

# The Scotts Miracle-Gro Company

## NYSE:SMG

# FQ3 2020 Earnings Call Transcripts

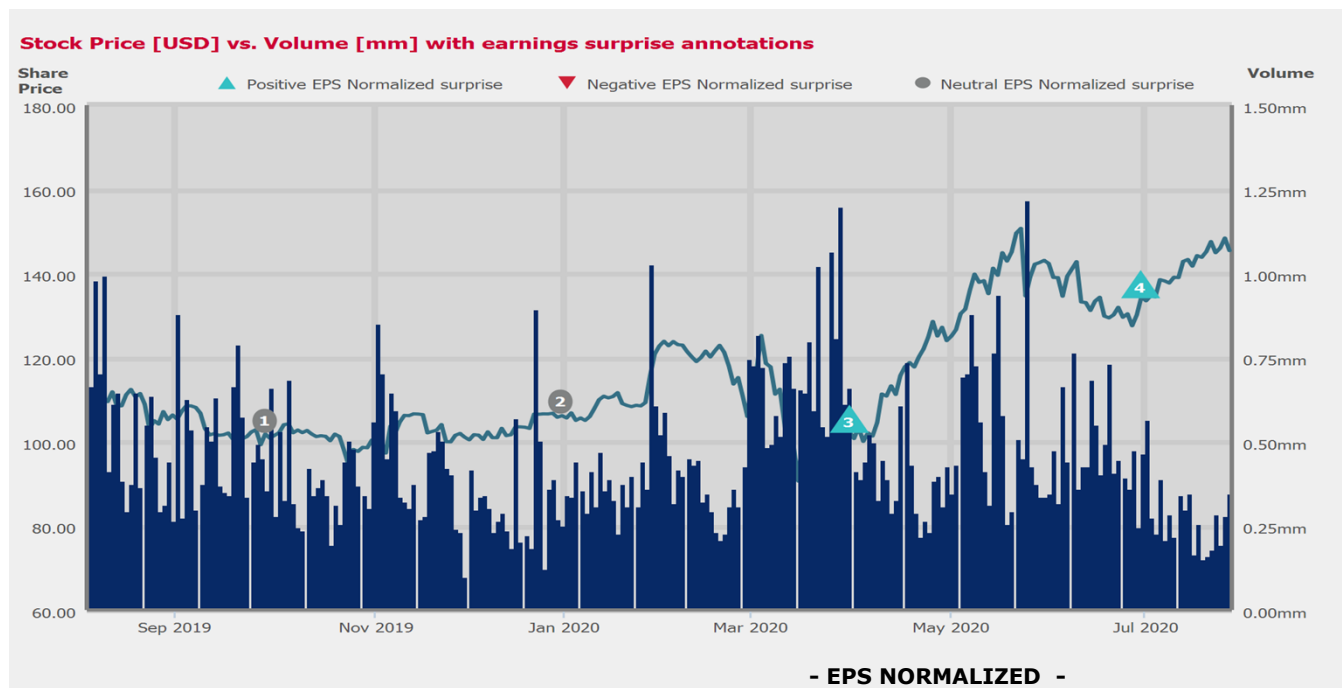
Wednesday, July 29, 2020 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2020-			-FQ4 2020-	-FY 2020-	-FY 2021-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
<b>EPS Normalized</b>	3.42	3.80	▲11.11	(1.03)	5.78	6.29
<b>Revenue (mm)</b>	1326.90	1492.70	▲12.50	628.13	3688.70	3783.66

Currency: USD

Consensus as of Jul-29-2020 1:35 PM GMT



	CONSENSUS	ACTUAL	SURPRISE
<b>FQ4 2019</b>	(0.85)	(0.91)	NM
<b>FQ1 2020</b>	(1.26)	(1.12)	NM
<b>FQ2 2020</b>	4.25	4.50	▲1 5.88 %
<b>FQ3 2020</b>	3.42	3.80	▲2 11.11 %

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# Call Participants

## EXECUTIVES

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**James D. King**

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**Michael C. Lukemire**

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# Presentation

## Operator

This is The Scotts Miracle-Gro Company's third quarter conference call. Today's call is being recorded. Mr. King, you may now begin.

## James D. King

*Chief Communications Officer, Executive VP & President of The Scotts Miracle-Gro Foundation*

Good morning, everyone, and welcome to the Scotts Miracle-Gro third quarter earnings conference call. With me this morning are Jim Hagedorn, our Chairman and CEO; Randy Coleman, our CFO; Mike Lukemire, our President and Chief Operating Officer; as well as Chris Hagedorn, who is General Manager of Hawthorne Gardening Company.

I'm sure you've already seen this morning our press release that includes the details of our record third quarter results, updated guidance for fiscal 2020 and the announcement of additional plans to return cash to shareholders.

In just a few moments, Jim will share some prepared remarks, providing more color on these issues as well as others. Afterward, Randy will drill a little deeper into the numbers and set the table for communicating our year-end results in November, which is also when we will provide guidance for fiscal 2021.

After Randy's remarks, we'll open the call for your questions, and both Mike and Chris will also participate in that session.

Given the amount of content being covered today, we ask that you help us manage through the time by asking only 1 question and 1 follow-up.

If we don't get to everyone in the queue or if you have additional questions we don't cover, please call me directly at (937) 578-5622, and I'm glad to give you as much time as needed.

Obviously, our comments this morning are going to contain forward-looking statements, so I'm compelled to remind everyone that our actual results could differ materially from what we discussed.

A discussion of the risk factors that could impact future results are provided in the press release this morning as well as within our 10-K, which, of course, is filed with the SEC. I want to remind everyone that this morning's call is being recorded.

An archived version of the call will begin available on our Investor Relations website.

With that, let me clear the stage and turn things over to Jim Hagedorn. Jim?

## James S. Hagedorn

*CEO & Chairman of the Board*

Thanks, Jim, and good morning, everyone. In the late 1990s, we created a commercial that was used for our sponsorship of the American Experience on PBS. The ad copy read as follows: at the Scotts Company, we make grass greener, trees taller and flowers more beautiful. If there's a better business to be in, please let us know. As all of us here reflect in what we've seen over the past several months, the question posed in that PBS spot feels more relevant than ever.

What our category does for people's emotional and physical well-being has never been more evident than it has been in 2020.

How our brands and products enhance the lives of consumers has never been more important, and our ability to thrive during times of macroeconomic distress in delivering for all of our stakeholders has never been more obvious.

This is a great business to be in, and all of us are grateful to be a part of it.

The record results we announced this morning are both exciting and humbling.

On a full year basis, we now expect to exceed even our most optimistic expectations. The unprecedented success we're seeing continues in both the U.S. Consumer segment and in Hawthorne.

We're now in positive territory with every product category in both businesses and momentum we've enjoyed does not seem to be slowing down as we enter the final 2 months of our fiscal year.

I want to start by thanking our consumers and cultivators for their support of our brands. I want to thank our retail partners for their support of our category and our business.

And most of all, I want to thank the associates of The Scotts Miracle-Gro Company who delivered these results.

Our success this year has required a level of dedication, creativity and collaboration that's been inspiring to see.

I'm compelled to say that our shareholders, all associates a debt of gratitude, especially those who work on the front lines in our manufacturing and distribution facilities as well as the field sales force.

As the severity of this crisis has ebbed and flowed, these frontline associates have been there every day, demonstrating a level of loyalty and at times even bravery that allowed us to keep up with consumer demand.

In the face of our success this year, perspective matters. We know too many Americans are still unemployed, and it's becoming increasingly apparent the economy has a long road ahead in terms of recovery.

And of course, we know that the families of more than 140,000 Americans continue to grieve for the loss of loved ones.

We also lost a member of The Scotts Miracle-Gro family to the coronavirus just a few weeks ago. He was just 34 years old, and his passing reminded us of the severity of the crisis.

We continue to extend our thoughts and prayers to his fiancée and his family.

As we move on this morning, I want to divide my remaining comments into 4 areas: first, it's important to understand what's driven our results this year. So I'll talk about the successes we've seen in both U.S. Consumer and Hawthorne at a high level, while allowing Randy to focus on the financials; second, I want to talk about where we expect to finish in 2020 and the investments we're making for the balance of the year; third, I want to share some initial thoughts about next year. This is not guidance. It's far too early for us to target specific numbers for either the top or bottom line for 2021. But to some extent, I want this call to provide the road map for what we see in 2021. The obvious question on table this morning is how do we comp this year's results, and we want to address that issue proactively; and fourth, I want to address our current thinking about our balance sheet, uses of cash and elaborate on our other announcement this morning of a special dividend of \$5 per share, which will be paid in September.

That's a lot to cover, so let's dig in and discuss current business trends. I'll start with the U.S. Consumer segment, which reported a sales increase of 21% in the quarter and is now up 15% year-to-date. That year-to-date number is expected to improve further, which is why we raised our guidance again for the U.S. Consumer business to a range of 20% to 22% compared to the previous guidance of 9% to 11% growth.

Entering August, consumer purchases are up 23% on a year-to-date basis at our top 4 retail partners. When you look at consumer activity more closely, we continue to see gardening as the driving force, even though we are weeks past what would normally be the peak of that season.

Consumer purchases of our branded soils are up more than 40% year-to-date, and plant food purchases are up more than 30%. Bonnie Plants in which we have a 25% financial interest has seen an increase in POS of about 50%, as edible gardening continues to swell in popularity.

The success of Bonnie this year increasingly reinforces our long-held interest in this category and our belief that edible gardening is critical to our strategy in the years ahead.

Our controls business continues to see significant increases from last year. Ortho outdoor insect control products has seen more than 60% increase in POS and Ortho indoor insect products are up more than 40%.

Most of these gains have come from increased consumer activity, although we have also benefited from improved listing support.

Ortho weed control products are up about 15%, driven by the continued success of GroundClear, which continues to improve its market share position in the nonselective weed control space.

Roundup, which we represent for Bayer, has seen an 8% increase in POS on a year-over-year basis.

In lawns, grass seed continues its multiyear run with POS up nearly 25%. Consumer purchases of lawn fertilizer are up 9%. Across all retailers, our lawns portfolio recently cleared the \$1 billion milestone for the first time, and that's with 2 months still ahead of us.

In fact, the severity of this summer and its damaging effects on lawns should bode well for our fall grass seed business as well.

Finally, mulch crossed over in a positive territory near the end of June, and POS is now up more than 4% as we enter August.

Recall that mulch was still in deep negative numbers entering Q3 and suffered as retailers canceled Black Friday events and other aggressive promotions that used mulch to drive foot traffic into lawn and garden departments.

While mulch isn't a high-margin business, it's a highly strategic one. Retailers began to aggressively reengage in the mulch category beginning in May. As they did, we joined their efforts. We employ a rightful shot approach to using digital media to drive consumer purchases of mulch in specific markets across the country, which helped clear the inventory from both our distribution points as well as retail stores.

The success of that combined effort, again, showed how this product category can create momentum for the entire lawn and garden space. We've seen strong double-digit improvements in every retail channel.

We continue to see especially strong year-to-date growth in the hardware, club and farm and fleet channels.

Retailers in the home center channel significantly reengaged in May and June as the economy began to reopen across the country, which allowed them to operate with fewer restrictions.

The big picture trends around COVID-19 undoubtedly had a positive impact in our industry and our brands. But it's important to stress that success we had this year didn't just happen.

Our marketing team has done an outstanding job all-season long adjusting our messaging ad campaigns, especially in the digital space.

Early in the season, no one was talking to the consumer, except us. The team didn't just carry the load for the entire industry, but did so with smart, innovative and fast efforts to hit the right note at the right time in the right places.

Our direct-to-consumer business was also significantly impacted. This is both at home delivery and curbside or an in-store pickup.

We've seen more than a 200% increase in volume. Growth, we easily absorbed because of the groundwork laid by the team over the last several years.

Our sales force did more than just work with our retail partners. They stayed engaged during the peak of the crisis, often adjusting their efforts to work in the middle of the night in order to keep our products in stock, while operating in a smart and safe way.

And our supply chain has been exceptional. I'm not saying we were perfect, we weren't, and we often employed a bend-but-don't-break mentality as our teams work 24/7 to keep up with record demand.

At times, service levels fell below our standard. We own that issue, and we're working to fix it. However, this team managed an unprecedented level of volatility in the midst of a pandemic. They didn't just keep product rolling through the system, but did so while establishing social distancing and other safety protocols, including regular shutdowns to accommodate deep cleaning activities in more than 50 locations.

It may be our most remarkable success story of the entire year. Our supply chain wasn't just challenged to keep up with demand in U.S. Consumer, but in Hawthorne as well.

Sales in the quarter for Hawthorne were up more than 70% against a nearly 50% comp from a year ago. And with year-to-date sales growth of 59%, we are moving our sales guidance for Hawthorne higher as well and now expect sales growth of 55% to 60% for the full year.

We saw third quarter growth in every Hawthorne category in nearly every geography. We were up 129% in lighting, driven by our recently introduced Gavita LED products. We were up 45% in nutrients, 62% in growing media and 81% in growing systems.

In our largest and most established market, California, sales in the quarter were up nearly 80%. Meanwhile, in expanding in recently approved markets like Michigan and Oklahoma, we were up 140% and 190%, respectively.

On a year-to-date basis, there was not a single negative market in the entire country. The other important story line here is we're simply running the business better. The shock to the system we experienced in 2018 is a distant memory, but the lessons remain.

We have better visibility into the marketplace, more focused on working capital management, and our innovation pipeline continues to improve. This has allowed the team to strike the right balance between driving growth, market share gains and margin improvement.

By the time we complete 2020, we will have exceeded expectations in all 3 of those measures.

The entire Hawthorne team deserves recognition for how they've evolved over the past 3 years. I was openly critical of this group on one of these calls in 2018.

Frankly, at the time, they deserved the criticism. But they've gelled as a unit since then and have established credibility as a true industry leader. They didn't just embrace the idea of remote management, they've excelled at it.

Their performance this year gives all of us confidence of what the future holds for this business. The second subject I wanted to cover is where and how we believe we'll finish the year. As you saw, we increased our adjusted EPS guidance for the full year, and I'll leave it to Randy to cover the details.

I just want to be straightforward. That range could be higher, if we wanted it to be. We're incurring some originally unplanned expenses, however, because we have the flexibility to do so and because it's the right thing to do.

For starters, beyond our normal bonus plans which apply to about 1,500 people, we've decided to share some of our upside with a broader group of associates.

As I said at the outset of my remarks, the success we enjoyed this year would never have occurred without them. They deserve to share on the outcome. That's why we plan later this year to make onetime

cash payments as well as enhanced retirement contributions to approximately 3,000 hourly and salaried associates who do not participate in our variable pay plans.

These associates work heroically all season to help us deliver this result, and they are the first people on the list to share in our upside.

We also plan to increase our charitable efforts this year, primarily with increased corporate contributions to The Scotts Miracle-Gro Foundation. We have also stepped up our support of specific view to the initiatives close to the home in Central Ohio, and more broadly like the 9/11 Memorial and the United Veterans War Council.

By the end of the year, we will more than double our planned contributions to charity. Those combined efforts are worth approximately \$0.20 per share on an adjusted basis.

All of this brings me to my third topic, which is our current viewpoint about 2021. Jim King has told us barely a day goes by when he's not asked about the tough comp we paid after this historic year. So we know it's the #1 topic on everyone's mind.

As a reminder, we're not providing guidance today for next year. We'll look to provide that in November, but I want to address the very big differences for 2021 as it relates to our ability to comp this year from a sales perspective and then on an earnings perspective.

On the top line, let's start with Hawthorne, where the story is relatively simple. If we extrapolate the current run rate of the business into next year, we would expect to see extremely solid double-digit growth in the front half of the year.

Given our current order book in view of the market, this seems achievable. Our comps in the second half of next year, obviously, will be a lot harder.

So even if we're flat in the second half, and I'm not saying that's the expectation, then we should still be able to hit our long-term targets of high single-digit growth.

In U.S. Consumer, we know the societal changes brought on by COVID-19 will begin to normalize at some point. We told you on our last call, the 30% of edible gardening activity came from consumers who are either new to the category this year or returned to the category after stepping away.

Since then, we've conducted some additional consumer research, which tells us that long care participation increased by 14%, meaning an additional 8 million households use grass seed or lawn food for the first time this year.

We also know that 28% of all homeowners said they spent more time on overall lawn and garden activities this year.

Keeping all of these consumers engaged will be the single biggest key to whether our U.S. Consumer segment grows in 2021.

I'll start by saying the primary activity that brought these consumers to us in 2020. Edible gardening is a good start. We know that most people who engage in edible gardening don't see it as a chore. It's a passion and a lifestyle choice. And it's been the fastest-growing area of lawn and garden for years. We believe most people will do it again next year.

To help ensure that outcome, we know we need to strengthen our relationship with these consumers and that means we intend to stay connected with them.

You will likely see us continue to communicate for them throughout the fall and winter, not just about our products, but about the lifestyle around gardening and being out in the yard.

We made major improvements to our marketing efforts in 2020. In fact, I believe we're as good as we've ever been.



Our team has transformed the way we communicate with our consumers. We know them better than ever before. And we're not simply advertising to them anymore, we're communicating with them in a way that is clearly delivering results, but that doesn't mean we're done.

You will see us continue to adapt to the marketplace faster than ever, with more creative assets and more ways to deploy them.

Come next spring, we also expect a different retail dynamic. Remember that home centers, which generate about 60% of our revenue, had a little to no promotional activity this past spring.

We expect a step-up of promotional activity, especially early in the season, but not necessarily return to the way things used to be.

Clearly, consumers remained engaged this year with very little promotional activity. We think there's a better balance out there, and we're working in partnership with those retailers to find it. But remember, our retail partners who are in that next year from a scale perspective had tremendous success in 2020 and clearly saw market share gains.

They aren't going to simply roll over in 2021, they're going to work hard to defend their space. So I believe we'll see a much more competitive retail landscape next year.

Finally, we would expect to take some pricing next year, pretty much in line with our historical behavior, and that should help the top line as well. We also know, even with the big gains we've seen this year, we left some sales on the table due to supply chain constraints during the peak of the season. While we feel good about next year, you should expect for us to be conservative when we set sales guidance in November.

If you told me right now, we could comp this year and hold our margins, I take it. Clearly, we'll incentivize the team to do better than that.

And as we've shown this year, we possess an incredible ability to rise to the challenge when we have higher-than-expected growth. I'd rather do that in 2021 than describing an unrealistic expectation.

However, when we think about earnings next year, growth should be far easier. Getting SG&A back to a normal level should be worth at least \$70 million or \$80 million, and that's primarily a variable compensation issue, so we have good visibility to the potential upside there.

We'll obviously be in a much better place to share details when we talk in November. But I want you to know that our 2021 upcoming budgeting has become our #1 priority, and we're sensitive to the same issues that we know all of you care about as well.

The last topic I want to cover is our balance sheet and our current thoughts about uses of cash. When we announced Project Focus in 2015, we said we'd focus on 3 things: first, to maximize the potential of our U.S. Consumer business, and I think we've done a great job there; second, to reconfigure our company-wide portfolio that meant divesting some businesses and acquiring others, and that's how Hawthorne evolved to what it is today; and third, we said we'd focus on cash flow and returning cash to shareholders, while maintaining target leverage ratio of about 3.5x debt to EBITDA.

We were in the mode of starting to return cash, but pulled back a bit in 2018 after the challenge we faced that year took our leverage ratio higher than we wanted. But once we got back to our comfort zone, we reengaged in our share repurchase activity in 2019 until COVID-19 hit us.

We suspended share repurchases in March out of an abundance of caution, which was the right decision at the time. Now with free cash flow likely to be in its highest level ever and leverage well below our target, we want to get back to returning cash to our shareholders.

A special dividend puts cash back into the hands of our shareholders right away and allows them to decide how they want to invest the money.

In my conversation with some of our largest institutional shareholders over the years, I've found most of them to be agnostic about share repurchase versus dividend.

So this time, we chose the dividend. Most likely, the special dividend will replace any meaningful share repurchase activity for at least the next several months. So we still have enough flexibility to be opportunistic.

We also have ramped up some of our M&A work in recent months and are currently pursuing a couple of small but strategic ideas for both U.S. Consumer and Hawthorne.

For obvious reasons, I don't intend to share details this morning, but we still see strategic opportunities to expand our portfolio and better position both businesses for continued success.

Before I turn things over to Randy, I want to wrap things up by acknowledging the good fortune that's come our way in 2020.

In late March, we issued a press release saying we've seen a recent surge in business, but also acknowledging we did not know where this season would take us.

At the time, we stuck a conservative posture, pulling back on SG&A and suspending our share repurchase activity. We didn't know what to expect. But then consumers stepped up, clearly demonstrating they viewed our categories critical to them as they navigated this public health crisis.

The trust consumers and growers put in us, the trust that our retail partners put in us has not been forgotten by any of the people on this team. We're working harder than ever to strengthen our relationship with them even further in 2021.

We're using the strength and flexibility of our financial position to make our company stronger, too, to position us for success, not just in 2021, but in the years that follow.

With that, let's switch gears and look at the numbers. Randy?

**Thomas Randal Coleman**

*Executive VP & CFO*

Thanks, Jim, and hello, everyone. It's obvious from our announcement today that our Q3 results greatly exceeded what we expected when we updated our guidance about 7 weeks ago.

Our momentum throughout June surpassed anything we've historically seen with continuing even as we speak. So I want to start by joining Jim in thanking our consumers and retail partners, but mostly our associates for helping us navigate the COVID crisis so effectively in delivering outstanding results.

This morning, I'd like to spend most of my time providing some core commentary on the P&L. I won't go through all the numbers. I know most of you have already done that. I also want to pick up on Jim's commentary about 2021.

I'll reiterate that we're not providing guidance today, but I'll also stress that we're confident in our ability to drive earnings even higher next year.

So let's get started. On the top line, the most important story to understand is what's happening with U.S. Consumer. In June, we raised our guidance and projected 9% to 11% growth for the full year. But even as we were making those comments, the landscape was evolving differently than we expected.

If I show you 20 years of consumer POS data, we see a consistent pattern of consumer behavior. In any given year, the timing of the season and impacts from weather could affect the flow of the POS curve to some degree within a season, but is very consistent after the middle of June.

So that's what we expected. Instead, we saw an extension of the season that went well beyond our expectations and also continued with dramatic year-over-year growth throughout the rest of June.

Given the consumer momentum in the market, we continue to push the category with more media and in-store support. That strategy worked. POS increased 50% in the month versus the prior year, and the result was that June sales in U.S. Consumer over-delivered by over \$100 million from what we expected when we established our new guidance range in [indiscernible]

Since then, the strength has continued. Consumer purchases in July, for example, are up 33% from last year. And while August is always the smallest month of the lawn and garden season, and that's what we'll see again this year, we are now forecasting year-over-year percentage growth to mirror what we've been seeing off-season.

We are also expecting a strong fall season, as Jim alluded to in his remarks. Actually selling of fall products in September should be very strong, too.

Our revised guidance assumes the trends we've been seeing through July will continue through year-end, which gives us the 20% to 22% sales growth on a full year basis for U.S. Consumer.

In Hawthorn, the story is starting to sound a bit of repetitive. We simply did not expect the second half of the year to be this strong.

For Q3, we reported 72% sales growth against the 49% comp. Hawthorne is now up 59% year-to-date, and we expect the full year number to be in a range between 55% and 60%, as we are facing slightly higher comps over the next 2 months.

Jim mentioned Hawthorn's profitability, and I want to share some thoughts as well. You'll see the segment margin rate in the quarter was 13.5% or at 11% on a year-to-date basis.

I expect the full year rate to hit our 10% target, but to decrease from Q3 to Q4 as we make more investments in supply chain, sales and marketing and other areas to strengthen our business for the long term.

The irony here is that I believe the margin rate would be even higher if the sales growth rate was closer to 25% or 30%.

We had to spend a good bit in the range to keep up the demand and some of the spending was less efficient and margin dilutive.

That said, the rate improvement we'll see for the full year will meet our original guidance to keep us on track for the 15% segment margin rate that is achievable for this business over time.

Let's move on to gross margin. There are a lot of moving pieces here, but it's a good story overall. The adjusted gross margin rate declined 10 basis points in the quarter to 36.1%. While both the U.S. Consumer and Hawthorne segments improved in the quarter, the relative strength of the lower margin Hawthorne business drove company-wide margin rates down nearly 80 basis points.

We also lost another 85 basis points from the timing of a \$20 million Roundup payment we received in Q3 of last year from Bayer.

Recall that we received a similar increase in our commission income in Q2 of this year, so there's no full year impact on rate.

On the other side of the equation, pricing and volume benefits combined and nearly offset the headwind. On a year-to-date basis, we're still about 25 basis points ahead of last year. And we expect the full year gross margin rate to be about flat once we get to September 30.

We plan to execute a few supply chain initiatives in Q4 that will increase costs in 2020 to help us improve service next year.

Moving on to SG&A, the 43% year-over-year increase surely stands out. So let me provide context.

As Jim said earlier, we've made the decision this year to share some of the upside of our results with associates.

On a full year basis, we expect our variable compensation will be \$60 million to \$70 million higher than a year ago, and we treat up our fall this quarter to reflect this. We also began to accrue dollars for our hourly and salaried associates who don't typically participate in our bonus plan, but will receive onetime bonuses this year, given their significant contributions to our collective success.

In addition to the compensation-related items, we have significantly increased our U.S. Consumer media spending. I expect we'll finish the year about 20% higher than a year ago. We also believe consumer impressions greatly exceed our growth in spending, as media costs are down significantly from last year.

We've also continued to aggressively invest in Hawthorne. The growth in SG&A is almost keeping up with the increase in sales.

Towards the operating line, you'll see the interest expenses down nearly \$6 million in the quarter and \$17 million year-to-date. The strong operating cash flows, the postponement of share repurchase activity this year beyond Q2 and the fact there are no acquisitions, collectively allow to lower-than-expected borrowing level with lower interest rates helping too.

Looking at the bottom line, adjusted earnings of \$3.80 per share or 22% higher than a year ago. And the year-to-date adjusted EPS totaled \$7.20, 34% above last year. We lost \$0.91 on an adjusted basis in Q4 of last year, and we expect our year-over-year earnings improvement to continue in Q4 of this year.

Continued top line momentum across the company, net incremental investments and incentives in the fourth quarter is expected to result in full year adjusted EPS, \$6.65 to \$6.85 per share, which is \$1 per share higher than our previous guidance.

We believe this is not a conservative outlook. Having said that, in early June, we clearly underestimated forward-looking demand in such an unprecedented season.

The possibility remains that we could still see this in the range. Regardless, I prefer to provide transparent forward-looking estimates versus just reporting results after the books are closed, even in such a challenging environment in which precision is extremely difficult.

Let me remind everyone that our adjusted results exclude incremental cost of premium paid to associates, who continue to work in stores, factories and distribution centers during the onset of the COVID pandemic.

The year-to-date amount we spent on 50% hourly pay enhancement be about \$18 million. It means that we are making more change from the approach we outlined last quarter. We will not be adjusting on enhanced cleaning and maintenance costs as we plan to continue those practices into the foreseeable future.

Thinking about next year, Jim shared his views about our ability to grow again next year, and he and I are in lockstep on this point. We will take a conservative view as we build our plans for U.S. Consumer and Hawthorne growth should continue, but not at the same rate we're seeing in 2020.

SG&A should be a significant tailwind and should allow us to see operating income growth in line with our long-term growth projections, while we're continuing to invest in our brands, Hawthorn supply chain growth initiatives and our direct-to-consumer distribution models.

Moving to the balance sheet. Our debt-to-EBITDA ratio stood at 2.8x at the end of the quarter. Given our strong anticipated free cash flow this year, which we now expect to be about \$400 million, and given our continued confidence in the business as we look ahead, we choose to again begin returning cash to shareholders, even though the time is a few months ahead of what we expected only a couple of months ago.

The special dividend we announced today will take our leverage up to slightly over 3x, around the midpoint of our target leverage range.

Looking ahead, we still have the flexibility to repurchase shares next year, and execute against the current pipeline of a few small and early-stage M&A opportunities, while maintaining a leverage ratio below 3.5x and possibly returning to a level similar to what we're seeing right now by this time again next year.

As it relates to cash flow for the next year, I would expect us to take a step back just a bit for a few reasons. First, the incentives we accrued in 2020 will be paid in 2021, and this will be a large headwind in next year. Also, as Jim pointed out earlier, the supply chain was stressed throughout the entire year.

While I applaud our effort to the unprecedented demand increases, we did see service levels fall below our expectations at certain times. We've been attempting to build inventory over the last few months.

Our sales growth continued to accelerate, and we finished the third quarter with inventories about \$40 million lower than a year ago.

Importantly, you'll probably see us rebook from inventory levels in the fourth quarter and throughout 2021 as we continue to attempt to get ahead of demand.

As I close, I can't help but reflect on the dramatic changes we've seen in our world, our country and our business over the past several months.

Scotts was fortunate to be in a position to help our consumers, and our management team and associates are extremely grateful for our success this year. Thank you for your support. And with that, let's move on to Q&A.

**James D. King**

*Chief Communications Officer, Executive VP & President of The Scotts Miracle-Gro Foundation*  
Steven, let's go ahead and start the Q&A.

# Question and Answer

## Operator

[Operator Instructions] And we will take our first question from Mr. Jon Andersen with William Blair.

### **Jon Robert Andersen**

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

One of the dynamics that play out this year is -- that you referred to in the prepared comments is a less promotion, and that's been driven by, I think, a couple of things, most notably COVID-19 and some of the restraints that, that put on the home centers.

So I guess my question there is, has that benefited -- has that benefit largely accrued to the retailers? Or has it also accrued to Scotts with less promotion frequency and depth? And how do you think this plays out in 2021, 2022?

Do we go back to a more promotional intense environment in line with kind of what we -- pre-COVID? Or have there really been some learnings around consumer engagement that can be applied here to maybe moderate the level of promotional activity in the category?

### **James S. Hagedorn**

*CEO & Chairman of the Board*

I think I'll start and then hand it over to Randy. Jon, here's what I think. Number one, most of the benefit, I think, accrue to the retailers. I think we got some benefit, but a lot of that, because there was no voice sort of to the industry/category, we upped our spending and pretty much just did kind of what we want.

And in some ways, it was good because we didn't have to ask a lot of permission. We just kind of ran for the industry. And I think that worked for us, and we learned a lot from it.

I don't think the retailer has probably pocketed a lot of that because their operating expenses were up significantly. So they kind of had to work their labor and cleanliness and stuff in the stores. So I don't think the retailers would be kind of beating their chest that they pocketed a lot of it. But I think as we look at sort of the margin at the retail level on our products, we thought it was -- we think it's a lot higher at the retailer side, a lot, again, I'll repeat, I think they spent most of that. We've talked about that -- my -- at least my view, and I think it's kind of our view here is that Black Friday, we were getting kind of more and more down on these Black Friday events, largely because if we looked at these early season, which are real tied to weather, what we saw is a real high miss rate of sort of cold and bad weather and at least 50% of everybody's promotional numbers is going into these Black Friday events. And our views with -- I'm going to say, call it, like a 20% hit rate, meaning a 80% miss rate.

So we've been engaged in conversations all in the last 12 months with retailers saying, dude, it doesn't seem like the way to do it. It's just a lot of money being spent for not kind of the results that we'd like to see, and we think there's a better or more kind of what we call rifle shot approach, which is, by market, by category, looking at the weather, which we can't do a couple of weeks in advance pretty easily.

And so I think there's probably more believers at the retail level after this year than there has been. Meaning, I think everybody is looking at the sales and saying clearly the consumer didn't require a level of kind of giveaways that they have typically got, especially in some of our larger categories.

So I think that's going to change, and we're engaged with retailers right now to see if -- what the balance is where it's a little less discount focused. So now that's kind of one thing.

I think on the other side, you're going to look and say, I think largely because of footprints that the big retailers, the big home centers, we're just under more pressure to not make their shopping like experience dangerous, both for their associates and for consumers. And so they were limiting number of people in.

They were limiting their promotions. We weren't working days there. We were mostly working nights during the peak of the crisis. And some places still doing that.

And so where do we go from here? I think that what you're going to see is some kind of mid-road where we promote. We -- you saw our comments on mulch, which is, as we looked at our -- kind of our inventory level, what I think we saw was a lot of mulch that we really wanted to get moved out. And so we started using very targeted marketing promotions, like what I'm talking about, weather -- sort of marketplace by almost ZIP code targeted with weather, and we were able to get all that mulch moved.

And so we know that this approach, which is kind of a new approach to sort of what used to be Black Fridays works. But what you're seeing is the home centers lost quite a bit of share.

And I would say roughly 10%, I don't know, Mike's next to me. I don't know if he likes that number.

**Michael C. Lukemire**

*President & COO*

Yes, yes, yes. I would say about 10% overall home center lost.

**James S. Hagedorn**

*CEO & Chairman of the Board*

And so I think they're going to want to get that back. And I think that the people who gained it, which would be wholesale clubs, hardware, general merchandise. I mean, there's a lot of people. Clients are split out online and you have direct-to-consumer.

I think there's going to be a lot of pressure for them to maintain that share. Farm and fleet was another area that like did really well this year. And so what do I think? I think it sets up a pretty competitive environment for the beginning of next season. And so I don't think we're going to be able to talk people out of that because I think you're going to have people who made big gains, want to defend them. And I think you're going to have people who lost.

And remember, lawn and garden is a major category in a season for us, the most important category, most important nonlumber category in home centers during our season. And so I think there's going to be a big fight -- and listen, depending on what happens with COVID, you could see that in the fall.

I think you're going to see Halloween being kind of a weird season this year. And so I think that opens up fall opportunities for us to promote, which were -- I think, are beyond discussions. I think there's actually planning occurring with our significant accounts on making fall bigger season than it would normally be.

And so what do I think? Back to your question. I think there's going to be a difference next year. I think most of the benefit did end up with the retailers. I think it's going to be more competitive, and I think you're going to see a more year-round business than you've seen before.

I don't know, Randy?

**Thomas Randal Coleman**

*Executive VP & CFO*

No, Jon, there's nothing I could add to that. So I think Jim cashed it all. You have a follow-up you wanted to ask?

**Jon Robert Andersen**

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

Yes. I do. A quick follow-up. And maybe for you, Randy. So I know -- thank you for the commentary on 2021. I know it's earlier than usual, but appreciate that.

I guess what I heard is, you'd be happy with kind of flat top line, I think, in U.S. Consumer is what you're referring to. And yet, you see an opportunity to grow earnings. And so let's assume kind of flat top line in U.S. Consumer plays out and there's some growth in Hawthorne, but in aggregate, modest top line

growth given the tough comp. Can you walk through, maybe just at a high level, some of the key puts and takes there? Like what are -- I think you mentioned \$60 million to \$70 million of perhaps swing in variable comp, then there's this kind of onetime bonus to employees.

I don't know if that's incremental for that. But just step us through the benefits that could get you to solid earnings growth despite maybe less top line than normal?

**James S. Hagedorn**

*CEO & Chairman of the Board*

Look, just before Randy jumps into that, and he'll do that, I just want to talk about really the top line a little bit.

Part of my job as we go through budget and which has been challenging, both the in-season here and as we look at next year is what would be kind of a victory. And so I think as we looked at this, especially early on. And we've got, I think, a lot more granular now than we did, like, call it, even a month ago, is would we be happy if we could comp this year, hold our gross margins and then pick up the SG&A tailwinds.

And I think Randy and I sort of set the expectations to the operating community that we thought that would be a good result. And I think that's what we communicated today. And Randy can sort of take you through details of that, at least the sort of SG&A tailwinds and what we think.

I do want to talk a little bit about just the top line just because I think it's important. I think anybody who -- Mike is pretty self-critical about our ability to execute in season when demand was just going kind of bananas. I'm much more forgiving of that. And my wife and I have done a lot of gardening this year. And so we've been in quite a few garden centers buying stuff, and there were a lot of empty shelves. I think Chris' demand on Hawthorne was also, I wouldn't say excessive, but it was a lot higher than we had forecast and that business is a lot younger and we just implemented SAP.

So I think you could easily sort of tag maybe \$100 million of money we left on the table on both businesses, which is pretty significant just because we couldn't fill orders sometimes. And I think we did a really, really good job like living up to kind of a standard. As we said, we know we could do better, but we left a lot of money on the table there. And I think we don't intend to do that again next year, meaning that I think there's been a lot of discussion about inventory levels, and Mike's got up major projects on what he calls the customer experience, which means our customers and making sure that we're the vendor we mean to be.

In addition, we're really looking at a lot of opportunity in Q4 and Q1 as we go forward and much more of a kind of year-round business. And I think that the Halloween fits into that, and our direct-to-consumer business fits into that. So I think we've -- as we spend more time talking and including with our retail partners and our direct-to-consumer people, I think we actually believe there is upside on the top line. But this issue of, if we could comp last 2020, I'm saying last year, this year, if we could comp this year, hold margins and get the tailwinds, it would be a really great earnings year. And I think that's kind of where we're at. But I think we actually have more visibility to growth in 2021 than we probably did like a month ago.

**Thomas Randal Coleman**

*Executive VP & CFO*

I completely agree with everything Jim said, Jon. I'd say, we obviously have a much more line of sight to what Q1 is going to look like and through this [ play ] momentum going into the fall. I think you get beyond that point, and you have to make assumptions and do scenario analysis around what's going on in the world and what's that going to mean. And we're doing that. But we're trying to put bets on what scenario is going to be the right one, I think it's way too early to get there.

But to your question does next year look like from the bottom line? It's pretty clear if we take our incentive plans back to more of a target or normalized level, plus some of the SG&A that we've expedited from Q1 into Q4 and trying to get ahead and build a better business for next year and year after that,



trying to quantify that -- as to dollar share of EPS of -- that's gross margins are flat on flat sales growth, which believe me, we'll be pushing for much higher numbers than that.

But as a starting point you just have each scenario to work against, that's the way we're thinking about it. And when we're trying to keep things in balance between sales growth, and we're going to be a \$4 billion company this year. And last year, slightly over \$3 billion. So we're beating ourselves up a bit on service, but trying to keep up with that.

If you go backwards 4 months ago, we were counting our pennies and just trying to be careful and make sure we'd be able to navigate through this year. So again, I give everybody a big pat on the back. But you unwind a lot of that SG&A that we're putting in our P&L here in 2020 and roll that into 2021, our operating margin rates will be significantly higher, and we'll see a lot of accretion across the company and Hawthorne too, which I know is a big focus for everybody. But we're trying to keep things in balance. We're trying to think about this year, but also next year and the year after and the year after that.

And I really like the way that we're running the business right now in order to prepare for that. So hopefully, that answers your question, Jon, and I'm really bullish on where we're going right now.

### **Operator**

[Operator Instructions] We will take our next question from Mr. William Reuter with Bank of America.

#### **William Michael Reuter**

*BofA Merrill Lynch, Research Division*

I just have one. I know it's a little early for line reviews for next year, but I would imagine your categories have been some of the most productive for your big retail customers. Have you heard from them that they plan on dramatically altering or increasing the shelf space allocated to your categories?

#### **Michael C. Lukemire**

*President & COO*

This is Mike Lukemire. Yes, we're in the midst of line reviews, and we're seeing retailers want to lean in more with us on that space. But we really don't finalize that until really December as they finish out their years. But the indication is they're definitely leaning into fall. So we are seeing expanded space there. And we're seeing a willingness with our retailers to lean in and do more and build off of what we've accomplished this year.

#### **Thomas Randal Coleman**

*Executive VP & CFO*

And the other thing I'd add -- this is Randy. Again, when you think about the way we go to business and we talk about e-commerce being up 200% or even higher on that when you look at buy online and pick up in store, and looking forward, I'd expect that to continue to be a key way the consumer shop. And I believe we're at a real advantage in that area just because of national advertising, national scope of brand across stores, regardless of -- if you're in Washington, state of Florida or Maine, California, we have it covered.

So I think there should be more focus by us and the retailers and just trying to focus on key core SKUs that consumers want to show up and buy. And I think we're at a big advantage in order to do that. And that business has grown faster than any other channel or any other component that we look at.

#### **James S. Hagedorn**

*CEO & Chairman of the Board*

Yes. I'd like to just throw a little bit into sort of that because that -- I think what Randy says an important point. It's not just us that are looking at kind of inventory levels, it's us paying the retailers. And again, Mike's hard on himself, but this year was very much kind of business combat and I think when you do that stuff, you break stuff. And so we had kind of what I'd call a good war, but we definitely broke some stuff. And that's going to help us be better, but it's us and the retailers. And I think this idea of kind of our core

SKUs and make sure that we have the inventory and the retailers do as well so that we don't have the stocks and empty shelves. So I think you're likely to see kind of a rebuilding both of our inventory and retail inventory on certain of our high-volume SKUs for next year.

**Michael C. Lukemire**  
*President & COO*

Yes. And we're seeing that playing out big time, but some of the southern markets will need to have 80% of the POS in early. So I mean, there's just good momentum right now. On being ready and taking advantage of that and occupying their shelves.

**Operator**

We will take our next question from Mr. Joe Altobello with Raymond James.

**Joseph Nicholas Altobello**  
*Raymond James & Associates, Inc., Research Division*

Congratulations. First question on U.S. Consumer. And can you touch a bit on this with respect to edible gardening and with respect to kind of gardening and just sort of speak to 2021 and beyond. But I'm curious if you think COVID, if it is permanently currently changing the way consumers think about your categories or is this more of a temporary phenomenon, which, if it's the latter, it would make even slack sales aggressive for next year?

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

I'll use profanity, s\*\*\*, I have not -- what do I think? See, I guess I disagree. And when I disagree with is the fact that the consumers are seeing it differently. I think that what we see is that how people feel about the category, which is -- I think people's attraction to gardening, clearly people being stuck at home has been helpful to us.

But I think people have really gone to things that make them happy. And I think they've, to some extent, rediscovered the value. I mean, hardly anybody, I don't know, that doesn't have a garden. And I know Carli and I, we're up at our place in Vermont. We have a pretty big garden. We intend to expand it next year. And I'm not sure there's not a lot of people getting a lot of satisfaction, often that aren't getting a lot of satisfaction from gardening.

And I think we expect that to continue. The focus of our communications efforts is weird, I'm not really calling it advertising efforts. I don't know, Randy would know the number, Joe, about like what over the last 3 or 4 years, it was really -- I got to say, Randy, who came to me like 3 years ago. And I think I told you guys this that said, we're a branded consumer company. And why is our like marketing dollars continuing to go down and our promotional dollars continuing to go up?

And so I don't know, Randy, what are we spending over the last 3 years. Last year, we were up 30% or so. This year, another 20%. And then this year, even beyond the dollars, the fact that media is on sale right now. Pricings are well above that 20% they're probably 35% again.

So really, our challenge is to keep those people engaged and communicate to them in a way they -- where and when. And so I've always been pretty negative on sort of digital advertising. We're just kind of taking what is like TV like advertising and banner ads and bulls\*\*\* on social. We are doing some incredible work, I think. And we're really just getting going on that.

So I think our ability to keep people engaged is pretty high. And so I -- personally, listen, I have no idea, like when people are released or they going to want to just rush out and go to bars and get COVID? I don't think so at this point. I think the more people are -- the more I talk to my partners here, the more -- like I talk to my family, the more I talk to -- and that my admin, people are really comfortable at home. And they feel vulnerable when they're around people they don't know and they don't know what they've been up to. And I don't think that's going to change a lot sort of this fall and winter.

So I think that you're going to continue to see people wanting to be home and wanting to engage in activities that make them feel good. And so I think that was always there. I don't think it was luck that got us where we are today. My father had this thing, "luck is where preparation meets opportunity" and I think we prepared -- we built this business kind of for what's happened -- not for COVID, but we built this because we thought it was kind of an essential business for people, and it turned out that way.

So look, is there risk? Clearly, if you talk to Mike, he'd say we can beat this year. Randy and I are basically plugging that would it be -- because I mean just think about what we've said. If we can comp this year, not lose margin plus \$1 on the bottom line, what do we think? We think that's a damn good result.

And I think could it be worse? Yes. It could be. I don't think it will be, but it's possible. And I think Mike actually is not in the talking stage with his business with the operators. I think there's growth out there. And that's up to us to prove. And we'll talk more about it in November. But I think -- look, Randy has also been frustrated on the financials. Because every time we talk to you guys, we're undercounting. And so I mean it's hard for us to even figure out how we're going to end Q4 right now.

And I know that's bothering Randy. And part of that is we've been so conservative. As you guys know in how we talk about our numbers, under promise, over deliver. That has not been our friend from accuracy of financials this year. And I think Randy is more interested in the real numbers, not message numbers that we can beat. And that's been hard for the culture here to sort of accept that what are the real numbers. And so I think that what you're hearing from us are probably more like the real numbers, which means there's upside and downside risk.

And -- but I think that it's balanced. I don't know, Randy?

**Thomas Randal Coleman**

*Executive VP & CFO*

The only thing I'd say, we could have taken the easy way out and just turn up our hands and said, we'll figure it out later. We'll tell you when we know. But SEC was very encouraging back at onset of COVID saying we should be providing more transparency about forward-looking numbers. We've tried to do that, but we do have a culture of trying to be conservative and make sure that we hit the targets. I think we clearly way too low back in June when we spoke at the William Blair Conference.

We've taken another shot and saying, if we just keep the same run rate we saw in July and that runs out the rest of the year, retail inventory stay about where they are, the Hawthorne forecast, maybe a little upside, but looks pretty good.

We do all that, that should be in the range that we talked about. Having said that, it's very unpredictable right now. And there could still be upside to that. And Jim's saying, [indiscernible] take it easy on yourself, but I think we all expect better from ourselves around here, and we've given it the best shot we can right now.

**Operator**

We will take our next question from Mr. Bill Chappell with SunTrust.

**William Bates Chappell**

*SunTrust Robinson Humphrey, Inc., Research Division*

And congratulations on an exceptional quarter. Two quick questions. I guess maybe not quick the way we've been going. The first is on kind of the outlook for Hawthorne next year. I mean I understand your early stages of planning. But I mean, do you have any real visibility to kind of how these come down the pipe for individual states in terms of like they utilize medicinal and then sales go here and then they go recreationally get here. I mean, after doing this for a couple of years, just trying to understand if you have any visibility, especially as you talk about potential tough comparisons in the second half of next year?

**James S. Hagedorn**

*CEO & Chairman of the Board*

We're all kind of looking at each other, say who answers that one. And I don't know. Chris, do you want to start on that and then hand it to Randy.

**Christopher J. Hagedorn**

*GM & Senior VP*

Yes, sure. And I'll be relatively brief, hey Bill, it's Chris. The way that we've sort of tracked this over those past few years, as you mentioned, starting to get a pretty good handle, we think, on sort of the time lines from this thing is legalized in one fashion or another, whether it's a [ vote ] or stat senate bill, whatever. There's usually about a 12-month lag time from when a law gets passed till we start seeing actual cannabis being sold. And typically, it's about a year lag time, even for our business to really see a bump from that.

And then, typically, there's a year or 2 of the state getting comfortable with recreation before they -- or, excuse me, with medical before they make a move for recreational. So typically, the way that we look at these another states legislated a bit differently, but we figured there's about a year from passage of law till we start seeing a real bump in our business in that geography and another year or 2 after that before the state starts to reach any level of what we consider maturity, hope that answers your question.

**Thomas Randal Coleman**

*Executive VP & CFO*

So a couple of things that I would add is, given the nature of the way the industry is set up is there's not really capacity within retailers to be loading inventory. So we have a lot better direct line of sight since we purchased Sunlight Supply a couple of years ago now. So we have good line of sight to what's going on with retailers. And they really just don't have the capacity load. Another area we look at a lot is wholesale and retail pricing in the marketplace, and it's fairly stable. It's up a lot from a couple of years ago.

So that seems to be in good shape right now even though the results are high. And then when you think about demand, I think it's -- like Chris said this on our last earnings call, people are staying home and gardening or people staying home and doing other things. So I think demand is high and it's understandable why, whether that will sustain. My bet is it will, but I think we're in a good place and the approach we're outlining right now and more to come in November is if we just stay at the same run rate through the first 6 months of the year, we'll be in healthy double-digit growth next year. Similar approach to what we took this year coming off of 2019 because we can't look at 6 months at a time. But I think that's a very healthy place to be.

**William Bates Chappell**

*SunTrust Robinson Humphrey, Inc., Research Division*

Great. I appreciate it. And then second, just -- and I'm sorry if I missed this, but on just your media spend for 2020, were you able to spend what you wanted to? And as you look to next year, do you still need to be at the levels that you've historically been? I just assume such advertising around early season baseball games or NCAA March Madness or stuff like that, I mean, it doesn't necessarily make sense to do it in the fall, but I'm just trying to understand what the total spend kind of looks like this year versus the pending next year?

**Thomas Randal Coleman**

*Executive VP & CFO*

Right. So when -- back in the March time period and even April, we were really careful and tried to preserve some of that money. And once things started looking a lot better in early May, we really -- there were a lot of fuel on the fire, again, we did that in June. We're still continuing to do that. Our fall program will be higher than it's ever been.

I don't know if there's any expectation we're going to go backwards next year, difficult to predict what will be going on with media rates next year. Hard to believe that they'll go down again. But again, you never know. But I'd expect us to continue investing in the brand as our business grows, and I don't see that changing at all.

**James S. Hagedorn**

*CEO & Chairman of the Board*

I mean we will definitely be spending more money next year on with our marketing group. And we do like sports. That's been challenging and Major League Baseball for one has been very flexible. And our view is no games, no money. But they -- baseball has been good to work with, and we continue to like March Madness.

So I think if you look at our media people, they continue to like sports. And we're doing a ton in -- on the social side as well, but sports and news are -- will continue to be important for us.

**Operator**

We will take our next question from Ms. Carla Casella with JPMorgan.

**Carla Casella**

*JPMorgan Chase & Co, Research Division*

My questions related to M&A. You mentioned that you were still looking at opportunities. I'm wondering if you're seeing more from smaller or weaker competitors through COVID? And also, in the event you do find an opportunity, what's your comfort level? What's ticking leverage up above your target range for the right opportunity?

**James S. Hagedorn**

*CEO & Chairman of the Board*

I mean I will start with a latter part. I don't think that's actually necessary. I have actually been pushing Hawthorne to kind of think bigger and where they've ended up is kind of close in adjacencies, which are smaller deals. And I wouldn't put them in the -- so just on the Hawthorne side, I would say our opportunities are not what people who are struggling. I think the whole industry is actually doing pretty well. But it's people who are, I think, open-minded to being with us and monetizing all or some of their investment.

So -- but I think that the business has tried to push back to me to say, there's areas within Hawthorne that are clearly opportunities that the owners are willing to monetize that would fit in really well with our kind of pillars or business, which is the places that we operate. And so I think they've pushed back to say, we don't need to do big giant deals, I am pushing Randy and Chris. You know, Randy, the strategy group reports then to Randy to look at kind of game-changing opportunity, which are not part of our plans at the moment.

That basically say, if we believe that this country is moving toward sort of national legalization and that because of sort of tax code and problems with banking that these businesses are struggling to some extent unnaturally. What -- if we believe that it's going to be legal, what do we want to -- do we want to step in early? Those are in very early stages, and I'm not predicting we're looking at game-changing opportunities there.

But I do want the company taking a look and saying, is there a possibility to go big here? And what does that mean to Hawthorne as far as in Scotts, next to Scotts? I don't think we know. But I don't want to miss the opportunity to sort of have the strategic group and our banking partners, helping us look at industry structure, not tomorrow, but sort of 10 years out and that we're being smart about it. But for right now, what everybody is saying is, let's just look at closing adjacencies that are easily integrated. A lot of times, we're already dealing with these companies because of our relationship with Sunlight, our ownership of Sunlight and so that's that.

On the consumer side, again nothing groundbreaking, this would be businesses that we're already operating with and just sort of rationalizing sort of the ownership structure. But I think you're probably talking less than \$200 million on both Hawthorne and Consumer side for 2021 or possibly at the end of 2020 if we continue to make progress.

So I don't think we're having to operate at higher leverage ratios than we're comfortable with. But if we thought there was a big enough opportunity, I think we can start by talking to our Board and Randy would start reaching out to our banking partners to figure out how we finance that.

**Thomas Randal Coleman**

*Executive VP & CFO*

And Carla, I'd point out back in 2018 when we purchased Sunlight Supply, our leverage did go in size about 4.5x. And we took a lot of actions to pay that down as quickly as possible. So really comfortable with where we're at. 3.5x is still a very reasonable place to be. And even after this dividend, we won't be even close to 3.5x.

So we would do it again if we had the right deal, but we don't have the right deal. But I'd also say Sunlight was clearly the right deal. So at the time, the industry was in all kind of flux. If you compare to where we are now versus 3 years ago, the #3 competitor dropped out of the industry. When you look at us compared to our largest competitor now is #2, our sales are 3 to 4x bigger, our profitability is 5 or 6x higher.

So this has been a terrific success. And looking ahead to next year. We still have a lot of momentum and we can do a whole lot better. So more to come on that.

**James D. King**

*Chief Communications Officer, Executive VP & President of The Scotts Miracle-Gro Foundation*

Steve, I'm going to jump in here. If we can just take 2 more questions, and then we'll wrap things up there would be great.

**Operator**

We will take our next question from Alex Maroccia with Berenberg.

**Alexander Rocco Maroccia**

*Joh. Berenberg, Gossler & Co. KG, Research Division*

I'm trying to get a better sense of sustainability of the [ gain ] seen in U.S. Consumer. The public landscaping wholesalers also saw some decent growth this quarter, which implies non-DIY spending didn't change much year-over-year despite the pandemic so based on that, do you have any visibility into how many of your end customers are servicing their own properties to some degree in addition to using a professional?

**James S. Hagedorn**

*CEO & Chairman of the Board*

So we would have had a lot more insight, Alex, back when we were partners with TruGreen. Now that we no longer have that relationship, we don't have nearly as much insight. I can tell you back then when we were able to compare and contrast. When we look at sales by geography. So Florida was having a great year for Scotts. TruGreen was as well, for example. So at this point, I can't really speak to that. But...

**Thomas Randal Coleman**

*Executive VP & CFO*

I think most of it's Consumer gain, if not pro.

**James S. Hagedorn**

*CEO & Chairman of the Board*

If you look at, let's say, our home center channels and say, how much of that was being -- going on the back of a pickup truck with [indiscernible] who is the landscaper. I think you would see much more gain on the Consumer side.

**Michael C. Lukemire**

*President & COO*

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Yes. I agree with that. I mean, people didn't really want people on their property. And so they're very sensitive about that. They wanted to do it for themselves. So I think we're seeing that.

**Alexander Rocco Maroccia**

*Joh. Berenberg, Gossler & Co. KG, Research Division*

That's helpful. And then just a follow-up. Can you explain how you laid the special dividend decision versus internal growth opportunities or other capital allocation options?

**James S. Hagedorn**

*CEO & Chairman of the Board*

Yes. I mean - Chappell lauded us for like talking too long, I guess. So we sort of said to ourselves what this people used to ask, like, how did you decide how to do it. I think we looked at the equity and saying we believe it's pretty fairly valued. So I think that pushed us toward a cash special dividend. But I think we just kind of made a choice said that seems like the appropriate thing.

We've, over the years, talked to a lot of people who generally have said -- and I'm talking investors that I really respect. And where you talk to them and they say, my only problem with your share repurchase stuff is you guys buy like crazy when you're feeling good and your equity is high. And then when the business is not good and your equity blows, you would like to put the brakes on. And you just give me the cash and I will decide because I have more kind of cahonies when it comes to buying when things aren't great than you do.

And so I think because there's nobody really felt strongly about it either way. We just made the decision to go with a special and we feel good about that. And remember, we had a call with my family yesterday and they asked about what are the kind of future plans. And I just want to say the same thing to the Street, which I told them, which is we're in the mode of after reconfiguring our businesses, which is TruGreen, Scotts LawnService out, Europe out, Hawthorne in, live goods in, that we would then pay down debt and go back to being shareholder friendly.

And so this is not a onetime deal of returning cash to shareholders. We just decided that with the equity price the way it was, we thought it was a better move to -- for you to just do us a special. But we intend to continue to return cash to shareholders, the question is how -- and we'll just look at it every time we have that opportunity, but we plan to continue this.

**Thomas Randal Coleman**

*Executive VP & CFO*

Alex, what I'd add is our free cash flow is coming in better than we expected just a couple of months ago. So a \$400 million of, say, plus for this year, and we were in a situation where we were going to have cash on our balance sheet starting into July, August, September.

So originally, we were contemplating doing something in the fall, we just thought why wait, let's do it now other than sit on cash, and we don't really want to pay down any kind of debt capacity. So that has a lot to do with it.

And if you do look at our share repurchases over the last, let's call, the last 5 years, I'm going to give you rough numbers, but we repurchased about \$800 million, and the average share price was around \$90. So something in that range. So we will be doing share repurchases again. We're not going to wait for \$90, though I'll tell you that.

**James S. Hagedorn**

*CEO & Chairman of the Board*

And the last part of it is that as Randy and I talked about preferences of investment in the business versus shareholder friendly. I think Randy has taken a point of view, which I'm completely in agreement with, which is we actually can do both. We can't be accessible in either area, but we can do both. And I think that's what you're seeing right now is Hawthorne is not requesting more money than we're prepared to

hand over. And the Consumer business is not requesting more money than we're handing over. So we're meeting the needs of the business to invest, and we're also upping the shareholder-friendly side.

So I think we feel like we're pretty well in balance right now.

**Operator**

And we will take our final question of the day from Eric Bosshard with Cleveland Research.

**Eric Bosshard**

*Cleveland Research Company*

A question and a follow-up, if I could. The -- having 8 million new consumers engaged in the category is a tremendous accomplishment, achievement, however, you want to view how '20 has played out. But something I know that Jim, you've been focused on for years of getting more people engaged in the category.

My question is, as you think about '21 -- in '20, they engaged, I would assume, in part because I didn't have anything else to do. In '21, if there are more alternatives for how people spend their time, I'm curious for what you're doing or what the sort of buckets of focus are to say, don't forget about your lawn and garden in '21 when you can do other things. Where is the focus to sort of keep them engaged?

**James S. Hagedorn**

*CEO & Chairman of the Board*

Massive. Massive. It is our major focus is retention of that customer pool going into '21. I think that I don't want to jump on this COVID bandwagon in ways that are kind of inappropriate. I lost a kid, I know how that feels. We lost an associate here just a couple of weeks ago, only 34 with no underlying health conditions. It sucks.

But I think that my view, based on sort of America's kind of shaky response to this, that I think the fall could be squarely and I think people coming on. So I look at saying, I'm not sure the behavior of next spring is going to be a ton different than it is -- it has been this year. And I think that in some weird unfortunately way benefits us, Eric. As we look -- so we are doing tremendous amount of work and the work we're doing with the [ intermedia ], and we've reconfigured our marketing teams and our sort of advertising efforts. And that's broad when I say advertising, it's more communications.

They have like unlimited ability to really do what it takes to keep those consumers. And then I know the retailers want to do the same thing. And our online and direct businesses also continues to sort of do well. I think what drives us is that '22 is going to be the interesting year. That's kind of where we're getting to is that I think everybody is hopeful that this is behind us in the '22 season.

But I think the '21 season is kind of setting up okay for us. But the major focus is going to be on retention of those customers. And they really don't have a budget to do that. I think we -- the work we did this year was very much in the moment. Meaning, just think about how we the level of content, I would say, you're dealing with probably tens of thousands of pieces of content that were produced. A lot of that was done where we couldn't get talent. We had to use sort of stock footage for imagery. It was all done overnight, meaning we say we got to do something here, and it would be done sort of overnight where these creative teams were working through the night to produce stuff that we could run kind of the next day.

I think that's going to be easier for us, but we were just kind of learning this s\*\*\*. Look, I'm speaking aspirationally a little bit, but I was not a big believer in sort of digital, up till now. I think that it's kind of everything right now, and that's not because we're -- I don't think we're doing it stupidly, but I think we can do it so much better. And I think we have a great partner with [indiscernible]. And our teams are really organized around it. Randy is a believer, Mike is a believer. And so I'm hopeful that when we have this conversation next year, we can say to you that not only we retain that group, but we've also gotten to sell more, and we didn't lose sales because we couldn't deliver.



And Hawthorne is better than high-single digits. So that's what I'm hopeful for. But I think we've got a lot to show the sort of the community of consumer goods that we're engaged in sort of a new approach to how we market our products in a way that lawn and gardening really works well for.

**Thomas Randal Coleman**

*Executive VP & CFO*

Eric, I'd add, we know who the consumers are, and we're targeting them directly. And we're not being cheap, so we're spending lots of dough to get after it. But even beyond the social media, we recently developed a new TV spot that we're in for the first time and the first baseball game that was played last week pretty quickly after the game started in. It runs for a while. But if you watch that, and if that doesn't look an a emotional response from people, people pulled harder because it really goes to what we're trying to do, which is more focused on lifestyle and people with their family in the yards, and I thought it was terrific.

**James S. Hagedorn**

*CEO & Chairman of the Board*

We're seeing more people [ lean ] in, in the fall and gardening. They're looking for the second harvest. Their AeroGarden is tremendously up. We see that momentum of a 365. And then a lot of people are moving out of the cities into the suburbs, which is a huge opportunity for lawn and garden. So I think those trends, we got to capitalize on it. That's where how good we are at that will be the determining factor.

**Eric Bosshard**

*Cleveland Research Company*

Okay. And then just a follow-up. You sounded optimistic about price next year. I'm curious if there's any challenge to that in a year where it sounds like your home centers lost share this year, and they're going to want to drive traffic. Can you sort of square those 2 points that your price can go up and it sounds like their price is going to go down?

And I understand maybe the opposite happened this year. But curious how you think about that?

**James S. Hagedorn**

*CEO & Chairman of the Board*

What do I think? We want pricing. And -- but it's a fight this year to be transparent. And I think for pretty reasonable -- there are retailers out there. Some of the biggest retailers in the world who would say, dude, all kinds of unemployment, you guys are making money like crazy, your numbers are stupid good. Really, you want pricing? But we've got a lot to do to drive comp numbers. And so do they.

So we also view it as -- to some extent, unbalanced because of the real lack of promotion, the effect it's had not really on our margins, but on their margins, that I don't think -- because if you look at the consumer price, the consumer price is probably up 10%. I don't know, something like that this year. And we don't think it's crazy to look for 100, 200 basis points of pricing. But there's definitely resistance out there. We will achieve our pricing, but it's, I think, requiring, Mike and I to make visits personally to sort of explain what we're trying to do and the challenge of comping this year, which, again, doesn't -- I don't want anybody to think. I don't think it can be done. But I do think that it is a tall order. And I think we know what to do.

And that means that we're going to continue to invest in the business to be a better vendor to have satisfaction rates that are higher and to invest the money in our brands, which is really -- I'll just repeat something that Randy sort of grabbed me at the end of a budget session like 3 years ago and said, dude, why are we putting so much money in promotion and so much less money into our marketing efforts, and that doesn't seem to me to go to the strength of our brands.

And so I think Randy was right, and we're trying to convince retailers that this is right, too. It's not an environment where they are just like completely the open minded to us demanding pricing, even though I think we really helped the industry this year.

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Mike, anything you want to add on that?

**Michael C. Lukemire**

*President & COO*

No, I think it's -- each one is a discussion and battle to try to get to the right spot for...

**James S. Hagedorn**

*CEO & Chairman of the Board*

But we were being successful, Eric, in getting the pricing. It's just -- it's requiring us to talk personally to top it up.

**James D. King**

*Chief Communications Officer, Executive VP & President of The Scotts Miracle-Gro Foundation*

And Steven, we're going to wrap up at this point. I know there are several people who are in the queue that we didn't get to. So feel free to reach out to me directly, (937) 578-5622. Otherwise, our next planned public communication is tentatively scheduled for November 4, when we'll be sharing our full year results and a more detailed outlook for 2021.

Thanks for joining us. Have a great day, everybody.

**Operator**

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

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