago.

Now again, like I said in the prepared remarks, I don't think anyone is anticipating this to be the same amplitude because like I said in the remarks, there's -- there were structural regulatory issues, that were compounding the oversupply then. Those don't exist here.

In terms of what gives us confidence that this is going to be sold through. And look, I was out in Vegas a couple of weeks ago. I know some of the analysts were as well. And I heard from a bunch of people who are pretty smart folks who've been in the industry for a long time. I'm talking real cannabis people right now, not sort of corporate folks, who've won their way in like us, but I mean real cannabis guys, who said, look, this is not to scare anybody, but this is the single biggest end product flood that the cannabis market has ever seen. And I think it's probably true.

The -- what gives me confidence here is -- This is a perishable crop. It's only going to stick around for so long. And as I also mentioned in the prepared remarks, this is something we're really seeing, affecting the kind of middle and lower end of the market is much more substantially than the higher ends. You talk to a lot of high-end growers. They're growing more cannabis, high-end legal growers, they're own more cannabis than they ever have.

They're selling it for higher retail prices than they ever have, and they're selling everything they can grow. And to be clear, that is the core of our customer base, our consumer base. It's folks growing high-quality cannabis indoors.

So we got a pretty high degree of confidence we're going to see this thing shake out, I would say, over the first quarter of the next calendar year. So first quarter of Q1 -- or excuse me, first quarter of '22, we think this thing will shake out. Look, we have been wrong before. I think we've got better intel on this than anybody, frankly, that includes our competitors. And I think we've got more experience here, too.

Cory is really the only member of my management team that's moved on since 2018, and he's moved into the CFO role, working with Jim. Our team has seen this kind of action in the marketplace before. We knew what was happening when we saw it coming, we knew how to prepare for it as best we could.

So I feel confident in the numbers for the full year. Obviously, they're back-loaded to the second to -- third and fourth quarters. But again, our confidence is high, the oversupply will shake out. And when it does, we are going to be better positioned than anybody to take advantage of the market.

Operator

We'll go ahead and take our next question from Bill Chappell with Truist Securities.

William Bates Chappell

Truist Securities, Inc., Research Division

I'll try to keep it short. First on Hawthorne kind of M&A commentary, explain to me, I guess, the rationale behind -- you have a pretty broad base of products, most of the M&A you've done or announced in the past year has been really, really small. And I understand that valuations are more attractive.

But I mean, it's kind of to a wide bother if you could end up buying 300 different \$10 million companies versus build it yourself. So help me understand why that -- what makes sense versus, a kind of a part 2 to that first question, of why didn't you actually repurchase shares in the quarter versus repurchasing them going forward?

James S. Hagedorn

CEO & Chairman of the Board

So should I -- I'm sort of stunned by the repurchase part. -- let's just talk real quick about sort of M&A pipe for Hawthorne, not the Hawthorne Collective or what we'd call Apollo internally because they're quite different.

Bill, you've been with us a long time. I would say what do we like on the consumer side, what we have always called, close in adjacencies. These are businesses and because of the Sunlight connection, there are opportunities in distributed products for us that we understand that we already sell, that we know if we bring into our supply chain, you're talking very significant IRRs. And I'll just throw in there that the cultivation industry with all due respect to the many fantastic people out there, doing that kind of work, people, when they have something that works, they really stick with that.

And so there are branded businesses out there where getting people to change is not as easy as it seems, and where there are significant opportunities, and synergies, and we can buy at a fair price. And then apply the synergies to the business, that if I took you through them, and I'm not going to do that right now, you would basically say, "Oh hell, yes, you should do that". Not very exciting. Look, I want to go back just to LED lighting for a second.

LED lighting was a business that really 3 years ago, hardly existed at a big level. That represents today our single largest category. And well over 50% of our lighting dollars, are now on LEDs. And I'm telling you this is -- this is all based on innovation, where I think together with, Mike, and his R&D team, Chris, and his folks, defining the need, Mike Sutterer from Harvard, building a strategic reason for the Gavita business that is based on unique and important innovation.

And so this is a business we did build by ourselves. We built a category by ourselves. And it's growing. And today, we are pretty significantly backordered on our LED lights. And so this is an area where we had more components, we'd be selling more products and not a little bit.

So I think that your question is we're doing both. We're doing both innovation and building it ourselves, okay? And where something is a close an adjacency, and we can just buy it up, Mike and Chris, and their guys on the supply chain side could do their work, plus we can then put our R&D effort against it. I think it -- the economics of it make a lot of sense. And if I was telling you about it, like deal by deal, you say, I agree with you.

So I don't think that, Chris, you should pick it up here if you want.

Christopher J. Hagedorn
Division President

Yes. No, I would like to. When you talk about the small deals that we've done recently, it's Riso Flora and HydroLogic. Those are deals more in the case of rise of floor is that close in adjacency, as Jim is describing. And I mean, we're talking close in both sort of from a category perspective. The Riso Flora facility in Santa Rosa, California, literally shares a fence with the legacy General Hydroponics facility that is still our main liquid nutrient production facility. They share a fence line their next-door neighbor.

So that was 1 we knew that team pretty well. We love the product. We love the brand. We love their ability to really get traction in the marketplace, and there could not have been an easier integration for us, because we were next door neighbors already. I mean literal physical next-door neighbors.

In the case of HydroLogic, that deal goes back to when we first bought General Hydroponics, I was talking to Ross Haley, who at the time was the CEO of GH, when we did that deal and said, "Hey, Ross, where should we go next? He gave us a long list of brands, most of which we've acquired in the meantime.

The top of that list was hydrologic. It took us a while to get that deal done. But that is a brand, that is really stands alone in the in sort of the subcategory of reverse osmosis water filtration. There is hardly a commercial growth you walk into that does not have a HydroLogic system in that facility. Their list of contacts and relationships in the industry is extremely deep and includes a number of called [features] that we didn't have much of a relationship with.

So to us, that was 1 strategically, it was always on our list. It took us a few years to get there, but it just -- we never forgot about that deal. And I'm really, really happy that we've got it done. The team there is phenomenal. And the past few months getting integrated the businesses overperforming our expectations, even in this marketplace.

James S. Hagedorn

CEO & Chairman of the Board

And then I just want to just last on repurchase. Our shareholder-friendly approach that was really came out of project focus or whatever -- I think that's what we call it. That was what we presented to everybody, that we don't really see a ton of opportunities out there to acquire that are attractive to us.

So we'll just send the money back to the people who own this business. I think, part of what you're hearing on this call, is that, that's not where we're at right now. That's the change. That's when I say -- I wouldn't say the strategy had a shelf life but what's changed the opportunities around us, whether it's in live goods, whether it's in direct-to-consumer, I mean, these pillars that I've been talking about are the opportunities, and we're organizing around those.

So Mike has the ability to stay on top of them, and they all report in. But they all have growth rates that we think, and we've got this fantastic business, the core, slower growing, high cash flow. And remember, that \$165 million, plus \$500 million of inventory, plus CapEx, plus you're talking like, I don't know, \$700 million of cash flow this in '21 before you make those adjustments. So it's a really great business.

The other businesses are, we think, are pretty obvious, and the higher growth rates. And that's kind of why we're chasing it. And that's why we basically have said we've got to integrate some acquisitions plus then if you look at the Hawthorne Collective opportunity, we want to invest there as well.

And that's really why we have decided that returning cash to shareholders is still an important component of what we're doing, but it's not the only thing we're doing. And that's a lot of what Cory, and I, try to balance, is what's the right investment in the business. But there's a lot of opportunity right now. And I'm sort of really hopeful, the United States, doesn't step in the way. I don't know, I'm watching the FTC. God Damn it. But what.

Cory T. Miller

Executive VP & CFO

I was just going to add, if you go back to last year, share prices were a lot higher. Our return to -- return of value to shareholders was going to be more and around in the realm of a dividend versus a buyback. If you go back 4 to 5 months ago, share price was a lot higher. We did buy back about \$40 million of shares in Q4, so it wasn't that we were out of the market.

Now going into Q1, we're feeling more comfortable with where our Q1 is, the results we're seeing in the marketplace. And we think that we can buy into the market on share repurchases at 2x to 3x that level, and feel comfortable with it.

Operator

All right. We can go ahead and take our next question from Andrew Carter with Stifel.

William Andrew Carter

Stifel, Nicolaus & Company, Incorporated, Research Division

I just -- I guess I wanted to ask, given that the midpoint of your guidance next year suggests, the gross margin will be down 430 basis points where it peaked actually earlier this fiscal year, trailing 12. So could you help us understand how the GM will face for the year as pricing absorbs inflation?

That comment around pricing above inflation. Was that a full year comment or was that expected to happen at some point?

And final comment, just so we can get a sense of the ongoing degradation potential for mix. Where does Hawthorne's margin stand today? And where do the own brands stand? What's your penetration?

James S. Hagedorn*CEO & Chairman of the Board*

Look, I want to start because, thank you for asking that series of questions. I was in [fitness] this morning with Ivan and I've said, I'm in a disavow the budget, or at least the expectations we're setting. I do want everybody to understand, how and why, we sort of talk to you the way we have today. And I think then it probably is useful. Setting the budget for this coming year was - I think Cory would say we are looking at sort of neutral operating '22 versus '21. I would say we looked at -- and they're both true. We looked at sort of what the street was throwing out there is a number for expectations for Scotts for next year or the year we're in.

And we built a number that -- I don't know, call it was a quarter above what we are seeing as sort of consensus felt, that was a pretty good place to start. To be honest, it's a pretty negative number for us. And based on that, we then started building an operating budget off of that, that said, if it's that bad, and I don't expect it to be.

This is the point, I'm trying to get across, is can we still -- can we build a budget that meets that number sort of your consensus plus, call it, a quarter. And still fund the things we want to fund and be responsible about how we run our business. And I think this is Cory's input to his first budget cycle with us in this role.

I really look to Mike to say, is just killing you because I view budgeting as a pretty corrosive process actually. I really don't like it that much. I know it's necessary but it's pretty corrosive particularly when you make inputs like that. And Mike was okay with it because I think it sort of forced this issue of saying, are we spending the money on the things we think are going to drive the business? And can we lighten up on some of the other stuff, and still make the numbers work, if the numbers are as bad as we're building the numbers from. And we came out with, I think, an agreement on that. And this is what we're reflecting in how we talk to you guys. But my numbers, and Mike numbers, are quite a bit higher than that.

And therefore, I just want everybody to kind of -- every time I say stuff like this, people freak out, everybody gets the joke that -- we -- this was a budgeting exercise. We're setting expectations, based on partly where you guys were, partly based on this view of quarries of, can we at least make the same operating numbers as we did last year. And how then does it fit in with, how Jim wants to manage the investment community. And as we get into the year, not get ahead of ourselves, but start to become more transparency on the upside.

Hopefully, that's there. And that's how we kind of got to these numbers. So I do think when you ask the questions, try to understand that it's not like we're absolutely committed to these numbers. What we're committed to is a budgeting process, that allows Cory to feel good, that he's not overextended on the expense side, and that Mike feels, that he's spending the money on the things he wants to, and we're not overpromising to you guys. And this is all part of the how we do it here.

This year, I briefly had a Board meeting yesterday to go over this stuff. And I wanted to kill myself during the meeting, based on what we were telling them, which is kind of what we're telling you guys. And it made me feel bad about the business, but the truth is I feel really good about the business. And Mike and I are committed to a lot higher numbers. And so I think when you ask the questions, try to at least look through at that sort of filter.

And Cory, so I'll hand it to you to answer the real questions.

Cory T. Miller*Executive VP & CFO*

Yes. I'd say the 2 things you've brought up. Total company margin rate, we guided to a decline of 100 to 150 basis points. If you look at the components that make that up, segment mix, as Hawthorne grows faster than the U.S. consumer business, we're going to naturally have an enterprise-wide decline in our margin rate, just because of the margin rate of those 2 businesses.

So that's going to be about half. And if the units come in where we planned, which is the decline, we're going to see some deleverage that will hurt our margin rate. And like Jim said, we're all expecting units

to come in better than that. But given the plan that we put in place, the deleverage could happen, should units come in lower. And I'd say, your point on pricing versus cost, they basically offset each other.

So if you look at the margin rate, pricing and costs offset each other, we do have some buying left to be done in the rest of next year. We're kind of 1/3 exposed, if you think of where we'll be locked at the end of the calendar year. So there is risk out there, or opportunity depending on what happens in the marketplace, for cost to change where they're at in our model today.

And last point, on the Hawthorne' EBITDA, you asked about where the Hawthorne profitability is. We're planning on about 500 -- I'm sorry, 50 basis point improvement year-over-year. So this is on the path that we've been on, trying to get to a total earnings percent of 15%, and we continue down that path. We saw good improvement in '21 and expect about 50 basis points in '22.

William Andrew Carter

Stifel, Nicolaus & Company, Incorporated, Research Division

Great. And this might be a difficult question to answer, but you've cited kind of the pull forward of the crop in the outdoor season in California, which I guess the potential upside of that is that the our crop [October] is overly bad.

So could you kind of quantify for us then, like maybe how the earlier pool, like not selling to growers in August, September, may have hit numbers, whatever product lines that might have affected nutrients.

Just so we can kind of think of a back half headwind that hit this year and potentially comes back next year?

Christopher J. Hagedorn

Division President

Yes, sure. I mean, look, you already said it. The this slowdown has affected our consumables business, significantly more than it affected our hardware business.

So nutrients, growing media, some other categories, we've seen much more downward pressure, which to me says that the operational guys are kind of slowing things down, waiting for product to sell through, and not waste a ton of time, pumping more product into a market, they know isn't really moving right now.

On the other hand, the kind of high-ticket hardware sales we're seeing. So this is lighting, dehumidification, water filtration, et cetera. So kind of infrastructure stuff, we're still seeing a really good uptake in the market on those products.

And again, it's in some cases, outstripping our ability to meet the demand just with some supply chain disruptions we're seeing, particularly on lighting. So we think that's all going to shake out. We're still seeing, again, new facilities get built, as what that tells us, and those facilities will come online. And when they do, they'll be buying our nutrients or growing media, which are all products we were seeing exceptional growth in leading up to figure in June, July.

So the back half of the year, we're really, it's kind of stacked with a lot of nutrient, a lot of growing media sales. But when we dropped innovation on kind of the hardware or infrastructure side, it's sold. I sort of beat my chest last year about the new Gavita LED light, that at the time was our first generation LED light. That set a record within Scotts Miracle-Gro for the single largest -- from a dollar perspective, the single largest product launch in company history. We beat that record this year with our new LED light.

We're selling more dehumidifiers from our partners at [Quest] than we ever had before, including some really exciting, very expensive, a kind of high-tech units, that cover a broad array of HVAC stuff for the grower. So we're seeing those products continue to sell. We're not seeing a lot of slowdown there. We're just waiting for the consumables side of the business to catch back up.

Operator

Okay. We'll go ahead and take our next question from Joe Altobello with Raymond James.

Joseph Nicholas Altobello

Raymond James & Associates, Inc., Research Division

So Chris, I just want to follow up on that last comment regarding California. -- how quickly can [indiscernible] growers ramp up their operations once pricing starts to improve?

Christopher J. Hagedorn

Division President

Pretty rapidly. Look, it depends on what stage of build out they're at, obviously, we've gotten pretty good intel that there are -- there's a number of largely built out grows in California that are available right now to -- for a potential acquisition.

So we know that there's some growth that are sitting there kind of half built or mostly built that their grow just aren't finishing until the market recovers.

So we expect to see a pretty rapid recovery once the market prices, a kind of encourage growers to get back into it. So again, these facilities that are largely done. It should be, I would say, certainly less than 6 months from when demand recovers until those guys can be operational at full steam. And I think, frankly, shorter than that.

James S. Hagedorn

CEO & Chairman of the Board

I mean, isn't it true also that in the legacy market or whatever you call it traditional markets, this is kind of like a gypsy business, where people can get in and out very quickly.

Christopher J. Hagedorn

Division President

Yes. Yes, that's always been the case. So this is for the -- and look, to the extent that we have visibility to the legal status of the people consuming our products, we sell ourselves to retail, and where it goes from there, is somewhat anyone's guess. But we are aware that there's a lot of black market growers out there, what we call legacy market growers.

Those folks will shut down for a quarter just because it's 4 lights in their garage, or 6 lights in the basement. And it's kind of a supplemental income for them. If they're not seeing the rewards for their activities that offset the risk they're taking, they'll shut down and wait that market to recover. And all that gears sitting there waiting to get switched back on.

So that recovery right there is pretty much instantaneous. And like I've said, we think our expectation is, wholesale prices will start to recover within the first couple of months of the new calendar year. And at that point, we expect to see market recovery to follow.

Joseph Nicholas Altobello

Raymond James & Associates, Inc., Research Division

Okay. Helpful. And then just 1 more for Cory. What's the anticipated incremental commodity and logistics headwinds in '22 in dollars? And it sounds like, correct me if I'm wrong, that the price increases, the high single-digit price increases, call it, not only offset that dollar for dollar, but you're maintaining your margins in both businesses as well.

Cory T. Miller

Executive VP & CFO

Yes. If we look at the rates that we're putting into the plan, for each of the segments. Segments are basically maintaining margin at the plan that we have built in now. If I think of headwind that we've experienced so far a kind of \$85 million, that we saw in '21, on that number will get annualized, as we go into seeing those higher rates on those commodities, for the entirety of '22 or at least the entirety of our purchasing cycle.

So headwind there. The pricing that we're taking, though, should negate that, and we should be kind of margin neutral as it comes to commodities.

Operator

We'll take our next question from Eric Bosshard with Cleveland Research.

Eric Bosshard

Cleveland Research Company

Trying to understand the importance of pricing on the Hawthorne business, and I'm talking about end product pricing. And I thought, Chris, your comment was interesting that your exposure is to the high end. And then I'm trying to square that with your -- if your exposure is at the high end, but your business is softer now, and it seems like the business softer now is not the high end.

So what I'm trying to make sense of is when cannabis prices go down is that bad for you? Does it matter for you? Is that changing? Can you just help explain that?

James S. Hagedorn

CEO & Chairman of the Board

Yes. Look, our focus is on the high end, but we've got pretty broader exposure here. And some of our really high-volume products are used across a kind of the quality spectrum. I'm talking things like our growing media products, it;s grow down that sort of thing. Growers of every different kind of quality level, and station in the market use those products. And look, wholesale prices absolutely, wholesale end product prices absolutely mattered to us. And that was something when we did a postmortem of what happened back in 2018, in an effort to just have a little bit more predictability because we knew that it would happen again in some form or fashion, and here we are.

1 of our -- 1 of the kind of leading indicators that we really zeroed in on was that wholesale cannabis price, both in the illicit and legacy markets. And we think we've got pretty good feelers out into both those areas to get to 0 in on what we think are, are pretty accurate prices. Look, the high-end guys are pretty insulated from the downward pressure, but they're not insulated 100%.

So when you've seen price per pound of outdoor flower hit all-time lows, and I'm talking well below \$500 a pound at wholesale for outdoor flower, the high-end indoor guys, they have seen some price depression as well. It's just not been nearly to the same extent. So if someone in the indoor market could have sold a pound of flower for \$4,000 a year ago, they may be down to \$3,200 or \$3,000 now. So they've still seen a significant downward pressure on their price. It's just -- again, it's been really well insulated relative to the outdoor guys.

Now again, so we do see some impact from those guys. But again, we sell plenty of product at the outdoor into the sort of light dep greenhouse does as well. It's just not the focus of the core of our product line.

Eric Bosshard

Cleveland Research Company

And then in terms of your assumption of where the business goes, like does the business work the way you want it to work, with pricing where it is now? Or do you need pricing to get back or halfway back to where it was?

Christopher J. Hagedorn

Division President

I think, look, obviously, wholesale prices recovering is going to be beneficial to our business. Growers will have more cash in their pockets, and they'll have more cash to go out and spend with our retailers. So we're looking forward to recovery. That being said, look, ultimately, we're talking long, long, long term and very speculative. I think most people who look at the industry expect ultimately, there will be sort of longer term and longer lasting downward pressure on cannabis prices.

And part of this is the responsibility of the cannabis industry as a whole, and something that we're more excited to hopefully have some influence over, once we really get the Apollo, the Hawthorne Collective strategy off the ground is preventing the commoditization of this product.

We've had 1 million questions from our board, and from investors, and other people to say, what's going to stop this from [being tomatoes or lettuce] -- now number 1, I think you guys have been talking not -- I shouldn't say you guys specifically, but people have been talking about how this [indiscernible] can go outdoor, and the margins, and the prices are going to get crushed, and that just hasn't happened. Now -- and we don't expect it to happen. We have long been advocates for it is going to stay largely indoor and greenhouse. It's just -- it's much more control, we can create a much better product for the consumer, for the patient.

We expect that trend to continue, and we've spoken to a lot of people who are, I think is informed, and intelligent, in this space as anybody. People who've been operating both in the illicit and licit markets for decades who believe that outdoor does not have a longstanding place in this. We've got products that are solving sustainability issues around indoor growing right now. And again, you can be so much more precise with how you control that environment.

Getting back to your question, now look, we want to see prices recover. We have a -- business that's built, and can survive, if prices do not recover all the way, but we don't expect that to be the case.

Eric Bosshard

Cleveland Research Company

Okay. And then a follow-up for Jim, you've made a comment that I know you didn't commit to, but of game-changing opportunities that the company could double in size in the next 5 years.

Is this collective Apollo? Is this the path that you're speaking to accomplish those?

James S. Hagedorn

CEO & Chairman of the Board

No. Yes, yes and no. It's the 5 pillars that do it. I think you're -- like I said, we believe that there's more growth in the consumer business, our legacy consumer business. Obviously, we believe that there's faster growth on direct-to-consumer.

Live goods, we think, is actually a big piece of that. Hawthorne, we continue to see in the hydro supply space, above average returns for us there. And then you add on top of that, the Apollo side, and I think you can pretty easily get to those numbers. I mean, a lot of stuff has to happen correctly. But I think the answer is it's all of them.

James D. King

Chief Communications Officer, Executive VP and Senior VP of Investor Relations & Corporate Affairs

Management, if I can just interject here for a second. We're going to just -- in the interest of time, we'll just take 1 more question here and then we'll wrap it up.

Operator

Okay. We'll go ahead and take our last question from Jeff Zekauskas with JPMorgan.

Jeffrey John Zekauskas

JPMorgan Chase & Co, Research Division

Thanks for squeezing me in. When you read some of the press accounts in California, it claims that the California market is about 2 million pounds, and there is 6 million pounds of capacity. That is it's 2x to 3x oversupplied. Is that a fair characterization?

And then secondly, the raw material costs continue to rise. That is, do you expect them to be higher in the December quarter and then higher in the first quarter of next year?

And how do you manage that conversation with your customers, if that is the case that you've got rising raw materials into next year?

Christopher J. Hagedorn

Division President

So I'll take the first half of that. This is Chris. Yes, I don't think, I think saying the California capacity is 3x what they're selling domestically in that state. That doesn't sound like a crazy claim to me at all. Because California has long been -- you talked about sort of the breadbasket of America, they have been in the cannabis breadbasket of America for the past 30 years.

So all the illicit market, or the legacy market that continues to exist, a huge portion of that is served by legacy growers in California. So it's a little bit of the weird dynamics to get in a market that has -- the legal market is bound by a provision on interstate commerce, the legacy market, obviously, is not bound by those things.

So you end up with potentially weird-looking dynamics, unless you just look really just 1 layer beneath the surface, which is California supplies, a huge lion's share of the black market cannabis for the country. And so you got to factor that in.

Now look, it something we expect to change over the next few years as East Coast markets get their own legal domestic supply. We expect that the market will balance a little bit more between the East and West Coast, but that has not happened yet.

Jeffrey John Zekauskas

JPMorgan Chase & Co, Research Division

Okay. And if it's our commodities, I'd say most of our commodities are at multiyear highs, oil, natural gas, multiyear highs. Plastic, we're seeing slowing down a little bit. So that's starting to pause. Urea is kind of at a 9-year high. So if it's going up, we don't feel like it can go up a lot more before it flattens out or at least comes down a little bit. And so we're looking at cost to kind of flatten to come down a little bit in our plan.

Certainly, there's risk to that. And if costs continues to go up, we'll have to look at other actions to try to offset that. But if you look at what the customers would be saying, I think they're seeing it across every category different than what we've seen. Historically, when a cost goes up on a certain commodity, the customers are seeing cost increases across all items in their store, which the consumer is going to have to bear that. The whole entire market is going to have to figure that out. But we are not at a disadvantage to the market.

James S. Hagedorn

CEO & Chairman of the Board

I just want to throw out that in the cost of goods part relative to Hawthorne, if that was worth focused on sort of pricing. I think we're dealing with -- this is really business-to-business, sales to professionals who, I think, understand, sort of what's happening in the global supply chain, and that a lot of our products, particularly sort of the hard side are more expensive, but there is a lot of benefit to having them, and it represents the ability to make more money for them. And these people, to the extent that I do know them, it's a very exciting place to meet these generally young people, with good businesses, that are making good money.

And I don't think they look at our products as sort of the back breaker. I do think on the consumer side, and we've talked about this a couple of times, I don't think, we know how the American consumer is going to respond to the cost pressures on pretty much everything that they buy.

I personally think it's not healthy. I've said that before, and that I don't know. I hope there's a lesson than what occurred in Virginia, and in other states, is that I think getting inflation under control, and getting the supply chain of America fixed is really important, because eventually, it's going to lead to, I think, issues with consumers' ability to buy stuff.

Now if we want to talk positively about that, this made our first rodeo, okay? And when the economy gets too hard, people still want to buy, have a nice house, and protect the value of their house, and they garden, when they can't do other things, we are highly resistant to recession, and therefore, I don't feel scared about it.

I do think that on the consumer side, nobody knows what's going to happen to consumer demand, in an environment where you're looking at basically double-digit inflation. And I don't think that's an exaggeration.

I was down in D.C. a couple of weeks ago, and every senator I spoke to, numerous senators said, do you think it's transitory. And I've said, no, and I think it's accelerating. And so I don't think we know -- I think on the Hawthorne side, they are professionals, it doesn't represent that huge amount of their cost of goods.

On the consumer side, it's a more worrying thing for America. And I think we're in a good position relative to it. But again, I don't think anybody knows. I think everyone should be concerned.

Operator

All right. Mr. King, I would like to turn the conference back to you for any additional closing remarks.

James D. King

Chief Communications Officer, Executive VP and Senior VP of Investor Relations & Corporate Affairs

Thanks, Madison. Thanks, everybody, for joining us this morning. I know there were a couple of folks in the queue that we weren't able to get to just because of time constraints on our side.

So feel free to give me a call any time over the next handful of days, including today. (937) 578-5622. And for everybody's planning purposes, we are currently, tentatively holding February 2, for our Q1 earnings results and conference call. So we will talk to you then.

James S. Hagedorn

CEO & Chairman of the Board

Hold on before everybody jumps. I do want to throw out there something I offered to King. I'm sure I'll regret this.

I think for people, particularly, who are interested in the Hawthorne business, we are doing some really good work. And I've encouraged Jim to find a way for the investment community, to actually get a look at what we're up to, because I think you'd be impressed. And I think it's important to your understanding of our business that we find some ways to showcase a kind of what we're up to so that it's not just a few minutes on the call, it's the real ability to say, I think they're actually changing the game.

So I'd encourage you to ask for it, and Jim to do it.

Unknown Executive

All right, everybody. With that, I look forward to your request. And we'll talk to you again on February 2. Thanks, everybody. Have a great day.

Operator

This concludes today's call. Thank you all for your participation. You may now disconnect.

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