

# The Scotts Miracle-Gro Company

## NYSE:SMG

### FQ4 2019 Earnings Call Transcripts

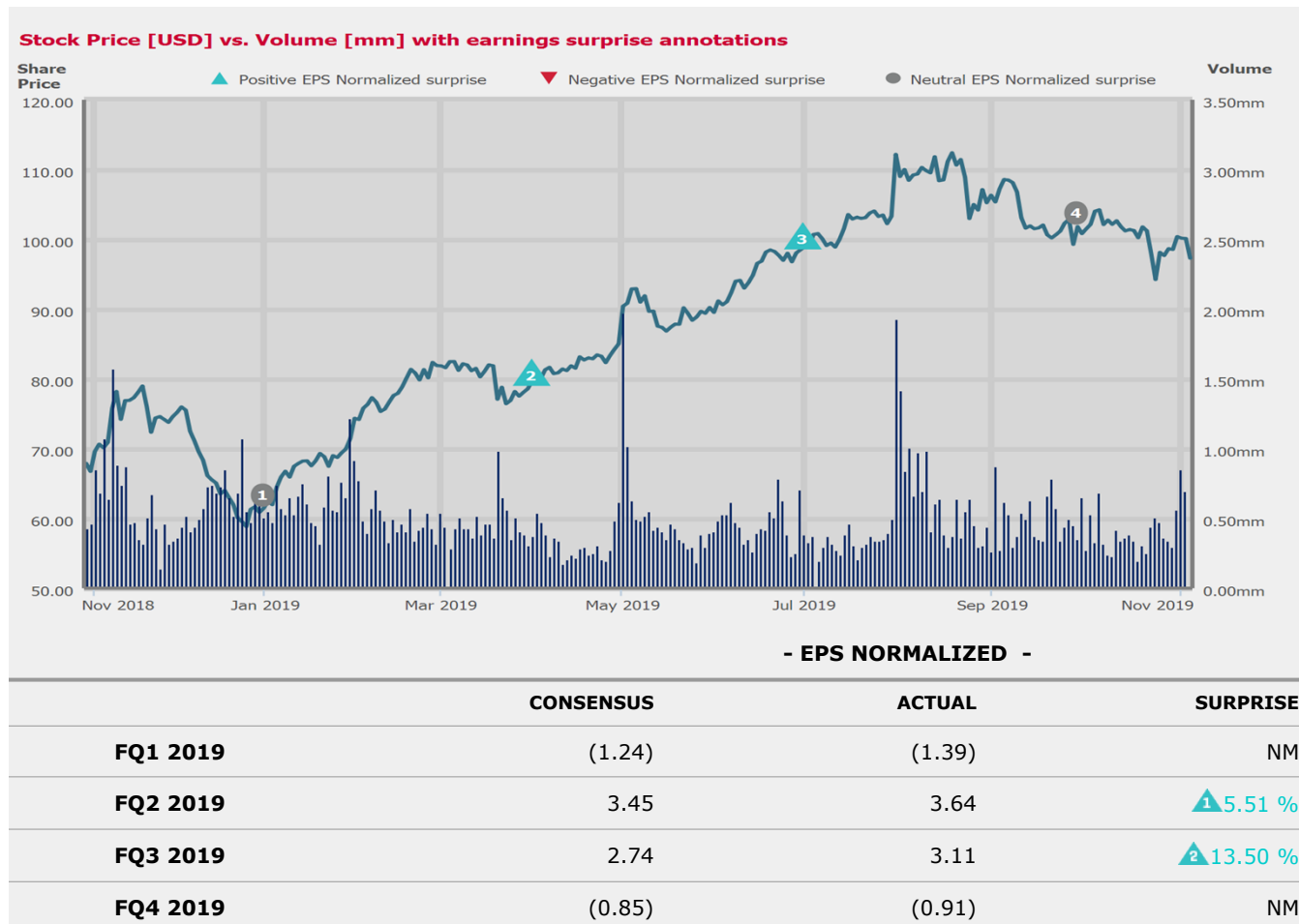
Wednesday, November 06, 2019 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2019-			-FQ1 2020-	-FY 2019-			-FY 2020-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS
<b>EPS Normalized</b>	(0.85)	(0.91)	NM	(1.19)	4.51	4.47	▼ (0.89 %)	5.01
<b>Revenue (mm)</b>	451.49	497.70	▲ 10.24	319.34	3110.01	3156.00	▲ 1.48	3208.17

Currency: USD

Consensus as of Nov-06-2019 1:36 PM GMT



# Table of Contents

Call Participants	.....	3
Presentation	.....	4
Question and Answer	.....	12

# Call Participants

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*Chairman & CEO*

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# Presentation

## Operator

Good day, and welcome to the 2019 Fourth quarter Earnings Conference Call. At this time, I would like to turn the conference over to Jim King. Please go ahead, sir.

## Jim King

Thank you, Anita. Good morning, everyone, and welcome to Scotts Miracle-Gro Fourth Quarter Conference Call. With me here this morning in Marysville, Ohio, is our Chairman and CEO, Jim Hagedorn; and our CFO, Randy Coleman. Also present is Mike Lukemire, our President and Chief Operating Officer; Chris Hagedorn, the General Manager of our Hawthorne Gardening Subsidiary and other members of the management team.

In a moment, Jim and Randy will share some brief prepared remarks regarding our 2019 performance and our 2020 outlook. Afterwards, we'll open the call for your questions. [Operator Instructions]

I've already scheduled time with many of you after the call to fill in the gaps. Anyone else who wants to set up some Q&A time, please call me directly at (937) 578-5622, and we'll work to set up some time as quickly as we can.

Before we move on, I'd like to take care of a bit of housekeeping. Randy and I will be in New York on December 3, participating in the Morgan Stanley Consumer and Retail Conference which will be held at the Crowne Plaza at Time Square. The two of us will participate in one of the conferences, so-called fireside chats at 10 AM, followed by a 30-minute breakout session and a series of one-on-one meetings. I would not anticipate to issue any new information at this event, but instead to provide color and insight into our long-term strategy and the issues that informed our outlook for fiscal 2020.

With that, let's move on to today's call. As always, we expect to make forward-looking statements this morning, so I want to caution you that our actual results could differ materially from what we say. Investors should familiarize themselves, the full range of risk factors that could impact our results and those are listed in our Form 10-K, which is filed with the Securities and Exchange Commission.

I also want to remind everyone that today's call is being recorded. An archived version of the call and transcript will be available on our website. So let's get started and to do so, I will turn the call over to Jim Hagedorn.

## **James S. Hagedorn** *Chairman & CEO*

Thanks, Jim. Good morning, everyone. When we first outlined our plans for 2019 on this call a year ago, I emphasize 2 points. First, I discussed the fact that we had just completed an extensive review of our strategy after a disappointing performance in 2018. The review of our strategy reinforce for us that we've made the right choices, and we were on the right path. I told you we would not deviate from the play we were running, that conclusion led to my second point. That our success in 2019 would be deterred by a single word, execution. So it's with good reason that we're pleased with the fourth quarter and full year results we announced this morning. The performance of the business in the quarter and throughout the year, met or exceeded our plans on nearly every front. And indeed, it was a year of exceptional execution by our associates across all parts of the business.

The growth in the U.S. Consumer segment, up 8% on a full year basis was the strongest growth we've seen this decade. Meanwhile, Hawthorne got back on track. Momentum built in every quarter throughout the year, and we finished up 24% on an apples-to-apples basis for the year, including 38% in the fourth quarter. During 2019, we also completed the reconfiguration of our portfolio with the divestiture of our 30% stake in TruGreen. This transaction essentially resulted in us receiving 13x earnings for the sale of Scotts LawnService. We made some other tweaks, too. We sold our interest in an industrial weed control

business to buyer for \$35 million and also sold back to them our Roundup brand extension rights for \$112 million.

Those transactions plus another year of solid cash flow is allowing us to accelerate the repayment of debt. I want to add that our cumulative free cash flow is now just shy of \$1 billion since we tied compensation to the goals outlined in Project Focus, and we expect the cash flow story to continue to be a good one in 2020. All of this gives us confidence that we'll have the flexibility to begin returning a higher level of cash to shareholders within the next several months.

Individually, the storylines I've outlined are good data points and speak to the progress we're making. Taken collectively, however, they demonstrate the focus and executional excellence of our team, the soundness of our strategy and our commitment to driving shareholder value. All of us here are feeling extremely positive these days, and I believe, with good reason. In fact, as I approach the 20-year mark as CEO, I can think a few times where I felt better about this business.

I want to spend a few minutes this morning giving you an overview of our 2019 performance and setting the stage for 2020. I'm going to let Randy cover the numbers and speak to the specifics of our guidance. Let's start with the U.S. Consumer business, which had a great year. For the first time since 2015, we saw growth in each of our major retail partners, and we believe all of them are well positioned to continue driving the lawn and garden category. Our partnership with them improved tremendously in 2019.

We work together to drive their respective businesses. We communicated frequently with them throughout the season in order to exploit the opportunities that presented themselves and manage through some challenging issues, especially those we believe could impact the consumer roundup business in 2019.

We were more flexible with our retail partners on promotional opportunities the peak of the season. We were more willing to experiment with new ideas. We were more inventive with our social media efforts. In each of these instances, where we were able to zero in on precise markets, individual products and certain consumer product consumer groups in ways that we had not done in the past.

Said differently, we demonstrated a level of leadership and collaboration that no one in our industry could match, and it benefited both us and our retail partners throughout the year. The result? Consumer purchases of our products at our largest 4 retailers, which represent about 80% of the U.S. consumer business, were up more than 4% for the year. And it wasn't a great weather year either. Still, we saw growth in every part of the country, except Texas, which was hit hard by wet weather for most of the spring lawn and garden season.

After a slow start to the season in the Northeast, POS in the region was up 6.5%. The South was up 1.5%, and both the Midwest and the West grew by 4%. Innovation was a great story throughout 2019. Products introduced in the 3 years accounted for 15% of our full year sales and a slightly higher percentage of our gross profit.

Performance Organics delivered almost \$40 million in the first year of sales, and it helped drive a 6% improvement in the consumer purchases of our branded soils. Performance Organics has us well positioned to meet a growing consumer demand and is a crucial piece of innovation for us. For the first time, we have an organic product that works just as well as the conventional products. We recognized, however, that in the short term we're competing against ourselves to a certain degree.

When retailers promote 5 bags of Miracle-Gro soil for \$10, it can be hard for consumers to justify paying nearly half that amount for a single bag of Performance Organics, but that's okay. That will change over time because there are already significant consumer demands for this product, and is only going to get bigger as time goes on.

Another big innovation success in 2019 was the second year of our 3-in-1 lawn care products. Our lawn fertilizer business grew by 3% on the year, the highest growth rate we've seen for years, driven primarily by our Triple Action North and Triple Action South products. And grass seed purchases jumped 14%, the second straight year of strong increases, driven by Scott's Thick'R Lawn, a product innovation that contains fertilizer growing media and grass seed. Products like Triple Action and Thick'R speak of how our mindset about innovation has evolved over time.

As we think about competition, I've come to believe the biggest threats are all the other things competing for the consumers' time outside of the lawn and garden. Homeowners want to participate in lawn and garden. We know that. But they also don't want to spend the entire weekend working in the backyard. They prefer to enjoy their backyard with friends and family. That means they need products that are easy to use, easy to understand and deliver great results. Our 3-in-1 products are exactly the kind of time-saving innovation we need to replicate more often going forward.

Another great story in 2019 was the reformulation and relaunch of Ortho GroundClear, which was the primary driver of a 21% increase in consumer purchases of Ortho Weed control products. I've talked in the past about the unprecedented speed in which we brought this product to the market. But the other part of the story worth highlighting is the extent which it shows our industry leadership as a product steward.

We know from our research that consumers often find weed and insect control products confusing. So the one thing we definitely don't want is a conversation with consumers about whether our products are safe when used as directed. That should be a given. When we decided last year to reformulate GroundClear with an active ingredient that is OMRI listed, we successfully changed the dialogue in the nonselective weed control category for both our retail partners and with consumers.

Despite an extremely short time line, we earned incremental support from every major retailer and consumers responded, too. We plan to expand the GroundClear line in 2020, and those new products are being embraced by our retail partners. The path we've taken with Ortho, where we drove the overall category and took market share, clearly has been successful and is a path that, as the agent for Roundup, we recommended to our business partners in St. Louis.

As it relates to Roundup, POS grew 2% for the year, and we're optimistic about 2020 as well. In fact, we expect buyers' own innovation pipeline next year to be focused on expanding the weed control category, and that's the right approach.

Our new product pipeline is the most obvious place for us to be talking about innovation. But we've also taken a much more innovative approach to our marketing efforts. Our digital efforts in social media campaigns were markedly improved in 2019. We use thousands of pieces of creative to target lawn and garden consumers based on their likes, dislikes and overall profile. We were far faster and more flexible than we've ever been, though we all believe we're still just scratching the surface.

As we look at what's happening in other consumer categories, it's clear to see that complacency is an ever-present danger. While we are clearly the market leader in lawn and garden, we can't just show up and keep winning. We have to keep pushing. We have to keep finding new ways. I've challenged our team to be disruptive, and I'm looking forward to seeing the results.

Let me shift to Hawthorne, where the recovery in 2019 gained momentum every quarter. The 38% growth we saw in the fourth quarter was the strongest improvement in any quarter since we entered the category in 2015. While we benefited from easier comps given the challenges of 2018, we're confident that current trends we're seeing will continue into 2020.

Lighting was up 22% in the quarter compared to last year. Our nutrients business grew 45%, and growing media was up 73%. For the year, lighting was up 24%; nutrients, 31%; and growing media, 18%.

Shipments to our top 18 of 20 retail partners grew in double digits for the year, and 8 of them grew by triple digits, including 5 of the top 10. California, our largest market, significantly exceeded expectations and was up 28% for the year. Our second largest market, Michigan, grew by 56%. Even Colorado, the first place in the country where cultivation of adult-use cannabis was authorized at the state level, grew by 21%.

We saw double-digit growth in 10 other states during the year, including Oklahoma, where business went from being virtually 0 a year ago to recording sales approaching \$10 million in 2019.

Our level of promotional activity was pretty consistent through the back half of the year, which not only helped propel our growth rate, but also helped us continue to take market share. It's difficult to get

precise market share data in this industry, but we're confident in our claim that Hawthorne puts significant space between itself and the #2 distribution player in this space over the course of the year.

We're highly confident the momentum we've seen will continue into 2020. We expect a higher growth of rate in the first half compared to the second half simply because the comps will get tougher as the year goes on.

2020 will also be an important year for innovation at Hawthorne. We're close to opening an R&D facility with our partners in British Columbia, which will make us the first company in the world to have a research effort focused on improving products used to grow cannabis indoors.

One of our most critical R&D field stations, which is in Oregon, has been modified so we can grow hemp outdoors and focus on creating products that will aid hemp farmers across the United States. And thanks to the work of our R&D team in both Marysville and Vancouver, Washington, we expect our new Gavita LED lighting products to be key to Hawthorne's growth next year.

So we're definitely seeing tremendous progress at Hawthorne on multiple fronts. The next challenge is getting our bottom line performance back on track with the Sunlight acquisition case. But we also have to strike the right balance between growth and profitability.

Clearly, we're looking to establish our products to professional growers as this market continues to expand. If we need to use promotions to establish the relationship, then we should do it. If we need promotions to further solidify our leadership in the market, then we should do it. We want our shareholders to know that there are higher margins out there for Hawthorne. In fact, we're planning on at least a 200 basis point improvement next year. We did a good job in 2019 wringing cost out, and we'll stay focused on that effort.

Our recent implementation of SAP at Sunlight should help us reduce cost even further. But this is much more than about installing an ERT -- ERP platform. It's about further improving our executional capabilities at Hawthorne and fully integrating the business into Scotts Miracle-Gro. In its early days, Hawthorne operated as more of a stand-alone business. But as it's grown, we're working to make sure it fully benefits from being part of the broader SMG enterprise.

Hawthorne continues to operate in a dynamic and quickly evolving space. The public dialogue continues to make us optimistic that more markets will take shape over the next few years. Even at the federal level, we're seeing progress.

We were pleased to see strong bipartisan support of the Safe Banking Act in the U.S. House of Representatives recently. In fact, we received a lot of media attention for our efforts to help members of the Congress better understand this critical issue. We're optimistic that the Senate Banking Committee will continue to move the bill forward.

Speaking of the public dialogue, let me anticipate one of your questions. Several investors have been asking us about the vaping issue and its potential impact on our business. So far, we've not seen anything. The indication that we're getting from the marketplace is that vaping of cannabis has decreased but has been replaced with other forms of consumption. Even though concerns around vaping have not had an impact on us, we have a small but dedicated team assigned to study this issue, so we can stay fully informed and better understand any potential market implications.

We know the nature of the cannabis and indoor growing market is likely to lead some occasional choppiness in our results. Fiscal 2018 was a perfect example. But when we think about the long-term trajectory, we are definitely bullish about the direction in which we believe this industry and our business is headed.

Before I turn things over to Randy, I want to give a shout out to our associates. I attended our national sales conference 2 weeks ago and was reminded what it makes -- what makes this such a great company. I honestly consider Scotts Miracle-Gro one of the world's premier consumer companies. Yes, there are bigger brands out there, and many of them have consumer awareness levels like ours. But there are a few, if any, who have our market presence.

There are a few that excel in sales and marketing, and R&D and supply chain, even fewer who literally define the category in which they compete. We have all of that, but we have none of it without our people. The results we announced this morning are because of the hard work and dedication of thousands of our associates, and I want to thank them for their efforts and trust that our shareholders feel the same.

I also want to recognize a board -- a member of the Board of Directors, Jim McCann, the Founder and Former CEO of 800-Flowers, who told us last week that he would not stand for reelection in January at the end of his current term. Jim's insights as an entrepreneur, a marketer and digital pioneer made our Board meetings better. We'll miss his counsel, and I want to thank him for his time with us. It's unlikely a new candidate will be named between now and January, but we will throw a wide net to bring in a new member to replace him.

I suspect that we're at the beginning of a multiyear transition on our Board. The average tenure of our directors is 16 years. Our members come from various walks of life and are more engaged than any group of directors I've worked alongside since I've been here. But as Jim's decision reminds us, it's also good to bring fresh thinking to the table from time to time. We're in the midst of an intense talent management and succession planning process within our executive ranks. That same process should apply to how we govern the company as well.

With that, let me turn the call over to Randy, and then I'll join you guys for Q&A.

**Thomas Randal Coleman**  
*Executive VP & CFO*

Thank you, Jim, and good morning, everyone. As you all know by now, our fourth quarter performance exceeded our expectations and outpaced the guidance that we updated on the last call. Before going any further, I want to congratulate my colleagues on the results in 2019 and thank them for their efforts. It was important for us to reestablish our footing after a tough year in 2018 and equally important to reestablish our credibility with our shareholders.

Since I know there's more interest this morning in our 2020 guidance than in the results we just reported, I'm going to largely forgo my normal quarterly run through the P&L. Instead, I want to highlight some things we saw in Q4 and, in some cases, the full year that impact our planning assumptions for 2020. This should provide the proper context to update your own models.

I'm going to start on the top line. [indiscernible] in August, we believe at the time, it was possible to see flat to slightly negative sales in the U.S. consumer business during the fourth quarter. However, our retail partners continue to be aggressive in both our merchandising strategies and inventory management. We saw a nice surge in September, which drove sales higher than we expected, not just for the quarter but for the entire year. As you may recall, we started 2019 assuming only 1% to 2% growth in the U.S. consumer business. We moved that range to 6% to 7% this summer but actually reported 8% growth for the year. This is the strongest growth we've seen in a decade.

But I want to peel back the onion a bit on 2019 because, as you saw in the press release, our 2020 guidance assumes 1% to 3% growth in the U.S. Consumer segment. There are 3 reasons why we expect the growth rates to return to more historic levels.

First, in 2019, we took 300 basis points of pricing. In 2020, pricing will increase about 75 basis points, perhaps more depending on product mix as the season unfolds. Second, retail inventory levels in 2019 increased considerably from 2018. Our assumption for 2020 is that retail inventory, which we believe is now at an appropriate level, will be about flat versus 2019.

Given our assumptions that shipments and POS will stay in sync this year, we do not expect net sales growth from higher retail inventories again in 2020. This also reflects a fourth quarter sales surge discussed earlier. And third, you'll recall in August, we announced the sale of our Roundup brand extension products to Bayer. While we now receive 50% of the profit from these products through our existing commission structure, the product sales are no longer recorded in our P&L, and this represents about a \$25 million to \$30 million year-over-year reduction in net sales.



Even though we expect a lower growth rate next year, the fundamentals of the business remain strong. Innovation will continue to be a major story line, and we expect to see meaningful growth with retailers outside of our big 3 in 2020.

Thinking longer term, beyond next year, we expect evolving demographics to be a tailwind for our consumer business. For example, we expect to benefit from the increase in homeownership among millennials entering the lawn and garden category. In addition, the continued movement of our core consumers into and through the key mid-30s to mid-60 demographic, which has the highest per capita spending. Will be helpful over time.

Also, in a macro sense, while we will not try to predict the timing of the next U.S. recession, we can tell you that our U.S. business has held up strongly during the last 2 recessions, given us confidence that we will perform relatively well when that period begins and then emerge with higher share in an even stronger and more sustainable business in the long run.

In Hawthorne, I'm not going to repeat the comments that Jim has already made about our 2019 results and our strong finish with sales up 38% in Q4. The quarterly result is purely organic as the benefit from the Sunlight acquisition was behind us entering July. Obviously, the recent trends give us great confidence as we enter 2020. But I will still tell you in advance that we are taking a wait-and-see approach regarding our top line guidance for Hawthorne.

We are assuming the pace of the business we've seen in the past 2 quarters continues into the first half of 2020. However, our comps become more challenging once we get to the February, March time frame. For now, it's our working assumption that second half growth for Hawthorne in 2020 will be in the mid- to high single digits, which is consistent with what we've said in the past regarding our long-range planning assumptions for this business. Based on those assumptions, full year sales should be in a range of 12% to 15%. Note that if we hit the high end of that range, our North America Hawthorne business, including Sunlight, will have fully recovered to the apples-to-apples 2017 sales volume before California's adult-use regulatory challenges create an industry downturn.

So the combination of the expected 1% to 3% growth in U.S. consumer and a 12% to 15% growth in Hawthorne, should drive total top line growth of 4% to 6% for the enterprise.

Let's move on. While I'm extremely pleased with our overall performance in 2019, the one area where we fell a bit short was on the gross margin rate, which declined by 70 basis points on an adjusted basis for the full year. We originally expected the rate to be flat to down 50 basis points on the year. As we've discussed in the past, we took a more aggressive promotional approach in Hawthorne this year with goals of accelerating growth and distancing ourselves from the competition. We exceeded expectations on both fronts. So giving up some 2019 margin to accomplish those goals was a trade worth making.

In the U.S. consumer business, we saw higher Q4 expense than we expected from volume-related trade programs as retailers continue their push through the end of the year. Unfavorable product mix from higher malt sales also had an impact versus our original assumptions. As we plan for next year, our current thinking is the gross margin rate will be flat to up 25 basis points on a full year basis. As I said earlier, we've baked in about 75 basis points in pricing to offset pressure from commodities and tariffs, so margins in U.S. consumer should be flat to slightly higher. We'll get some benefit out of Hawthorne, however, as we better leverage our fixed cost, also get the benefit of some additional synergies from continuing integration and our recent Go Live with SAP.

As it relates to our promotional activities, we will be more targeting Hawthorne entering 2020. We'll keep the pressure on key product categories like lighting, where we see continued opportunities for market share improvement. The strategic benefit to being aggressive in lighting is this category helps us establish a foothold with indoor growers. That should help us increase the scope of the relationship with them in growing media, nutrients and other product categories. I'll come back to this in a bit.

I'll be talking about the improved profit outlook for Hawthorne in 2020. You saw in our press release that SG&A on a full year basis was up 11% from 2018. The increase in 2019 was mostly driven by higher

variable short-term compensation, investments in media and marketing expense as well as some of the SG&A acquired from Sunlight Supply in June of 2018.

As we look at 2020, we are assuming SG&A in line with sales growth or maybe a point or so higher. The midpoint of guidance assumes a lower payout of bonuses in 2020. However, the marketing spend will not reverse as this is an area where we'd still like to find the opportunity to spend more, not less, as we look to the future. Strategic investments in 2020 will support our direct-to-consumer efforts in the U.S. and also enhancements to our Hawthorne sales force, innovation capability and marketing efforts.

When we look at next year's operating income, we expect to see modest improvement in the U.S. consumer segment. As it relates to Hawthorne, however, we are targeting improvement in segment income from \$54 million this year to about \$75 million to \$80 million next year. This would get our operating margin to 10% or slightly better.

Jim said earlier, and I agree, that we have to find the right balance here. Clearly, Hawthorne is in a growth industry, and we're working hard to enhance our market position and set this business up for growth well into future years. If we may margin our primary focus, I'm confident we could do much better than 10% or 11%. That gives me confidence that those improved margin rates will come over time. For now, our primary focus and should be growing this business.

If we move below the operating line, you can see in the quarter that our interest expense decreased slightly from last year, a trend that should continue for all of 2020. Interest expense for the year should be \$85 million to \$87 million. We'll see the benefit from lower overall borrowing levels as well as lower interest rates. Most of you probably noticed that we issued \$450 million of bonds a few weeks ago at 4.5%. That issuance replaces bonds that were paying 6%. And that move alone should save us several cents per share. In addition, these new bonds mature in 10 years, providing us with longer and better balanced maturities for our various borrowings.

You might recall that we are scheduled to receive a \$112 million payment from prior -- in January for the sale of the brand extension rights that I mentioned earlier. That should allow our leverage ratio to reach our target of 3.5x at the end of the second quarter, and 3.5x is where our leverage would be right now if the \$112 million were applied today. Instead, our leverage was actually 3.7x at the end of the fourth quarter.

Unless an unexpected acquisition opportunity presents itself, and there's nothing in the pipeline right now, then I would expect us to be proactive in returning cash to shareholders next year. The timing of share repurchase activity may even be accelerated from Q3 to Q2, given our confidence about 2020 cash flow generation and our ability to reduce and then maintain leverage and no higher than our 3.5x target. Accordingly, I expect share count to be slightly higher next year, approaching 57 million shares due to dilution from equity grants and the expected timing of share repurchases.

All this gets us to the adjusted earnings range of \$4.95 to \$5.15 per share that we announced in the press release. The midpoint of that range is 13% higher than 2019, significantly better than our annual long-range goal.

While we don't provide quarterly guidance, I do want to point out a couple of things to help with the phasing in your models. First, we expect our interest expense to be fairly consistent amount across each quarter next year. Second, as mentioned earlier, we have more aggressive growth expectations for Hawthorne in the first half of the year before prior year comps become more challenging. In fact, our fourth quarter momentum in Hawthorne has continued over the initial several weeks of fiscal 2020, and that should contribute to a smaller loss in Q1.

Moving on. As you saw in the press release, cash flow was also a good story for us again in 2019. Recall that we have recorded P&L charges in 2018 associated with legal settlements but the cash flow impact was delayed until mid-2019. Also, we owe taxes related to the divestiture of our 30% stake in TruGreen. If you exclude those onetime cash payments than free cash flow, that is operating cash flow minus CapEx, was \$329 million. This is a great outcome as we've now delivered roughly \$1 billion in free cash flow from 2017 through 2019.

I typically don't speak to specifics around our balance sheet, but I do want to point out a couple of things about September 30. Our inventory is much higher than a year ago as we plan for continued growth in Hawthorne and as we built earlier for distribution gains in U.S. consumer. Our accounts payable are similarly higher as a result.

Also, our CapEx in 2019 was lower than normal due to 2 reasons. First, we better align projects with scheduled plant downtime in the late summer, causing the cash outflow to occur a few weeks after year-end. Second, we reallocated CapEx spending within Hawthorne to our newly constructed Canadian R&D facility in British Columbia. This \$10 million capital outflow was classified in operating rather than investing activities on our cash flow statement due to the structure of our partnership in this facility.

Looking ahead, I would expect free cash flow next year to be approximately \$300 million. Items creating headwinds in 2020 include variable comp and working capital. While the increase in variable comp from this past year at the P&L in 2019, the cash flow impact is recorded in 2020. Also, we would expect working capital to be a net use of cash in 2020 largely due to higher inventory levels at Hawthorne partly offset by lower inventory levels in our U.S. consumer business.

Before taking your questions, I want to reinforce the comments Jim made. I'm extremely bullish on our prospects right now. We have our business back on the right track in 2019, and I have a high degree of confidence in our operating plans and our guidance for next year. As I now enter my 21st year at Scotts Miracle-Gro, I'm as confident in our product and our prospects now as at any time during my tenure here. It's now up to us to execute the plans we put in place. If we do so, I'm confident we'll continue to enhance value for our shareholders.

With that, I'll turn the call back to the operator so we can take your questions. Thanks.

# Question and Answer

## Operator

[Operator Instructions] We'll now take our first question from Jon Anderson with William Blair.

### **Jon Robert Andersen**

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

A couple of things. Jim, you mentioned weather was not very cooperative this year. I was kind of another impression, it was a pretty decent year weather-wise. Could you talk a little bit more about how would you characterize the year and whether it was a help or a hurt, just thinking from a comparative standpoint as we look to next year?

### **James S. Hagedorn**

*Chairman & CEO*

Well, I'd start by look at the ag industry and ask the ag people how easy it was to get anything in the ground, particularly here in the Midwest. Hard. I was doing store visits with some senior management of one of our big retailers in the last week of June, so just before the fourth of July. And the forecast was good, and everybody was pretty stunned and said, this is our first really good weekend, and we put some really cool promotions together that work great around that. But -- so in New York, it was the end of June before we actually started to clear things up. What we're learning is that the business is becoming, I think, and I keep saying this on these year-end calls that at what point do we say maybe the weather really is changing. And I think our partners at IBM, who are the data behind the Weather Channel, I think we're all links to the point whether is changing in what we would have defined kind of this the core of our spring.

So what we're seeing now is that we've got a lot of business that's occurring sort of June, July and beyond, including the fall and that more of our business is happening now in times that we would have said we were on the sort of -- so we have a lower sort of reduction in sales. So kind of a less of a peak, call it, mid-April just a longer business that's happening and I think what we would call end of spring, early summer. I'm sort of looking at the sales guys in the room, and they're nodding. So I don't think there's any doubt that the spring in the Midwest, Northeast was challenging in that time where we would have said, this is where everything should be hitting.

And I want to spend a little time on this just because I asked Mike to sort of -- if he would be willing to talk about this. Part of what we're learning is that a lot of our promotional activities are really focused on these early, what I think people call, Black Friday events, which are unlike sort of Christmas, Black Friday, which is around Thanksgiving where it's kind of 1, call it, week or weekend. Black Friday or kind of a series of events in lawn and garden that take place through the sort of what people traditionally would have called the peak of the season.

And what we're learning is that these weather challenges just mean a lot of our promotional dollars are being spent at times where -- I think I've said to you guys before, you want to know how the business is, look out the window. And so if you look out the window when it's cold and rainy and you're a store operator, I think what you'll see is not that many people in the aisles and especially outside where growing media happens and lawn fertilizer happens.

So part of the visit that I was talking about with one of our big retailers was about saying can we focus our sort of activation around good weather, call it, plus or minus 2 weeks of when we're having a -- what used to be called a Black Friday event. And can we see results when we say we just push a promotion a week or 2 when we know the weather is going to be better, and what we saw is fabulous results. And I think that's part of what you saw, not only throughout the sort of late spring, early summer, but I think it also explains the fall results. The fall results were a much more interesting activation kind of profile for how we're activating consumers and working with our retailers. And I think between us and the retailers and the consumer, we're starting to figure that out. But without a doubt, I would say the spring season using sort of -- it's kind of soft, dude, at least here in Ohio and in the Northeast.

**Jon Robert Andersen***William Blair & Company L.L.C., Research Division*

No, that's helpful. I guess, kind of somewhat related to that, the -- could you talk about the channels. I mean, it was, I guess, last year, the last couple of years, prior to '19, where one of your customers, 1 of the big 3 was -- had deemphasized the category a bit. How -- to what extent has that changed? And do you expect kind of all 3 to be kind of back on board in a big way behind the category? And I think in the prepared comments, someone mentioned expecting good growth outside the big 3. And so I'm just wondering if I heard that right. And if there was some stuff going on beyond the 3 we usually think about that holds promise next year.

**James S. Hagedorn***Chairman & CEO*

Well, I'd start by saying that the accounts that I think at least psychologically drive us around here would be, in no particular order, Depot, Lowe's, Walmart, Ace, Costco, as kind of thought leaders in very important, I think, to lawn and garden. So I -- and the lift would be probably greater than that. These are sort of the big dogs in lawn and garden. And it's not because we say so. It's because that's where consumers shop. And so we focus where kind of there's volume. I would say that this is a year where -- part of my speech to the sales conference, which is kind of a major -- it's not just to the salespeople. There happens to be a lot of corporate people there both in all parts of the business, supply chain, marketing, R&D, et cetera, is that last year, I said, "Look, we have to stop sort of making excuses with retailers." And we've got to figure out like what is going wrong that we kind of have to make excuses that people are either deemphasizing the category, which I think is probably not true, but deemphasizing us if -- I mean, it's something we have to think about a lot.

And so Mike and I made a real effort, together with the sales force, to make sure that we were directly dealing at the most senior levels of our retailers with what we could be doing better. And it really wasn't that hard, okay? It's understanding the differences and how we can be additive. And the thing that you learn, and I kind of learned this right after I got out of the military, was -- it's kind of the rules of life. Act like you care. Don't be an a\*\*\*\*\* -- sorry for the -- but I think if you go down and act like you care, and you don't act like a problem, people respond to that. Especially, one of the things that I learned this year -- and this is really a focus for us right now is that everywhere you go, you realize we are the industry. Where we are not succeeding, it's generally because of us. And what I think you saw this year is us really saying where we aren't succeeding, what are we going to do about it?

And I think I am reasonable going down and visiting with people, but Luke has turned out. Actually, he's a really good sales guy. And so we've made a lot of effort on our relationships, on our products, and this is not dropping our drawers. It's basically like acting like we care. And I think it's really working. And just in regard to sort of is the category important. I think all brick-and-mortar retailers are saying, well, I'm going to throw 2 things in there. One, the demographics for lawn and garden are really interesting. There are a lot of people who are either becoming young homeowners or about to. Everybody thought back in the day that what would happen would be like these young kids would all want to live in the city. That's not what's happening. People want to lawn and garden. So the demographics are good. And if you're a brick-and-mortar retailer and you're competing against digital online retailers, lawn and garden is a battle zone that they can win in, where you're dealing with, I think, tends to be bigger, bulkier products, live goods. Not as obvious for online retailers is, I think, other sort of easier products to manage would be.

So I think they're looking at lawn and garden as a very important place to be different than kind of digital retailers and I think it's working. And I think the demographics are good for us. And I think we are accepting our responsibility to say with stuff that's not working, we'll fix it. And Mike and his team are all about that. So it's really a cool time in the consumer market, and that our innovation pipeline is really rich. And this -- what we're talking about with like our digital, it is hard to basically say, we're -- I mean, TV does work. I can't, like, say, it doesn't work. Obviously, it does. There's a lot of people who watch commercial TV. But more and more, it's how can you create brand awareness and reason to buy online, and there's people figuring it out. They just tend not to be kind of legacy brand people. We are absolutely trying to disrupt the cells in regard to how we market and our use of online digital. I think we made a lot

-- I don't think we figured it out. I think we've made a lot of progress, though, and I think we know where we're going. Randy handling the dough over to help us do it.

And so actually, this is part of like the optimism. You look at everything I'm talking about just now with you, and then you add Hawthorne on top of that and you look at like our cash flow of our business, dude, we are -- I was going to use a bad word. We are on plan, okay? Or better. Okay. So I am really excited. Mike Porter is -- he's actually turning into more like, I think, Chris Hagedorn's like strategic and [indiscernible] than mine. But I was with Mike like 2 weeks ago when I said, "Dude, when strategy meets execution, good things happen." And so that's kind of where we are. It's a good place for us to be.

**Jon Robert Andersen**

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

That's great. That's great. One more -- I'm going to squeeze 1 more in. So I'm thinking on the consumer side of the business, your market shares are strong. Your trade relationships are exceptional. You've taken price in the past like you did this year, 300 bps, and you've seen volumes grow in the face of that. Why not take a little bit more pricing each year, given that it seems like any time you have, you've been able to grow your volumes through it and beneficial for the retailer as well?

**Thomas Randal Coleman**

*Executive VP & CFO*

Jon, why don't I take that one? Jon, I'm a margin [ hawk ] and a pricing [ hawk ]. But I think our plan for 2020 is reasonable. We have a lot of momentum in the category. I think Jim outlined, things are going well. We know we're going to pick up distribution next year across the board, not just the big 3 but beyond that as well. Commodities are softening a bit. So it still be up year-over-year, but we're not going to necessarily try to accrete our gross margin rate next year with pricing, but I do think we're going to see nice growth and I'm comfortable with what we're doing with pricing. We caught about 75 basis points. It could be a bit higher than that opinion on how the mix turns out. But I think that's a reasonable place to be, and we set our long-term plan is to take pricing more often than not 50 to 100 basis points when commodities are up or when commodities are down, and this is a year where we're basically running that place. We took 3% last year and '19, but that was because we didn't take anything the year before that. So I think when you run it across a multiyear period, I'm really comfortable with what we're doing.

**Operator**

And now we take our next question from Chris Carey with Bank of America.

**Christopher Michael Carey**

*BofA Merrill Lynch, Research Division*

So just a couple of specific questions for you. So just on Hawthorne, I'm trying to understand 2 parts here. So I guess on the sales guide, right, still looking for, obviously, strong growth. But I guess, it also implies that you're going to see a step down on a dollar basis from the Q4 level over the course of probably at least the first half of the year, just to get to these numbers, right.

And so maybe I'm scratching my head and just maybe wondering a little bit if this is just conservatism you're seeing something in the business, which would suggest that you're going to see some sort of slowdown in the first few quarters of fiscal '20. At least based on \$1 basis, I get that trend growth is going to be strong. But from a sequential basis, if you even get to 15% organic sales growth, your average quarterly dollar run rate is going to be down from Q4. So just trying to bracket whether there's just a level of conservatism here or whether you're actually seeing something in the business.

**James S. Hagedorn**

*Chairman & CEO*

We are definitely not seeing anything in the business. If I told you what October sales are -- I don't want to even mention it just because it's almost too good, okay? So it is -- it's -- the answer is yes. It's a level of conservatism. If you ask me what did I learn sort of in '18, it's do not overpromise you guys on this business. There's just too much stuff happening in this space, not because I know anything. It's not that

at all. But that if someone asked me, what's the biggest thing you regretted sort of going into '18, it's sort of setting this idea that we can consistently get 15% or more every year. And this is not -- I just -- there's not that many things I regret saying to you guys, that's one of them.

And so for sure, the answer to your question is a simple, yes, it is definitely a level of conservatism, and it's throughout the P&L, just so you know. I think Randy and Mike have done a really good job budgeting. It does not involved a lot of involvement by me, thank goodness. I generally view budgeting as pretty toxic. It's ink on a piece of paper and not reality.

Both on the consumer side and on Hawthorne, I think we have numbers that are achievable or more. But I think as we go through the year, promising, overpromising this time of year, I think, before we know anything is just a dangerous place for us to be, and we don't need to be there. We are making our objectives. Remember, this big bet thing we're doing. We keep accruing more and more numbers because the results of what we said we're driving this business for which is basically shareholder value, return on our capital, cash flow, we are exceeding those. That's how we're driving our business. Achieves us nothing, I don't think, to overpromise you guys and then be having to explain that 15% is like a [ pity ] result.

I don't -- honestly, I don't get it. But I'm very comfortable with the budgeting process that's happened here, and I do base that on a lot of, I think, the sort of maturity of my leadership team, that it's a not a disruptive process this year, but it's, in part, not an instructive process because we're kind of getting what we want to without having to sort of excessively set expectations internally or externally, on the top line. I don't know, Randy, how you...

**Thomas Randal Coleman**

*Executive VP & CFO*

Well said. I don't think I need to add anything to that, Jim.

**James S. Hagedorn**

*Chairman & CEO*

But the answer is yes, conservative.

**Christopher Michael Carey**

*BofA Merrill Lynch, Research Division*

Okay, Jim. That makes a lot of sense. And then just you had mentioned across the P&L and your response there. And I guess the other dynamic there is if you're looking for about a 10% operating margin. That's basically in line with for Hawthorne. That's basically in line with what you just did, right?

And so -- and I appreciate the comments you just made. So I'm not necessarily interested in as much how you would envision upside to that scenario because it sounds like there's a level of a balanced approach to building that outlook. But I suppose, philosophically, fiscal '19 very much about driving top line, taking back market share. Obviously, taking share against the other large competitor in the space.

And so just philosophically from the dialing down of promotional cadence next year, or do you stay promotionally? You talked about integrating the systems and that driving some cost savings. So do you get cost savings, helping margin, but you stay really aggressive on promotions and maybe that's kind of why you're flat from this level? I suppose, maybe just digging a little bit.

**James S. Hagedorn**

*Chairman & CEO*

No. Again -- this is one where if you want to get Randy kind of spun up, gross margin in Hawthorne will do it. Okay? So...

**Christopher Michael Carey**

*BofA Merrill Lynch, Research Division*

Don't want to do that.

**James S. Hagedorn**

*Chairman & CEO*

No. It's important. I mean, Randy is doing his job. And I think if you look at -- I mentioned the acquisition case for Sunlight, we're short of the acquisition case. And so I have my bosses, the Board, who's pretty interested in how we're doing versus the acquisition case, and I have had in investor conversations that are similar. So moving back toward the acquisition case is going to be driven by a couple of things. I think more discipline on promotional activity, which Hawthorne is bought in on.

The commitment was, which I think was in my script, was 200 basis points plus on gross margin. And I think the operating group is very confident that they can achieve that and continue that into 2021 as well. So a similar kind of increase. And so this is a matter of saying at what point can I get Randy to smile again, if we say there's a multiyear commitment to work back toward over 2 years, call it, like 400 basis points of improvement. And that started to get him less anxious looking.

The work that's happening on the integration of Hawthorne into the SMG business is really impressive, and a lot of good things happening. And we were joking around before the call started that this is a stressful period. The business has been accelerating through the fiscal year and continues to accelerate into the first quarter of 2020. That is putting a lot of pressure on the supply chain and the manufacturing process to deliver on time in full. The kind of things that we -- it's Scott, have always treated or at least in sort of Mike and my time operating the business, have treated extremely seriously, and so that discipline is approaching here. And the entire Scotts Company, which is the really cool thing about who we are, whether it's R&D, supply chain, our knowledge of nutrients and growing media, throw everything out there, who else can do what we're doing, okay?

And so Scott's supply chain is a really -- as you guys know, anybody who's invested in our company knows that we have a very unique and powerful supply chain. That is benefiting Hawthorne right now. And the margin -- look, if I was dumb enough, which I'm not, to ask Mike to tell you right now what he thinks he can do from a margin point of view, with just the efficiency in the supply chain. If you say they're a part Hawthorne, a part of us here at Scotts, it would be a number again that I wouldn't want to tell you because it would be kind of an overpromise. But I don't know, Mike, anything you want to add on that?

**Michael C. Lukemire**

*President & COO*

No, I think we're going to do the right things to win. And then we're going to improve margin through innovation and cost out -- and but we're not going to go backwards on shares.

**James S. Hagedorn**

*Chairman & CEO*

Well, this idea is -- listen, maybe -- I don't know the numbers, and people can correct me on that. We didn't lose share. Dude, we're being at the crap out of people. We are taking share. This is not some defensive reaction. This is offensive attack, to consolidate the marketplace post-Sunlight.

**Thomas Randal Coleman**

*Executive VP & CFO*

Yes. And Chris, because of that, we finished about 8% this year less than we expected, but we're all happy with the result. We took share, we're comfortable with the outcome. We have a lot of confidence that we're going to make it a lot better in 2020. If you look at the reasons why we're sort of business case, half was because of what happened with California that ran across the whole country last year. And we're going to going to pull out of that by the time we get through 2020.

The other half are decisions we've made to be more competitive. And we've done it purposefully and consciously, and we're going to continue that again next year. But when you think beyond '20, if we say 10% operating margin rate. So Jim said, the 2% will fall through from gross margin the operating margin, 10%, a lot of confidence in '20, but we also have confidence we want to get to mid-teens again in just a few years between the innovation we're going to roll out, the continued integration, SAP is going to



support a lot of that the scale just from adding more volume. And then we are going to be more choiceful in how we promote and how we do that. But we're not going to back off at all. We're going to continue to be aggressive. And I think that's the right balance. We're not thinking just in '20 but thinking about '21, '22 and beyond.

**Operator**

And now we'll take our next question from Joe Altobello with Raymond James.

**Joseph Nicholas Altobello**

*Raymond James & Associates, Inc., Research Division*

Great. So I wanted to kind of continue on Chris' line of questioning on Hawthorne for a second. And I know that, first of all, there's not a lot of great data out there. But how fast do you think, given the growth rate that you guys put up in the fourth quarter are putting up now in the first quarter, how fast do you think the market, I guess, is growing for hydroponics?

**Christopher J. Hagedorn**

*GM & Senior VP*

Joe, this is Chris Hagedorn. Like you said, it is difficult to get reliable kind of aggregated data in the marketplace. It's our belief -- I hesitate to say our certainty, but it's our belief that we're outpacing our growth is outpacing that of the overall marketplace. But I think pegging growth right now, somewhere in the mid-teens, maybe 20% growth for the overall category, I think, is a reasonable perspective. If you look at it over the course of '19, again, it's -- we're pretty certain with the perspective we've got talking to our retailers, our customers that we're out ahead of that a bit.

**Joseph Nicholas Altobello**

*Raymond James & Associates, Inc., Research Division*

Okay. That's helpful, Chris. And just a follow-up on that. Looking at the competitive landscape, it seems like it's a different set of competitors between the small, medium-sized grower and maybe the larger growers. So if you guys can maybe characterize what the competitive landscape looks like on the lower end of the market versus the higher end, that would be great. How you see that evolving maybe over the next 12 to 18 months?

**Christopher J. Hagedorn**

*GM & Senior VP*

Sure. Our...

**James S. Hagedorn**

*Chairman & CEO*

Let me just prime the pump, and Chris, you can take it from there. We actually spent a lot of time on this. And this discussion, I think it was 1 or 2 calls ago with Chris about the resurgence of the black market in California. We've talked about that, so that part of the market, which I think is a result of a failure of proper regulatory scheme, and I think lots of states could learn from that, to be honest, is that that part of the market, I think, tends to go more toward what I think we'd call hydroponic retail. What's really interesting is how the hydroponic retailer is evolving to deal with some of the mid- to large-sized customers.

**Christopher J. Hagedorn**

*GM & Senior VP*

Yes. So just to build on that, yes. So we've seen an evolution of our retailers, as Jim mentioned, to much more of a pro service model, which is something we talked about in previous calls about the retailers need to evolve in that direction. And to their credit, some of the more sophisticated retailers have done exactly that. In terms of our competition at a distributor or product level, you're right. In the smaller growers, it's

more of our historical competition, people that we've talked about and people you're aware of that we've competed with.

At the large scale, we are starting to see more movement from what we would consider traditional horticulture and agriculture distributors. So we're looking at that hard understanding how those guys go to market, how they make sales and how they deliver products. So there's a different set of competitors, and we do see more in the future and moving towards that hort and ag distributor model, which will mean different product sets, different margin rates, et cetera. I think it's something we're pretty well prepared to combat and to compete against, but that's the evolution we're seeing is away from the traditional hydro distributors towards hort and ag guys.

**Joseph Nicholas Altobello**

*Raymond James & Associates, Inc., Research Division*

And has that shift accelerated at all?

**Christopher J. Hagedorn**

*GM & Senior VP*

I'd say it's gaining momentum. Certainly, we're seeing more of the horticulture guys picking up product lines that serve this industry. We're hearing about more of them calling on customers that we call on as well. Again, I feel like with our product set and our knowledge of the category and our commitment to the category that we are well equipped to compete, but we are seeing an increased momentum.

**James S. Hagedorn**

*Chairman & CEO*

But Joe, I -- so I would say that the sort of the rapid growth of the hemp market, called the CBD market in the United States, to some extent, driven that because it tends to be an outdoor grown a little bit more of a commodity business. And therefore, I think, ag people are going to look at that. But remember, that is a relatively new market. It's been only a few months where it's been legal in Ohio, hemp-growing. And so I'd say it's a market that's, call it, a year old. That's what I would call it. Just kind of on a national basis, it's legal. There's a lot of work in mentioning the Oregon facility. We are doing some incredible work on the hemp side to make sure that we're not handing business to the sort of corn dude. This is a business we intend to own. And I think we have got more experience and more understanding of that market than any farm boy does, and we intend to compete hard there.

So I think that part of what you're seeing is not so much on the dedicated Canada side, but more on the hemp side. And I think it's a brand-new market, and we're just not going to give anybody any room there. I mean, when it comes to nutrients and like how to grow things, pesticides, nutrients, there's nobody better than us at that.

**Christopher Michael Carey**

*BofA Merrill Lynch, Research Division*

These known with the breadth of offering, especially on manufactured products. So the knowledge of the plant is deeper in our business than anyone we compete against. I'm very confident in saying that. And I think you -- to build on that, the relationships that we've been able to form with what we refer to as MSOs, multi-state operators. These are large commercial growers like acreage holdings out of Massachusetts and countless others throughout the U.S. and Canada. We've been able to build very strong relationships with them. And that, to me, speaks to our ability to continue to be successful in the future. These are guys who are going to continue to be successful across the country, and the more strength we can add to those relationships now, the more service in the future.

**Operator**

And now we'll take our next question from William Reuter with Bank of America.

**William Michael Reuter**

*BofA Merrill Lynch, Research Division*

I just have 2 quick ones. The first, the 2019 price increases, obviously, your input costs, freight, et cetera, had a lot of inflation, taking 75 basis points this year. I would have expected a lot of your input costs might be down next year. Can you talk about your input cost outlook?

**Thomas Randal Coleman**

*Executive VP & CFO*

Sure. So at this point, we'd expect our pricing and our commodity costs, including tariffs to more or less match dollar for dollar. So the tariffs are more biased towards the Hawthorne business. Call it, 2/3 to Hawthorne, about 1/3 of our U.S. business. So it's things you expect, steel and plastic and so on.

For the U.S. consumer business, the method we employ is we hedge diesel, urea and resin, and we're 60%, 65% hedged right now for next year. We always do that to sink up our pricing expectations with our input assumptions. So we have pretty good line of sight to what that's going to look like. And it does look like perhaps there's some softening in the urea market looking forward, but we're about 2/3 hedged at this point. And over time, using that approach has helped us.

When you think about the U.S. commodities and where we are seeing increases, it's not necessarily in one big place. So it's -- it's pallets. It's grass seed. It's peat that we import from Canada. It's packaging, a lot of places like that. So it's not necessarily pointing to urea or diesel or resin, but we're more or less matched dollar-for-dollar at this point.

**William Michael Reuter**

*BofA Merrill Lynch, Research Division*

And then my second question, Jim, in your prepared remarks, you talked about how you might not necessarily be competing against others in lawn and garden but against other activities in general. It sounds like that is a little bit referring to growing the category. And I remember several years ago when you've ramped up advertising to grow the category, I think at least in that instance, it was challenging. How, I guess, are you thinking about the increase in advertising this year and potential risks there?

**James S. Hagedorn**

*Chairman & CEO*

Good, low. I mean, it would be, I guess, how I'd respond. Everybody wants to beat me up for what we did. I think, was that 12 or something? We -- that was it, like, really, I think, sort of the end of the banking crisis and sort of housing crisis.

I wanted to prove that we could take share and grow the market at the same time. What didn't work was just the level of spend was disruptive to the P&L. But we did grow share, and we did grow the market. So it's not that it didn't work. It's just that it was too expensive to be able to sort of on its own, sustain that.

And -- but everybody sort of looks at me when I talk about 12 and say, yes, you screwed it up. Actually, we had like great incentive results that year because the entire incentive plan was saying, can we grow the business, can we take share, and we did. What we didn't figure out is how to do that and not screw the P&L up. What I'm confident in right now is -- and I'll go with is saying, I use the word maturity, call it, the partnership that exists between Randy and Mike on running the business and the operators that that are down below and the attached to finance people that work with the operator community, I think we figured it out. I think part of it is pricing, but I think we are figuring out how to activate because that's what I would call it, build your brands. Well, I think we're figuring out how to activate without screwing up the P&L. If you look at '19, the increase in percent in what we would call traditional marketing, what was it, Randy? It was big.

**Thomas Randal Coleman**

*Executive VP & CFO*

It -- start out seeing 50% more than it being about 35% to 40% more versus 2011.

**James S. Hagedorn**

*Chairman & CEO*

So and we've done that without screwing the P&L up. So I think that, that's -- I'm much more confident that we can do it and that we can make it pay.

**Thomas Randal Coleman**

*Executive VP & CFO*

And Bill, I'd remind you, in 2019, it's not completely obvious because when we look at our P&L. But when we look at the nonselective category, the money we spent there, everything across the other categories as well, we had about 25% to 30% increase in media spend in 2019. So not only do we deliver our bottom line, move it up and hit it again, but we delivered on the cash flow. We invest in the business, better build the moat around our U.S. consumer business, invest in more Hawthorne as well. So this wasn't just a year where that we just delivered earnings, but we significantly strengthened our business. And looking ahead to next year, we expect to spend several million more somewhat on Hawthorne, more on D2C, more on other categories and innovation that we're going to support. So I'm comfortable with the amount we're spending now. We're going to keep spending more.

**James S. Hagedorn**

*Chairman & CEO*

And I want to give credit to my CFO. Because Randy, a couple of years ago, sort of leading into '19, basically said, "Dude, I'm not comfortable with where the marketing support for the business is going isn't our brand." So we sort of need to be reminded by a finance guy that are our brands, what separate us from other people. I think there's a lot more to that of how we operate our ability to partner with our customers. But the bottom line is, he was right. And Mike and I have work to build a plan that Randy is cool with -- but it was Randy who's the one that said, "Dude, I'm not comfortable with declining marketing dollars because otherwise, what do we have?"

**Operator**

[Operator Instructions] And now we'll take our next question from Bill Chappell with SunTrust.

**William Bates Chappell**

*SunTrust Robinson Humphrey, Inc., Research Division*

I will attempt to have 2 short questions. One, on Hawthorne, as you look to next year, kind of what's the state makeup that you expect? I mean, you talked about where the growth came from California, and Michigan and Oklahoma. Do you expect it to be similar? Or are there new states coming on or you slow down in some states? What does the picture look like as you build to that total top line growth?

**Thomas Randal Coleman**

*Executive VP & CFO*

Yes, we're pretty confident in some new states coming on. I think the Northeasters, there's an opportunity. When you look at these states, we don't want to just look at which states will come online, but which states have -- that may come online, have the opportunity to be big markets for us, basically, a lot of people. And we're pretty confident we're going to see some movement in what I would call kind of the quad state area of the Northeast: Pennsylvania, New Jersey, New York, Connecticut. We see some pretty positive things.

To be honest, those are states we've expected, at least some of them, to have moved already, and they've been a little bit slower than we would have hoped. We've got high expectations there. I think there's going to be some significant movement towards a more permissive adult-use market in the southeast as well, particularly Florida. We expect to move to adult use soon, which has the opportunity to be pretty significant.

Our relationship with some of the largest growers down in Florida, this is state published information, is extremely strong. So that's a market we look forward to seeing go in adult use. So again, I'd say we do see some new states that are looking like they're at the tipping point, and these are high-population states that have the opportunity to be extremely significant markets for us.

**William Bates Chappell**

*SunTrust Robinson Humphrey, Inc., Research Division*

Got it. And then, Randy, just a thought on the top line expectations for U.S. consumer. I mean, I think historically, you've kind of felt it was a 0% to 1% growing business. You obviously get about a point on price, so that gets you maybe to the midpoint of the outlook you have. But usually, you're a little more conservative in kind of the start of the year. So I'm just trying to understand, are you seeing kind of what you're talking about, the demographic changes, something that really drives that to where you feel this is still a conservative number? Or has the market really changed that much?

**Thomas Randal Coleman**

*Executive VP & CFO*

I don't think the market has fundamentally changed. What we saw in 2019, we did take more pricing last year than we'll take this year. We also saw a big increase in retail inventories that helped us get to 8% sales growth. We're not going to expect that same kind of inventory growth and expect that to be year-over-year we'll push our sales down 2%, maybe 3% just to better match up POS and shipments. So those numbers should be more or less the same.

But when you look across our business, we're aware of distribution gains that we have year-over-year. We have a lot of confidence in that. And the point about demographics and potential recessions that are looming those are more long-term than things that I necessarily expect to be tailwinds looking just to next year, but it does give you a lot of confidence just thinking be next year and down the road that we have a franchise here that should continue to grow.

**William Bates Chappell**

*SunTrust Robinson Humphrey, Inc., Research Division*

And do you worry about tougher comps on the new product front just because organics was so strong this year?

**Thomas Randal Coleman**

*Executive VP & CFO*

No. In fact, from Performance Organics, which was almost \$40 million of first year sales, we're going to extend that brand with some new SKU offerings next year. So I'd expect that number to be even higher in 2020, continued momentum behind a lot of products Jim talked about with Thick'R Lawn, our Triple Action products and fertilizers, I'd expect GroundClear to drive sales again. So I think continued momentum on all those ideas and just some distribution gains. We feel good about how we're set up for next year.

**Operator**

It appears there are no further questions at this time. Mr. King, I would like to turn the conference back to you for any additional or closing remarks.

**Jim King**

Thank you, Anita. Our next scheduled call with all of you would be to announce our first quarter results, which will happen the last week of January. If you have any follow-up questions from today, again, feel free to call me directly at (937) 578-5622. And recall that Randy and I will be in New York at the Morgan Stanley Conference on December 3. So thanks for joining us today, everybody, and have a great day.

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