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SMG - Q3 2017 Scotts Miracle-Gro Co Earnings Call

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OVERVIEW:

Co. reported 3Q17 adjusted net income of $158m or $2.63 per share.

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PRESENTATION

Operator

Good day, and welcome to the 2017 third quarter earnings conference call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Jim King. Please go ahead.

Jim King - *The Scotts Miracle-Gro Company - Chief Communications Officer and SVP of IR & Corporate Affairs*

Thank you, Jennifer. Good morning, everyone, and welcome to the Scotts Miracle-Gro Third Quarter Conference Call. With me this morning in Marysville, Ohio is our Chairman and CEO, Jim Hagedorn; our CFO, Randy Coleman; and also joining us for the Q&A session is Mike Lukemire, our President and Chief Operating Officer. In a moment, Jim and Randy will share some brief prepared remarks. Afterwards, we'll open the call for your questions. In the interest of time, we ask that you keep to one question and one follow-up. I've already scheduled time with many of you later in the day to fill in the gaps and anyone else who needs some Q&A time afterwards can call me directly at (937) 578-5622.

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 today. Investors should familiarize themselves with a full range of risk factors that could impact our results. Those are filed 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I also want to remind everyone that today's call is being recorded and an archived version of the call will be available on our website.

With that, let's get things started, and I'll turn the call over to Jim Hagedorn.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Thanks, Jim. Good morning, everyone. As I'm sure most of you know by now, we reported strong third quarter results this morning. And as we begin to wind down our efforts for 2017 and move into full planning mode for next season, I want to kick off my remarks by stressing that I remain extremely pleased with how we're executing our strategy. While I'm pleased, I also know it's not been a perfect year. There aren't many things I'd do differently, but there have been some key learnings from this year that will make us stronger going forward. As you saw in June, we revised our original guidance downward due to the combination of a late start of the season and disappointing results in the mass retail channel. I'm confident we could have overcome either one of those challenges individually, but not both of them. I want to stress, however, there are a lot of good stories in our U.S. core business, if you look behind the numbers, and I'll elaborate on that in a bit.

I'll also elaborate on the progress we're making with Hawthorne. As we wind down the major M&A phase for Hawthorne, we're stepping up our focus on integration. The goals are simple. First, to become the best supplier of hydroponic growing products in the world to both the consumer and professional markets. And, second, to leverage the financial synergies that exist within our portfolio to further improve our profitability while also investing to drive long-term growth.

On a company-wide basis, we're also progressing on our commitment to improve our cash flow. Entering the year, we told you we expect to deliver at least $300 million of operating cash flow. We not only continue to feel comfortable with that number, but we're tracking to over-deliver. And finally, we expect to close on the sale of our international business later in the quarter. Once that deal is done, our operating margins will have improved more than 400 basis points in just 2 years. And I can't just move on from that point without saying more.

2 years ago, when we announced Project Focus, we outlined a clear plan that we believe would drive shareholder value. From there, we just put our heads down, and we did what we told you we would do. Many of you listening today, most of you, I hope, have benefited from the roughly 50% shareholder returns since we announced Project Focus.

As I said on the last call, we're moving into the next phase of this plan. The headline grabbing reconfiguration of our company is mostly behind us. Our job now is to create consistent double-digit shareholder returns by generating 3% to 4% organic sales growth per year, getting operating leverage out of the P&L, using our cash to repurchase shares as well as fund well-priced bolt-on acquisitions and paying a solid dividend to our shareholders.

With that broad context, let me shift gears and provide more details on the results we announced this morning. I want to start with Hawthorne. It's hard to see the actual results because Hawthorne is still categorized as Other and won't be its own segment until Q4. But if it were its own segment today, you'd see sales growth of 146% in the quarter and 160% year-to-date. Obviously, the impact of the Gavita and Botanicare acquisitions are driving those numbers. But if you assume we owned both Botanicare and Gavita a year ago, we would have had sales growth of 21% in the quarter and 15% year-to-date. And the profitability of the business is ahead of plan so far this year, providing some relief to the corporation from the shortfall we expect in the U.S. core.

Late in the third quarter, Hawthorne acquired a lighting company called Agrolux. This transaction broadens our offering and allows us to compete more effectively with the mid-tier product in addition to our industry-leading Gavita brand. There are still a couple of potential deals in the pipeline, one we hope to have in place within a few weeks and one that will likely take a couple of months longer. From there, I'd say the product portfolio will be in pretty good shape. We'll probably continue to explore tuck-in deals here and there, but we'll have most of what we need.

It's not just the continued growth curve that has us so encouraged about Hawthorne. We're now moving into an integration phase that will help improve the profitability of the business. Remember, the individual companies we purchased already had about a 20% operating margin. However, the gross margins were roughly 500 basis points below our corporate average, and we see a clear pathway to improve. For example, nearly the entire Hawthorne portfolio is currently sold through a 2-step distribution model. There is no doubt we have some room for improvement here, which is prompting us to take a deep look at how to create a better model to drive our growth, while better supporting our retail partners and the professional users of our product. It's important to understand that this will not be a quick fix, rather something that evolves over time.

For Hawthorne, taking costs out of the system will do 3 things. First, some of that savings will drop to the bottom line, creating an even higher level of profitability. Second, it would create a bigger pool of dollars for R&D, marketing and other initiatives that will keep Hawthorne on the leading edge of the industry. And third, it will allow us to develop a more flexible and creative pricing and trade programs that will benefit consumers and our retail partners in a way that helps us maintain a loyal customer base.

As we approach our third year on hydroponics, I think we're in a great place. I want to tip my hat to Chris Hagedorn and Ross Haley and the entire team at Hawthorne. They're doing a great job driving the business and navigating what has been an ever-changing industry landscape.

With that, let's shift over to the core business, which requires a fair amount of explanation to fully understand our performance this season. U.S. consumer sales in the quarter were up 5%, but were still down 2% on a year-to-date basis. But if you pull the numbers back, there are more good stories than you think. So let me give you that context. The most important place to start is consumer purchases or POS. It's important to remember that about 2/3 of consumer purchases occur in home centers and hardware stores and only about 12% occur at mass retail. The balance occur in independent retail channels where we don't get POS data.

Across the company, POS of our branded products, this excludes mulch, is up 1% when you look at home centers, hardware and mass retail on a combined basis. Home centers and the hardware on a stand-alone basis, however, are up nearly 4%. That means, unfortunately, that consumer purchases at mass retail are down mid-teens.

So if you look at our performance by product category only in home centers and hardware, you will see this year was not so bad. In those channels, every major product category is in positive territory year-to-date, ranging from a 2% increase in lawn fertilizer, 14% in grass seed, 13% in controls, 12% in Tomcat and 2% in soils. This is true even though the season was pushed out as much as a month in parts of the Midwest and Northeast. Unfortunately, each of the categories I just mentioned is down at mass retail so far this year, most of them double digits due to tighter inventory controls and a bigger focus on private label.

Those of you who read our SEC filings know that lawn and garden sales have been shifting out of mass retail to home centers and hardware for several years. I want to be clear on 2 fronts. First, we are not seeing a shift to private label in home centers, hardware or garden centers. In fact, our brands have gained share in those channels over time. And second, we remain committed to our partners in mass retail and stand ready as the industry leader to help them win in lawn and garden based on the strategy they choose. Clearly, the burden is on us to fully exploit the opportunities that exist with our partners in all channels of retail.

Beyond the broad POS and channel stores, there are a couple of other highlights we're sharing. First, one of the other challenges to the top line this year was mulch, where we lost volume after taking pricing. This definitely impacted the ability of retailers to use mulch to drive consumers into their stores and is likely a decision we will reverse next year. I know Randy plans to elaborate more on this in a few moments, so I'll leave the rest to him.

Second, our new Roundup for lawns product has been a solid success. We expect sales of roughly $40 million, which would be in line with our original target. Retailer support has been strong all season and consumer reviews of the product have been very encouraging. In the traditional Roundup business, consumer purchases in the Midwest and Northeast were more or less in line with the rest of the business. However, we saw our best results on the West Coast, including California, despite some negative PR related to the active ingredient in the traditional Roundup product. While this is an issue that we're watching closely, so far we've not seen a material impact on the business.

And third, we have seen some really nice trends lately with Bonnie. On our Q2 call in early May, we told you Bonnie was having a slow start due to weather in the Northeast. Bonnie's business was up about 20% in June and July against double-digit comp from those same months the year before. This included a 40% increase in herb sales. We've also seen great progress in areas where we've been innovating with Bonnie, premium product lines, like larger-sized items and projects like salsa gardens.

As I look out for the remainder of the season, I feel good about our plans and our numbers. In fact, I want to reinforce that we are reaffirming our revised guidance this morning. We've seen positive trends over the past month and have made up ground on our year-to-date POS numbers. Retailer inventory levels are in good shape, and we have good support in place for our fall programs. I'll let Randy elaborate on the details, but we're seeing nice margin improvement again this year, good control over SG&A and a disciplined approach to managing working capital that should allow us to see a material improvement in cash flow. Said another way and to come full circle where I started, I am encouraged by the way we're executing the business and remain extremely optimistic about the long-term opportunities to drive shareholder value.

After our last call, the stock price fell pretty sharply as many investors reacted negatively to the slow start of the season. We were buyers. In the early weeks of May, we took advantage of the pullback and quickly bought $50 million worth of our shares, a level of repurchase that was largely incremental to our repurchase plans at that time. When I think about our strategy and when I look at the ability to create value over the next 3, 5 or even 10 years, I want to acquire more of our company and that's the plan. We're not providing guidance this morning for 2018, but I will tell you that I'm encouraged by the plans that are coming together. As we finish up the line review process with our retailers, we're encouraged by the continued support we expect to see next year. Additionally, we think 2018 will be one of our best innovation years in quite a while.

2018 will also mark an important historical milestone for the Scotts Miracle-Gro Company as we celebrate our 150th anniversary. For those of you who don't know, I'm only the 8th CEO in the history of this company. So thinking and behaving long-term is in our DNA and long-term thinking is what Project Focus is all about.

We've embraced the reality that growth in our core business is challenging and saw evidence again -- that again this year. And that's exactly why we invest in areas like live goods, like rodenticides and like hydroponics. Our investments in these businesses all came at reasonable prices and are delivering what we expected and then some. These are also businesses that are complementary to our core strengths and allowing us to continue to grow. We've also embraced the belief that future value will be driven largely by cash flow. We're executing extremely well against our cash flow goals this year, even with lower top line growth than we expected. This is somewhat of a cultural change for us, but one that has taken hold. We have clearly aligned management incentives against the strategy that requires a higher level of cash flow productivity. So I remain extremely optimistic about where we're headed.

I look forward to your questions, but for now let me turn the call over to Randy to cover the numbers.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Thank you, Jim, and good morning, everyone. Our results for the quarter are pretty straightforward as is the path for the updated guidance we provided in June. So I want to pretty quickly walk through the P&L with you and then share some other high-level thoughts.

Along the way, I'll share a few early thoughts about how things are shaping up in planning for 2018. But I want to be clear that we are not providing 2018 guidance at this time. As it relates to 2017 guidance, I share Jim's confidence on the revised ranges we provided. As I will describe in a few moments we've had another minor challenge thrown at us in recent weeks related to our JV with TruGreen, but it should not impact our ability to hit our revised EPS range. With that, let me walk you through the P&L.

Jim covered the top line results pretty thoroughly. So I'll just state that 5% growth in the U.S. quarter -- in the quarter was driven mostly by initial sell in as well as solid replenishment in most channels of retail after a slow start to the season. Year-to-date sales are still down 2% due to the reasons Jim outlined during his remarks. The European consumer business was down 3% in the quarter and 6% year-to-date, largely due to FX. And as Jim said, the Other segment is mostly a Hawthorne story with both the positive impact of acquisitions and organic volume growth that continues to be in the high teens.

Year-to-date, company-wide sales are up 4%, a level of growth that is in line with our revised full year guidance. Gross margin remains an extremely good story for us, with our margin rate up 250 basis points in the quarter and 100 basis points year-to-date. Benefit from pricing and reduced trade expense have been essentially offset by acquisitions. And lower commodity costs for the most part have been offset by negative conversion costs that were impacted by lower-than-expected volume.

What then rises to the top is a benefit from product mix. The introduction of our new Roundup for lawns products was nicely accretive to margins, is an example of innovation that only Scotts Miracle-Gro can bring to the industry. We delivered a new solution to the consumer and expanded offerings for the retailer and successfully leveraged the value of the Roundup brand. Another piece of good news from a mix perspective has been the relative strength of our high-margin fertilizer business. POS is in line with our total POS this year, eliminating our product mix headwind that we've seen in many recent years. Also we saw higher percentage of gardeners choose our potting mix products this year, a trade-up from the lower margin garden soils.

Finally, our gross margin rate benefited from the decline in mulch volume that Jim mentioned a few minutes ago. Jim also said earlier that if we had to start the year over again, there probably wouldn't be many things we would do differently. While I agree, I would also say mulch pricing may be that one thing we would change. The trade-off between volume and margin on mulch this year was a push in terms of gross profit dollars. This is a critical category for both Scotts and our retail partners in driving store traffic and consumer engagement. So I would expect us to reverse that decision next year. That said, we remain committed to improving our margins in this business over time through continued supply chain improvement as well as innovation.

But for 2017, all these factors will likely mean we finish the year on the high end of our guidance range for gross margin rate improvement. But as I look into next year, maintaining this year's rate will not be easy. In addition to mulch pricing, commodity costs still look like a slight headwind, maybe worth $0.05 or $0.10 of EPS, based on today's market prices. Those costs have been trending favorably in recent months, however. So, hopefully, it will be able a better outcome than that.

Also you heard me say a moment ago that lower trade program expense benefited the margin rate this year. That was not planned but came our way because certain volume rebates were not earned this year by some of our retail partners. Our assumption entering 2018 is that normal volume levels result in higher trade program expense next year. So the related rate benefit we saw this year will likely reverse. We're still finishing up our budgeting process for next year, so I can't be more specific at this point. But I wanted these issues to be on your radar for when I provide more details during our year-end call in November.

Getting back to the quarter, SG&A remains a good story. While we are up 13% in the quarter, that is primarily a function of acquisitions in the timing of year-over-year accruals for variable pay. On a year-to-date basis, however, we're up only 5%, and the vast majority of the increase is coming from acquisitions and some start-up costs related to a few small corporate initiatives. For example, implementing SAP for Hawthorne acquisition.

My assessment is that we're staying extremely disciplined with SG&A. We have significantly increased our support of Hawthorne, but we're doing so without putting any real pressure on the total company P&L. So this is a story we can be proud of.

Income from continuing operations in the quarter was $231 million compared with $197 million. On an adjusted basis, it was $240 million versus $208 million. Year-to-date income from continuing operations on a reported basis is $388 million, down from $424 million. However, those results include expenses incurred as a part of our pending international sale as well as both restructuring and noncash amortization costs at TruGreen and also insurance reimbursements related to the Bonus S matter. Excluding all of those factors, the number is $413 million year-to-date versus $404 million a year ago.

Speaking of TruGreen, let me move to the equity income line. It's a benefit of $7 million in the quarter on a GAAP basis and $12 million on an adjusted basis. Year-to-date, we're showing a loss on that line of $30 million on a GAAP basis and $13 million on an adjusted basis. Last year, the full year net benefit from TruGreen was $5 million, which we expected to be flat entering the year. You'll recall in February, at our Analyst Day event, we revised that outlook and expected the benefit to be 0 for the full year. However, we had other offsets at that time that made it neutral to our guidance.

As our own business saw some challenges at the break of our season, so did TruGreen. In recent weeks, they've adjusted their outlook. We now expect to lose roughly $5 million to $7 million on the equity income line for the full year, which equates to about $0.05 of EPS. At this late stage of our fiscal year, there is little time to respond. But, as I said earlier, it should not impact our ability to fall within our revised range. What I don't want to do is lose sight of the great progress we're making with TruGreen. When we contributed Scotts LawnService to a JV with TruGreen in April last year, the 2 business had EBITDA combined of about $120 million. At the end of the first year, that number had improved to $150 million. And at the end of this year, we expect EBITDA to increase significantly once again. The cost synergies we expected are on track to be realized and restructuring of the business is largely behind us. While there have been a few operational hiccups here and there, the overall performance has been solid given the complexity of putting these 2 business together.

I continue to believe this was an outstanding transaction for us. I would encourage investors to remember there's a significant amount of value that is locked up in our 30% ownership of this business, value that we believe we can realize in a very tangible way at the right time.

In the meantime, as announced yesterday, TruGreen is planning to relever the business at a better interest rate than we have under the current capital structure and then issue a dividend to shareholders. Our share of the dividend would be almost $90 million under current planning assumptions. Assuming TruGreen's recapitalization is successful, we'll have received about $290 million to date while still maintaining our 30% share of the enterprise.

Back to our P&L. Interest expense was up $5 million in the quarter and nearly $7 million year-to-date reflecting higher borrowing levels. However, our leverage ratio on a rolling 4 quarter basis stood at only 3.0x at the end of the quarter. We're still half a turn of leverage below our target, which gives us plenty of flexibility to fund some tuck-in acquisitions or to return more cash to shareholders. When we take everything down to the bottom line, adjusted net income was $158 million in the quarter or $2.63 per share. That compares with $134 million or $2.16 per share last year. Year-to-date, adjusted net income of $269 million translates to $4.44 per share and that compares with $251 million or $4.04 per share last year. Obviously, these numbers suggest we'll report a greater year-over-year loss in Q4 in order to fall into our guidance range. Other than equity income, the real potential headwind for the balance of the year will be volume. I expect we'll continue to see nice improvement on the gross margin line as well as strong expense control. So the quality of the earnings will be solid.

As Jim already said, we were opportunistic in May when the stock price fell after our last call. We quickly acquired over $50 million worth of shares, and I now expect our repurchase activities for the full year could be as high as $275 million. I would expect repurchases of at least a similar amount next year as well, and would expect to return an additional $125 million to shareholders through quarterly dividend payments.

Speaking of our dividends, our Board of Directors just this morning approved a 6% increase on our quarterly dividend to $0.53 per share or $2.12 on an annualized basis. Part of what's enabling those activities is the strong improvement we're seeing in cash flow. I said earlier in the year that operating cash flow would exceed $300 million. In fact, free cash flow may actually approach that number this year. At the end of Q3, inventory was essentially flat on a year-over-year basis and this includes the impact of acquisitions. We remain on target to reduce working capital by roughly $30 million in the core business this year even with lower-than-expected sales. In the years ahead, I continue to believe we can take out another $60 million to $70 million of working capital. Jim mentioned earlier that we're beginning to focus more intently on cash flow productivity as a key financial metric, so let me elaborate.

When I look at our performance versus our peer group on this front, we are lagging. In 2016, we finished in the bottom quartile of our consumer product peers with cash flow productivity of about 75%. This year, I would expect that number to easily surpass 100%. That's my goal for next year as well. From there, we need to track closer to 90% to 100% every year. I share Jim's goal of driving for a double-digit shareholder return every year. In the current growth environment, that will require continued repurchase of our shares and that, obviously, means staying focused on cash. Whether it's cash flow or the operating margin improvement that Jim referenced in his remarks, we continue to make good progress on the key financial metrics that we're tracking. So I'm convinced we're doing all the right things to drive shareholder value. I would call 2017 a solid year, one impacted by unanticipated issues and not from poor execution. In fact, I tip my hat to the entire team here for the way we've managed through some of the challenges that were thrown our way.

With that, let me open the call for your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). And we'll go to Jon Andersen from William Blair.

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

One question, bigger picture on point-of-sale season to date. Can you talk about kind of the all-in level of point-of-sale that you've seen season to date, not kind of channel-specific? And then with respect to the mass channel, more specifically, how are your kind of initial discussions going? And how are you thinking about that business relative to 2018 and beyond?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Sure. Jon, your first question about year-to-date POS. We finished June about 2% down in total, as we sit here today, August 1, August 2. We are a little bit better than that getting close to minus 1, but we've had a really strong July. And we think we're going to see the same kind of outlook as we look ahead to August and September with a strong finish. As related to Walmart, Luke's probably in a better shape to handle that question.

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

Well I think we're going to work with our strategy and balance of private label and what they're going to do for the season. And the discussions are happening as we speak. So I really don't want to get too far out ahead of what we're going to do.

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

Okay. The follow-up question is, and I know you're not giving guidance per se for '18 at this point. But when I think about the outlook for '17 and then introduce the sale of Europe, so you take kind of let's take the midpoint of the range $4.10, take $0.20 off that, we're kind of running at $3.90 base. And then, Randy, given your commentary around low single-digit growth in the core, more challenging perhaps year in 2018 to drive gross margin improvement over '17, how should we be thinking about -- it just seems like there may be a disconnect, if I kind of think about it that way, $3.90 is the earnings base post the sale of Europe, kind of low single-digit core top line growth and flattish gross margin next year. It seems that there's a bit of a disconnect with respect to Street expectations in '18 relative to how you've talked about the complexion of the business? Is that fair?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Let me try to set expectations just so there is more clarity around that. So I follow your math. Once we take out the earnings from Europe and Australia, that we'll be somewhere in the $3.90, $3.95 range, more than likely assuming the middle range of our guidance for '17, like you said. At that point, we think about the cash that we'll realize from the sale of Europe here, probably in the next 30 days or so. We'll be able to use that cash and essentially replace a lot of the lost earnings. So at that point, I'll call it pretty even. Also the dividend that we expect to receive on triggering will help fund some of these deals as well. So we will be in a really good positive cash position that we'll be able to be use to fund these deals.

In addition to that, we plan to continue repurchasing shares. And at this point, I expect that share repurchase amount to be, in addition to what we'd say, as far as replacing the international earnings. And then, again, like you said, the core business will likely have some gross margin challenges next year. I think we're feeling good about our top line outlook for next year. And we still have a lot of work to do as far as managing through the P&L, and we're actively in that planning mode for next year right now. But we will be more specific when we come back in a few months here. We'll provide more specificity around each line of the P&L. But we're feeling good about 2018 as well. And we're really proud of the progress we've made over the last 5 years here in driving EPS growth every year.

Operator

And we'll go next to Jason Rodgers from Great Lakes Review.

Jason Andrew Rodgers - *Great Lakes Review - VP*

It was good to see the acceleration at Hawthorne for the quarter. Was there any especially large deals that drove that?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

When we pull apart the numbers, just on an organic apples-to-apples basis, we were up very solidly year-over-year. When you look at the deals that were consummated, the Gavita deal, which is the largest individual business that we've purchased to date, is performing very strongly. But Botanicare and GH, which are -- are more in the liquid nutrients and other pieces of our hydroponics business, they're performing in the teens as well. So whether you look at it apples-to-apples or look at it with all the acquisitions rolled in, really strong performance. But we continue to expect more of the same, and we think we'll land in the mid- to high teens as we close out the year.

Jason Andrew Rodgers - *Great Lakes Review - VP*

And what should we expect as far as the tax rate for the fourth quarter and for fiscal '18?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Well, for the balance of this year, we started out with an effective tax rate about 35.5%. We've brought that down a little bit this year, just due to the mix of earnings across the globe. Gavita's strong earnings has helped that as well, being a lower tax rate overseas. And then looking ahead to, hopefully, 2018, we'll see a benefit from lower tax rates. It appears that the border adjustment tax notion seems to not be happening at this point. So we're optimistic that we'll see a big tax benefit on our rate, hopefully, as early as 2018.

Operator

We will go next to Jason Gere from KeyBanc.

Jason Matthew Gere - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

I guess I want to follow up maybe on just some of the inventory that you're seeing out there. Maybe if you could talk about DIY and the home center. When you saw kind of the better trends coming in, in June, July, I was just wondering if you could talk about the controls business. Obviously, I think you talked about -- you had some strength in there. How much of that is share gains coming from some of the new innovation with Roundup coming through? We've heard your competition talk a little bit about some of the delays into the fourth quarter. Are you seeing that as well? So just maybe if we could talk about maybe how the retailers are positioned for it? And maybe some of the trends you saw end of June and into July as well?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

So addressing your first question about retail inventory levels. So home centers are again more the same. So whether you look at them individually or in total, were about flat, maybe up a little bit, whether you're talking into June or into July. And I think we're well positioned to drive POS for the rest of the year. On the mass side, it is a bit of a different story. Retail inventories are down quite a bit. And that's been the case for the last few months. We don't expect continued reductions in retail inventory levels, at least on a percentage basis as we close out the year. And as Luke said, we're working actively with all our mass retailers to drive the business next year and embrace whatever strategy they want to employ so that we're working together with them.

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

I think home centers have stayed in the season and they're having good results. And as Jim talked about Bonnie and that growth, we're seeing the same thing in controls and other categories. We had a really good July. And so I don't really see so much a delay. It's really moving through the inventory and extending the season, and it's been so far good for us at home centers.

Jason Matthew Gere - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Okay, great. And then the second question I guess, just on the Hawthorne margin. Obviously, it's low double-digit now, but the potential there, it sounds like as you make some of these acquisitions and you're making the investments. What do you think is a realistic time frame? Are we thinking 2 years down the road that it could get closer to the corporate? I mean I guess what the pro forma corporate average will be once Europe is out of there. So how should we think about the cadence, I guess, of Hawthorne's kind of margins improving over the next couple of years, like quickly or just kind of like more reinvestment that it will gradually get there as you build scale?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Jason, this is Randy again. So when it comes to the supply chain, I think it will be more gradual. But the numbers are going to be big. When you think about SG&A and optimizing all the businesses, I think we're starting some of that work, but it's a little bit further down the road as well. But I think in the immediate future just thinking about 2018, the deals that we've consummated to date and that we plan to complete over the next couple of months here, they will be very accretive to our operating margin rate. So for 2018, I'd expect us to make several hundred basis points improvement. Over time, I think that business should be in par with our U.S. consumer business. But that's probably a few years down the road.

And then again, a lot of the investments we've made upfront here in 2017, some of those will roll off next year as well, for example, the implementation of SAP and some of the start-ups related to that. So big improvement over time. I'd say 8% to 10% improvement by the time we're done from where we are today.

Jason Matthew Gere - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Okay. Great. And Randy, just if I missed the housekeeping. Did you say where interest expense would be for the year? Just, I know it came a little bit higher and, obviously, you've had some acquisitions. But what should be the range we think about for this year and maybe for next year?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Yes. So interest expense, we're coming in favorable versus our initial expectations. So our borrowing levels are higher year-over-year. We'll see continued increase in the fourth quarter. But we're really pleased with the way we're managing our capital structure. And looking ahead to next year as well, we'll continue to see some increase in interest as we borrow more money and -- to fund some of the repurchases and some of the deals. But we're really pleased with not only the share repurchase levels, but also this unexpected to a degree inflow of cash that we will get from the TruGreen dividend is going to help us quite a bit as well. And then total interest expense for the year, Jason, is going to be about $80 million.

Operator

We will go next to Chris Carey from Bank of America Merrill Lynch.

Christopher Michael Carey - *BofA Merrill Lynch, Research Division - Research Analyst*

So just sticking on Hawthorne, it was a pretty solid quarter. I mean, what are your main priorities for that business, as you think about sustaining or even accelerating growth, especially as you turn to the core portfolio once some of these deals are completed? And how you think about leveraging your current distribution network to expand distribution into additional channels?

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

All right. So it's my first answer.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

All right, Jim.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Look I would say if you look at sort of the case that Mike Porter wrote called Scotts North America and you call this Hawthorne hydroponics, I think it's pretty much the same story. So if you look at kind of what we're up to, I think we're really kind of playing the same storyline that we did with Scotts, put together the market-leading brands and then consolidating and call it one face to the customer. And I think that -- if you say, "What is the power of Hawthorne?" it is not just that we've bought a bunch of good brands with good P&Ls, it's converting that into the best supplier to a professional industry that I think has ever been seen, at least in this space.

And I think we know how to do that. We -- remember, we did this with our professional horticulture business, and we've done it with our Scotts business. But to be a sort of great partner to people who use these products. And that means that you're putting the whole line together, you're tying it together with a single sales force, single billing, of technical. This is a very technical business. So tie it together with a technical support system that is both in the field and at the headquarters level. So that we just become this fabulous vendor, innovate.

I think Randy talked about kind of what he views as the aspirations, and I agree with that, from a margin point of view is that, we think we can take money out of the system, tie these brands together as a leading vendor, maybe the leading vendor in the space, and put it together with a tech support line on the professional side, that is I think extremely necessary in this space that's still fairly undeveloped from sort of a PhD and Masters level support side on the technical side.

So -- and I think we're doing a lot of work to get ready for that. And I think we're seeing sort of major steps forward particularly in Canada where we're starting to act as sort of one company, and we're seeing a very positive reaction from the user community up there for that. I think within that, part of your question, is I think we're looking at the sort of layers of distribution that occur within that space between us and the ultimate user and that's something we're going to continue to focus on and look to make it the best for us and the user, while still maintaining relationships with our distribution partners. So I think that this is one area that is pretty sensitive. But I think there's room for efficiency gains in distribution as well, which we are planning on. Mike, I don't know if you would add anything.

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

No, I think that's pretty clear.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

So it's really exciting to see the progress they're doing. Like -- I think at Hawthorne, they've got about half their business now through SAP. And SAP is not for the faint of heart, I think you don't hear the sort of crazy blowups that you used to hear back when people were putting enterprise systems in. But for a group of sort of young people who aren't used to this sort of level of sort of technical financial reporting, having these businesses get successfully through these SAP implementations, I think just tells you something about the -- how quickly this group of people are maturing as managers. It's -- and I think Randy spoke about how we're supporting it. We've built a what we call soft team here at Scotts that's run by a guy named Mike Hoover. And that does our strategic planning. It does our M&A work, and it also does, what I call, bandwidth support.

And if we want to run our businesses pretty skinny, there are times where they can outrun their ability to support themselves. And generally in the past, we would have gone out for consulting help when we did that. When we resized the company a couple of years ago, we kept sort of the best of our young folks, put them in Mike's unit and they've been providing sort of without adding any incremental consulting cost support to Chris' team. And that has been really helpful. And I have to be complimentary of Chris' boss. But I would say that Mike has been an excellent leader for Chris and the Hawthorne team, as he's integrated them into his operating team.

So I -- what do I think? I think it's all going pretty darn well. I am sure they're going to stub their toe at some point. But they've done a pretty good job so far. And so I'm actually really encouraged about -- I think we have a board meeting on Thursday and Friday of this week up in Vermont. And Chris will be presenting again sort of changes since our January meeting of the strategy. And we mentioned in the scripts that it's kind of a changing landscape. And so I think they're adapting well to that, and I really look forward to what Chris is going to be presenting to us.

And I'm very thankful of what I've seen so far and sort of Mike's work sort of -- but what they don't seem like anymore is kids. They definitely seem more like grown. I know -- listen, listen, this may sound like, of course, "You've invested hundreds of millions of dollars, wouldn't you expect." But it is kind of a business that's been really scattered and very -- depending on the businesses, less disciplined than others on sort of the finances. So for them to have gotten where they've gotten to and have a strategic plan, that I think they know where they're going, is pretty impressive for -- I think it gives me faith in young people, I should say.

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

No. I like the distribution plan, and what they've come up with sales, and they're on the beginning of a journey. And since I've been through a lot of this before with Jim, I'm pretty confident we're going to get there. So -- but they're progressing along.

Christopher Michael Carey - *BofA Merrill Lynch, Research Division - Research Analyst*

Got it. I really appreciate the comprehensive answer. If I could squeeze in one follow-up. Just on the mass channel. This is something we're seeing more pressure on price inventory across a number of consumer categories, but it does feel like lawn and garden is a bit more pressured. I know you're still putting together the fiscal '18 plan, but why wouldn't this level of magnitude -- this magnitude of decline be a bit more lasting? Because it seems like it has worsened for a number of categories in 2017, specifically.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Listen, we -- first of all, we have teams in Bentonville right now. So I do not want to piss anybody off in Bentonville on the customer side and throw my own folks or Mike's folks under the bus. We are, I think, pretty active with call it our colleagues in the space. And these are the other well-known brand, consumer companies. And I think -- actually, I think because -- to us, mass is less of a percent of our total sales we are actually in better shape than they are. I'm not going to sort of attempt to sort of understand really to be honest their strategy.

It's their strategy, it's not mine, it's not ours. We need to live with it. And who knows if it will be successful. I got to say that. I haven't seen it before. But it's possible that this will be, for them, a successful strategy, and we want to play with them in that. And that -- it's good for us. And we will play, and we'll play hard to win and help them win because that's kind of our job. I would say, I'm not sure in my advice to my team to say, "Oh, everything's going to better tomorrow" in regard to masses' commitment to lawn and garden. So let me just circle back for a second. People we're talking to have it worse than us, not better, okay?

We are seeing, I think, pretty good results over the summer, the only issue is it's not going to get much better. They tend to have a shorter season because they're not as committed into the fall as sort of DIY and hardware is. But I think we did see pretty decent recovery during the late spring and early summer with mass. So -- but what do I think? I think right now they're going to continue on this approach, and my encouragement to Mike and the team is to look at all of our, and I think I made this comment and it was on purpose, all of our opportunities for distribution to consumers. And I think we're seeing accounts that are growing very well, and we want to continue to support them. And we will continue to wholeheartedly support Walmart. But I think we've got to -- if we're not going to say this is over, then we've got to do what we've done in other parts of our business.

If you look at live goods, why did we get involved in live goods? Because it's growing 2 or 3x what our core is. Why did we get into hydro? Because it's growing like 5x what our core is. Why did we get into rodenticides? Because it's growing like 2x what our core is. So I think if we look at channel, we've got to also invest behind channels that are growing above average. And there are plenty of them. So I think what it means is, I don't think we're the ones that are going to change Walmart's strategy. I think Walmart defines what it is and it's up to us to play along with that, and I -- and we'll do that happily, okay. But I think we will also be looking to invest in channels of trade that are growing faster than average, and we will also happily do that, okay.

So we're pretty agnostic to where growth is. We believe there is growth. I think that our view on the core -- and this gets to the point of I think we'd look at kind of, I would say, 0 to 4% on the core. And so call it notionally 2%, and I think we don't feel particularly challenged doing that. But I think -- and I think, we're being realistic in embracing our reality on mass as well. So it's not like we're saying, "Everything is going to be wonderful tomorrow." So I think that answers the question. I hope it does.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

And Chris, let me add a little bit more to what Jim said. The issue with mass is not a one-year phenomenon. So we've seen a shift by consumers away from mass towards home centers and hardware and independents for several years. And we've been managing through that successfully for a long period of time. This year, it's a bit larger than years past, and it's bit more of a surprise. But I would say we've -- this is not something new to us, and we'll continue to manage through it.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

And listen, it's probably not quite as bad as it sounds. I mean there were definitely some inventory issues. I would also say remember that mass, just in general, has got a more truncated season. And so they don't get quite the advantage of other retailers that stick into the -- because what are we seeing? And we haven't really talked about it, but I think we're seeing it for sure with our business and Bonnie's business is really like the best July we've ever seen, okay? And so for people who are basically looking to exit and get into back to school so early, I think it does mean that if you have kind of a bogus spring, the ability to recover from that will make this look a little worse. The inventory reduction will make it a little worse. And there were some commodity SKUs in our numbers on a sort of garden soil side that also made it look a little worse. So it's not like the end of the world. But it is definitely reflective of decisions that Walmart's made, and we'll -- we will and -- we'll continue to work with them on it.

Operator

And we'll go next to Joe Altobello from Raymond James.

Joseph Nicholas Altobello - *Raymond James & Associates, Inc., Research Division - MD and Senior Analyst*

So first question, I just wanted to go back on TruGreen and the issues there this spring. It sounds like it's mostly weather. I just want to make sure there was -- that, that was indeed the case and there was nothing on the execution front that impacted that business.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Weather in the Northeast Midwest, we've seen play out similar to what we've seen in our own business. So no real surprise there. I would say customer count is a bit of challenge just putting together both businesses. So that's something that we're having to manage through. But synergies are on track. The outlook for the year still is pretty good. Just yesterday CD&R with TruGreen announced the recapitalization, and we expect that to be successful as well. So lot of good news here. And I'm glad Mike and I are going to be there in a couple of weeks for the next board meeting, and we'll get the latest up-to-date news. But I think the outlook is bright.

Joseph Nicholas Altobello - *Raymond James & Associates, Inc., Research Division - MD and Senior Analyst*

Okay. That's helpful. And then just looking toward 2018 a little bit. I think Randy this morning you sort of strongly implied that there's going to be some margin pressures, obviously, next year. Should we model gross margins down next year at this point? Or do you think you could still see some expansion?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

I'd say it's too early to model anything that precise. But I think down slightly to up slightly is probably what we're thinking right now and kind of expecting gross margin in total to be flat. But still more work to do on that. We're not done with our planning. We've had a lot of supply chain savings initiatives that are in place. Commodities, we're hoping will still get a little bit better. Urea is a really good story for us right now. And we're in a pretty good position like we typically are at this point where we will be about 2/3 locked by the time we have our call -- our next earnings call in 3 or 4 months here. So I think we'll provide a lot more specific guidance at that point. But that's -- those are our thinking -- our thoughts right now.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Mike gave you a face when you said commodity pressure. Mike?

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

I'm pushing hard for it not to have pressure, but...

Joseph Nicholas Altobello - *Raymond James & Associates, Inc., Research Division - MD and Senior Analyst*

And just one last one, if I could, on Hawthorne. I guess if you look at the pro forma growth year-to-date, it's 21% -- or 15%. This quarter a little bit better than that. I mean do you guys see that business given what's gone on, on the legislative front, et cetera? Do you see that business accelerating next year?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

It's going to be a bit lumpy. If you recall back in our first quarter, we were below double digits and there was some concern that growth rates were slowing, and we explained it as there's some cyclicality as to whether it be ordering patterns from distributors or just the lumpy behavior of projects. And then we came out Q2, beat our numbers. Q3, the momentum is strong. So I'd expect more of the same when you go back to what we talked about in February when we were in Florida. We're expecting 15% as a normal run rate and that's still our outlook for next year at this point.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Joe, if I was to throw out, like -- and say, it's a 2-year horizon, I would say, yes, I expect acceleration. Because I think what we'll be doing is we'll be tying a product line together. We will have sort of looked carefully at our distribution model and our sort of go-to-market sort of call it orders to the cash. I think that in the short term, there's potential for disruption as we change our distribution model. And that's not a threat anybody in both ways. But what it says is that I agree with what Randy is saying, I think over a 2-year model, and I'm not concerned on the -- in the short-term by the way, on a 1-year side, I just think that any time you're changing things, you have the ability to sort of say, "I'm not totally sure how all that's going to work." But I think in the long-term, it's very much positive, because what it'll do is it will enable a one face to the customer and that's so important because it not only is funding innovation, it's funding your sort of tech support group and it's funding programs that really, I think, we called it loyalty to customers. But I think it gives us the kind of programs that just make us a valued supplier to professionals.

Operator

We will go next to Bill Chappell from SunTrust.

William Bates Chappell - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Just a few financial ones maybe to make it quick. Randy, you talked about $275 million of share repurchase next year, and you also talked about share repurchase and acquisitions offsetting the $0.20 dilution from the divestiture of Europe. So should we assume the $275 million, at maybe roughly $95, gets you part of the way there. And then the accretion from the acquisitions planned or already done gets the other $0.20. Is that the math I should be doing?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

When we last spoke about the dilution from Europe, we had combined both acquisitions and share repurchases. At this point because we're further through the pipeline and the acquisitions we were considering have come to bear, we have more confidence to say that those M&A deals combined should offset the impact from Europe and Australia coming out of our business. And then at that point, the share repurchase impact will be incremental to that.

William Bates Chappell - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

So you could actually grow EPS faster if we're factoring in kind of the share repurchase?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Yes, faster than we thought 3 months ago.

William Bates Chappell - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Okay. And then second, just, I know last year, I'll put it in roughly 1% price increase. Not sure, how much of that was driven by mulch pricing. But if the thought is you're going to roll that back to some extent, do you expect price increase in 2018 overall?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Yes. As far as 2017 price increase, the mulch piece was about 25% to 35% of that, when you just think about our U.S. consumer business. Next year, again, we're not done with our planning around pricing and trade programs for next year. But we do expect to take some pricing as we have most every year. Mulch's, obviously, been an offset to that. But at this point, we don't have our plans complete, and we'll have lot more details again in 3 months.

William Bates Chappell - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

But just to understand, are you rolling back the mulch price? Or you're going to have to have that headwind to overcome to get overall pricing?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Yes. So there will be a rollback and then on top of that, we'll have other pricing initiatives. And what we net out will be on a gross invoice pricing basis. We'll be no worse than flat just to think about new product pricing and existing product pricing and that reflects the impact of mulch.

William Bates Chappell - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Okay. And just last one just to make sure I understand kind of how you're viewing mass. I mean, are you assuming that the mass channel will continue to be down kind of high-single digit, low double digits for the foreseeable future as they shift away or change their plans, I mean, as you look to '18? Or is there something that you see now that -- I guess, looking back it's always been a disconnect between mass and the other channels. This was a bigger disconnect than we have seen, I think, ever. And so is it -- this is the new regime, new plan, and so you're going to have a double-digit decline of mass as kind of the go-forward rate?

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Look, I'll pick that up. The answer that Mike would give you would be a lot easier here than the answer I would give you. And it's not because I know more. In fact, Mike knows more. So I think, it's -- I think you're dealing with the season. I think they were late in Texas coming in. I mean, I think you're going to add a lot of stuff up and say you can probably explain half of that just by inventory reductions, soil lineup, Texas. I'll bet Mike, I'm pretty close on that. And so -- but I think it is new regime, new plan. My view is just embrace the reality, don't assume it's over and let's build our growth plans embracing the reality that this may be not the end. That said, as we've talked about this, and we talk about it a lot, it is a briefing item that Mike, I think has gotten 2.5 hours on, on Friday, which is channel, is I think Mike's view is it's a lesser number. I'm just trying to basically say let's be prepared, let's not be flat-footed on this and let's not try to overoptimistic. But I don't think we know what it is. I think if we have a normal season last year, we've been through the inventory change that's happened, I think it's likely to be way less than what we've seen this year. And as I said, their actual POS in the summer was -- or late spring, early summer is not bad.

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

I mean, I hate to say go back with anything. So my plan is to compete with their strategy and figure out ways to win. So -- but I'm prepared if it goes the other way as well. So -- but I'm going after that. The volume will come back and will lend in certain categories, sharpen our pencil and help them with the private label strategy. So we'll see what happens with that. So -- but we'll definitely be aggressive. So...

William Bates Chappell - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

And, Mike, just to follow up. So were you expecting the mass channel to be down at least high single digits this year anyways?

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

No, I was actually -- they were pushing us to go higher on volume. So I think the bigger surprise is how early they exited the season. And I think that's a result of having the severe markdowns from the previous year. That's -- I think their initiative with their supply chain is, you take inventory out and be in stock. So I don't think that's fair on their part. I think kudos to their supply chain to be able to do that. So I think they'll get out of stock, we'll supply. I'd say in the first part of the year they were participating pretty strongly and so -- and there were some things that -- listing that got changed or whatever. We're going to try to go win those. So -- but I mean I understand the strategy and what they're trying to do. And so I think there are some things we can do better. I think there's some adjustments from their part. Whether that's a destination for consumers ultimately, that will be totally up to them. But we'll certainly play as hard as we can in that channel and support them. So it's not a critique on what they're doing overall. It's what they're doing, you're seeing it across the board, does it work or not. And our mission is to try to be supportive of that.

Operator

And we'll go next to Jim Barrett from CL King & Associates.

James Richard Barrett - *CL King & Associates, Inc., Research Division - MD*

Randy, this is a question for you. The $90 million dividend from TruGreen, should I assume that it's going to funded by debt? And if so, could you talk about what the interest is on that debt? Whether it's nonrecourse? And whether -- and presumably, I would assume you are releveraging up the JV, and how does that affect your longer-term outlook on the JV? Is the plan to maintain it highly leveraged or is it to then deleverage?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Yes. So, Jim, back when we formed the joint venture, April last year, if you recall, the credit markets were in a bit of turmoil. So we weren't very happy with the rate at that point. We have made plans even at that point in time that fast-forward a year or 2 that we would likely go back and refinance. So this has been part of the thinking all along. So nothing new there. Interest rate will be about 150 bps -- 100 to 150 bps better than the existing rate. And if you recall as well, we loaned some money back to the JV along with a few others with a rate that -- in the high double -- low double digits. I believe about 12%, that we'll able to refinance that debt when we fast-forward about another year or so. Does it indicate in the long run that there is any change in plan? I'd say, no. And we're going to continue to execute the business, and as our EBITDA grows, we'll have a lot more options collectively to figure out what the next step's going to be.

Jim King - *The Scotts Miracle-Gro Company - Chief Communications Officer and SVP of IR & Corporate Affairs*

All right, Jennifer. I think that's all the questions we have this morning -- or time for this morning. So we appreciate everybody's time today. If there are follow-ups or gaps in things that we have not covered, feel free to give me a call later in the day. If I can't get you today, we'll make it work tomorrow. You can reach me at (937) 578-5622. Otherwise, thanks, everybody, for joining us, and we will talk to you again in early November when we announce our Q4 results. Thanks.

Operator

That does conclude today's conference. Thank you for your participation.
