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EDITED TRANSCRIPT

SMG - Q2 2018 Scotts Miracle-Gro Co Earnings Call

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Co. reported 2Q18 non-GAAP adjusted EPS of \$2.88.



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CORPORATE PARTICIPANTS

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

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

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

Thomas Randal Coleman *The Scotts Miracle-Gro Company - Executive VP & CFO*

CONFERENCE CALL PARTICIPANTS

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

Eric Bosshard *Cleveland Research Company - Co-Founder, CEO, Co-Director of Research & Senior Research Analyst*

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

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

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

PRESENTATION

Operator

Good day, and welcome to the Scotts Miracle-Gro 2018 Second Quarter Earnings Conference Call. Today's conference is being recorded. And at this time, I would 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, Savannah. Good morning, everyone, and welcome to our second quarter conference call. With me this morning in Marysville, Ohio is our Chairman and CEO, Jim Hagedorn; and our CFO, Randy Coleman. 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 prepared remarks, afterwards we'll open your call for questions. (Operator Instructions) I've already scheduled time with many of you later today to fill in the gaps. And anyone else who needs to set up some Q&A time, can call me directly at (937) 578-5622.

Before we start, I want to cover one quick housekeeping item related to our Investor Relations outreach. Randy and I will once again be participating in the William Blair Growth Conference in Chicago on June 13. As we have in the past, we'll use our presentation that day not just to cover our long-term strategy but to also update the investment community on our performance so far this year. In fact, we currently expect to provide an update that day on our fiscal 2018 guidance. We'll provide more details near the beginning of June on the logistics of this event.

With that, let's move on to today's call and as always, we expect to make forward-looking statements this morning, so I want to caution everyone that our actual results could differ materially from what we say. Investors should familiarize themselves with the full range of risk factors that impact -- 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 started, and I'll turn the call over to Jim Hagedorn.



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

Thanks, Jim. Good morning, everyone. I feel pretty crappy today, so hopefully I can get through the script.

We already shared our anticipated top line results for the quarter when we announced the Sunlight acquisition 2 weeks ago. Therefore, we don't have a lot of new news to share with you today as it relates to our year-to-date financial performance. So I'll keep my comments relatively brief, but I'll cover 3 things.

First, I'll dig behind the numbers to give you better color on our U.S. consumer business and share our thoughts on the balance of the season. While spring is just beginning in the Midwest and Northeast, we're seeing some encouraging signs, where the weather has at least started to break.

Second, since our Q1 call, we've developed a better understanding on what's happening in California and what it means for Hawthorne. So I'll speak to how we see the rest of the year and our thoughts moving forward, including the impact of the Sunlight transaction.

And third, I want to reinforce our commitment to cash flow. We continue making good progress here, even in a challenging season. As I've said in the past, I see cash flow as the single most important driver of shareholder value. So let's get going.

We weren't sure what the reaction would be 2 weeks ago when we preannounced the expected sales decline for our U.S. Consumer business. I guess the challenges of this season were in plain view and everyone had already figured out the slow start to the season.

Many of us in Marysville can't remember a year in which the season started this late across the entire country. Usually, you'll have a snow event or a cold snap that slows the momentum of the season in a particular region. But this year, the season simply hadn't broken anywhere, almost as late as 2 weeks ago. Even in markets like California, Texas and Florida, the season started several weeks later than normal. So overall, POS is down more than 10% entering May.

Over the last 2 weeks, however, things have started to bounce back and that gives us confidence that we'll start making up ground. In fact, this past week was our strongest in 2 years. In California and Florida, we're almost back to breakeven. We carefully track 27 markets around the country. Where the weather has cooperated and spring broke early, we're seeing POS levels in line with our expectations entering the year.

If you dig a little deeper behind the numbers, you'll understand why we think there's an opportunity to close the gap. Our lawn fertilizer business is probably the best place to look. This category had slowed over the past decade for a variety of reasons, but our lawn fertilizer business is the cash flow engine of the company and our goal is to keep the category healthy and find growth where we could. We knew innovation was an important part of that equation.

This year, we introduced 2 products, 1 for the South and 1 for the North, that we call triple action. The southern product is a fertilizer, weed killer and insect control. In the North, it's fertilizer, crabgrass preventer and weed killer. Previously, consumers would have to buy 2 separate applications to get all of those benefits. Both of the triple action products are exceeding our expectations. Compared to the products it replaces, POS of our southern product is up 10% this year. Everything from our production levels to the timing of shipments, advertising and in-store promotions has been right on the mark. We expect these early-season products to completely sell through, allowing our sales team to seamlessly make the transition to our weed and feed products that are more popular in late spring.

We also introduced another lawn care product this year called Thick'R, another 3-in-1 product. This one contains grass seed, fertilizer and a soil amendment. It's also exceeding our expectations. In fact, the combined sales of Thick'R and the 2 triple-action products have already exceeded \$40 million, which makes it the best innovation year we've had in our lawns business since the launch of EZ Seed more than a decade ago.

POS in other product categories is down across the board on a year-to-date basis, but we're finally seeing forward momentum. We don't believe the overall health of the categories changed or that any new market share shifts have occurred, it's just been a challenging spring.



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I also want to emphasize that our retail partners remain highly engaged, especially in the home center and hardware channels. They have inventory in place, they're supporting new products and their promotions continue to feature our brands. We're confident they'll push all the way to the finish line, and they should know we will as well.

At the end of the day, the math is the math and it's clear we have our work cut out for us. That said, it's too early to reach any conclusions. Even in a normal year, we'd still have about 50% of POS in front of us entering May. In fact, we'd only now be entering the gardening season, regardless of what happened in March and April. It's possible the season just shifts out 3 or 4 weeks, and we make most of it up. It's also possible that the season gets compressed and we fall short. I'm not going to presuppose the answer, but I will commit that we'll provide a market update when Jim and Randy attend the William Blair event in mid-June.

Let's move on to my second topic, which is Hawthorne. Again, the top line numbers are not surprising since we shared them 2 weeks ago and I'm not going to shy away from saying we're disappointed in the result. Since our Q1 call, we've pushed our strategy team to collect and analyze as much data as we can and to more deeply understand qualitatively what's happening in California, which accounted for about 55% of Hawthorne's sales last year.

Let's start by stating the obvious. California continues to struggle with the transition from a large and loosely regulated market for medical marijuana to an even larger but strictly regulated recreational marijuana market. I want you to know that I support what California is trying to do and believe it will have a positive impact in the long run for the entire country, but I'm not alone in my belief that the approach they've taken is overly complex and creates a heavy tax burden that could wind up undermining the objective to move to a regulated legal market.

Today, only 12 of the 58 counties in the state are granting licenses to growers and dispensaries, and 3,200 such licenses have been issued. This compares to 6 counties issuing just 500-or-so licenses when we held our Q1 conference call. So we're seeing progress, though it's happening slower than we'd hoped.

That said, we continue to hear strong support for the legal industry across the rest of the state. That's good. But what's clear is that every community will approach this issue as a truly local one. The zoning requirements will often be different place-to-place. The number of licenses per county will likely be different and the level of regulatory activity will likely differ as well.

The other learning that has become more apparent to us over the last 3 months is that the industry probably got ahead of itself in 2017, anticipating the creation of a legal recreational marketplace. A lot of growers saw legalization coming and were chasing the opportunity. As a result, most of the industry experts we've talked to believe there was more cannabis grown in 2017 than the market needed.

The combination of the slow approval process and the excess inventory is likely to result in fewer players once everything shakes out. The survivors are likely to be only those with deep-enough products to get through this rough but temporary disruption.

If you respect the entrepreneurial spirit that helped create this industry in the first place, and I do, then you view this through a pretty negative light. And it's not just in California where this is happening. In most states where the laws have changed, the marketplace has quickly evolved in favor of mid and large-sized players. That said, we built off on anticipating this shift to a more professionalized market, so we're definitely in a position to thrive in that environment over the long run.

As we look ahead, we continue to believe growth will return, a view based on the fact that consumer demand for legal cannabis continues to grow, more states continue to authorize and regulate growing and sales, and even the President of the United States has now agreed to support federal legislation that defers to the states that have legalized it. I would urge Congress not just to provide President Trump with legislation that makes this a states' rights issue once and for all, but also a solution that allows the players in the space to have adequate access to banking and to pay a fair tax rate like other businesses.

While this industry continues to rapidly evolve, our confidence has not been rattled and our vision has not altered. That's what gave us the confidence to move forward with the Sunlight acquisition. As we built our modeling assumptions for this deal, we didn't use crazy growth assumptions. In fact, we used conservative estimates and also modeled for a worst-case scenario, in which the business lost ground for 2 years. Even in that scenario,



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which is not what we expect, the deal made sense for us, given the efficiency and other competitive advantages we would acquire and the synergies we would generate. I should stress that we didn't pay for those synergies, so I'm satisfied with the valuation on this deal.

I also want to stress that our investment in Sunlight is not based on our short-term view. This makes us stronger now and well into the future. The creation of a more vertically integrated business model for Hawthorne was a necessity. This investment gives us the scale that should result in meaningful profit improvement as well as a direct relationship with the retailers, who sell our product and in the future, the growers who grow them. We're also better positioned -- of users of hydroponic products continue to professionalize and will want a more direct distribution model in the future.

The acquisition of Sunlight creates unique competitive advantages for Hawthorne, and gives us the largest, most modern and most cost-efficient supply chain in the hydroponic industry, which benefits our end consumers and retail customers. After fully integrating this deal, our goal is threefold. One, to drive our existing brands as well as the signature brands owned by Sunlight. Two, to be known by all of our stakeholders as the ultimate supplier in this industry. And three, to create a level of technical expertise that results in hydroponic growers, big and small, looking to us as the product experts in this space.

Again, I don't want to repeat what I've said in the past, so I'll urge you to listen to my remarks from April 17, which I believe you'll find useful and relevant to this conversation. Talking to you about a disappointing quarter in both our U.S. and Hawthorne business isn't fun, but it is part of the job. But still we're staying focused on creating shareholder value during a challenging period.

When we announced Project Focus 2 years ago, I was clear in my belief that cash flow was the ultimate driver of value, and I committed to you that we'd stay focused on this metric more than any other. Five or 10 years ago, I'd pull out all the stops in a season like this to make the year from an EPS perspective. That's not what we're doing these days. Will I continue to invest in sales and marketing to close the gap this year? Yes. Will we stay focused on keeping SG&A to a minimum? Of course. But I'm not going to do anything that hurts next year or is shortsighted just to make an EPS target. We also won't build inventory we don't need and we won't chase sales that aren't there. We'll stay focused on reducing working capital and there won't be a week that goes by where I don't remind the team to stay focused on cash flow.

I still expect a cash flow productivity number that is north of 100%. Shareholders can count on us to do everything we can to hit that number. But I want to add one more thing before I close. I want to tell you that 3 weeks from now, my colleagues and I will celebrate the 150th anniversary of this company. In some ways, it seems appropriate that we hit this milestone in a challenging season. I've had the privilege of serving as the CEO for 18 of those 150 years. Along the way, I've learned a lot about the importance of playing the long game, and I've also learned that playing the short game, which admittedly I've done a few times, almost always leads to regret. So you have my commitment that we will work as hard as we can to make up lost ground over the balance of the year. You also have my commitment that our main focus will be on driving long-term value for our shareholders.

With that, let me turn things over to Randy.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

Thank you, Jim, and good morning. I'm going to quickly run through the P&L and help you understand some of the key drivers in the quarter other than sales, because I think we've covered that pretty thoroughly already. Then I want to provide a little more color on the implications of the Sunlight deal and how we see the integration and pacing of synergies we outlined 2 weeks ago.

I want to be clear that we are not adjusting our guidance at this time. While we've been transparent in saying the deal could dilute EPS this year by \$0.30 to \$0.40, we'll adjust our guidance once the transaction actually closes. This is the same practice we've employed with other deals. Also, as Jim said, we'll provide an update in mid-June related to our U.S. Consumer and Hawthorne businesses and we'll make adjustments then as necessary.

With that, let me walk you through the P&L. I'm going to jump straight to the gross margin line. The rate in the quarter was 40.4%, down 240 basis points from the same period a year ago. On a year-to-date basis, we're down 290 basis points through the first half to 35.9%. The decline in the



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quarter really comes down to 3 items. About 1/4 of the decline is due to higher trade program expense, an item we've been talking about since last fall. The rest of the decline is split between the lower-than-expected volume and unfavorable distribution costs. The volume shortfall affects both our fixed cost leverage as well as our Roundup commission, which drops straight to the gross margin line.

Regarding distribution expense, many of you have been inquiring about this issue, and I'll tell you that it really did not present itself to us until the final weeks of the quarter, when volume started to increase. As I look ahead to the rest of the year, I don't expect to see an easing here. In fact, in a season like this, you often see some pressure on distribution in April and May, when the season gets compressed. There are a number of other offsets in the supply chain, some planned and some unplanned, that will help, but this is likely to be a headwind for the rest of the year.

As it relates to commodities, we continue to see pressure but nothing material enough to change the outlook I've shared with you in the past. By year-end, commodities will probably impact EPS by about \$0.10 this year, perhaps a bit more. That's already baked into our assumptions, but we don't expect to see relief anytime soon. So I will reinforce that pricing will be part of our plans for 2019.

I'm going to move on to SG&A, which continues to be a good story for us. These expenses are down 7% in the quarter and down 3% for the year. This is true despite the impact of acquisitions. We entered the year with a pretty tight plan on SG&A especially in the U.S. Consumer segment. Recall we had some restructuring in this segment at the end of last year and the savings generated from those efforts have stuck. Also, as we told you on our last call, we've begun to pull some of the contingency levers in Hawthorne as a result of the top line results. These are not items that will affect our long-term efforts but are focused on current year spending like variable compensation, sales promotions and open headcount.

On a full year basis, we had originally planned for SG&A to be up 0 to 2%. We'll likely do better than that, which should offset some of the gross margin pressure I just discussed. The one major change to the P&L is the equity income line. I told you in previous calls that our investment in TruGreen no longer impacts equity income, because we're in a negative investment position with that business. So the \$24 million loss we showed in the second quarter of last year is no longer present. In fact, we had \$1.5 million in income on that line this year due to our joint venture on our professional business. So this good guy in the P&L in the first half will reverse in the second half of the year.

Recall that the lawn service industry makes all of its money in the second half, so you'll see negative pressure on our quarterly results in Q3 and Q4. On a full year basis however, this issue is a slight benefit, about \$5 million. Beginning in fiscal 2019, there will be no year-over-year impact at all.

If I move down the P&L, everything else is pretty much as we would have expected. Interest expense in the quarter is up \$1 million to \$22.6 million. And I'll point out that our effective tax rate for the quarter was 26.2%, thanks to the tax reform policies implemented by Washington.

On the bottom line, non-GAAP adjusted earnings were \$2.88 per share compared with \$2.57 a share, a year ago. On a year-to-date basis, non-GAAP adjusted earnings were \$1.78 per share versus \$1.70.

During the quarter, we invested \$160 million in share repurchase activity, bringing the total to \$257 million on a year-to-date basis. Our leverage ratio at the end of the quarter was 3.4x. I'll revisit this issue in a moment when I discuss the impact of the Sunlight transaction on our 2018 and 2019 results.

One other item on the balance sheet that I want to highlight is inventory. We remain committed to improving our cash flow productivity and we're off to a strong start through the first half of the year. Inventory levels at the end of the quarter were essentially flat from last year, even with the year-to-date sales shortfalls across the company, the introduction of new products in our U.S. Consumer business and the impact of the acquisitions of Agrolux and Can-Filters. Our supply chain team has been all over working capital management again this year and they deserve recognition for their efforts.

With that, I'm going to switch gears and talk about the Sunlight transaction and the impact on our full year results. I want to stress that my comments assume we close the deal by June 1. Obviously, a delay in closing could alter those estimates.



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I want to start by saying I believe in this transaction. As I've met with many of you over the past 2 years, you've heard me say there was a great deal of profit improvement potential in Hawthorne that we could tap into once we started to fully integrate all the acquisitions we made. We hesitated to start that process in earnest until we solved for a missing piece within Hawthorne, strengthening its supply chain capabilities.

Now that we've acquired Sunlight, the vertical integration we have will allow us to drive significant leverage from the Hawthorne P&L. And as Jim shared in his prepared remarks on April 19, we clearly create a number of strategic competitive advantages as well. For this year, we expect \$0.30 to \$0.40 of dilution.

Let me bridge these numbers for you. First, we'll have the impact of purchase accounting adjustments related to writing up inventory. We also have deal costs. Combined, these 2 items account for roughly \$0.20. In addition, we're anticipating 4 months of increased interest in amortization expense; that accounts for about \$0.10. The range I'm providing goes up to \$0.40 in the event of some modest level of short-term market disruption that could lead to revenue dissynergies.

In terms of the synergies we expect to see from the deal, I expect us to immediately take action when the deal closes. There is significant overlap between our workforces that will lead to some consolidation of roles. If we close on June 1, I would expect to incur restructuring charges in the third quarter of up to \$15 million. However, we would expect to break even on those charges within the next several quarters.

By the end of this calendar year, I would expect the steps we take will result in annualized savings of about \$20 million. The other \$15 million will be largely realized by the end of calendar year 2019 and will come from consolidating facilities and moving as much of our operation as possible to Sunlight's facility in Vancouver, Washington.

As it relates to the total impact for fiscal 2019, we currently expect the year-over-year change from this deal is worth \$0.60 to \$0.80 per share. Here is how the math works. \$0.20 of purchase accounting and deal costs in 2018 will be offset by the full year impact of interest and amortization in 2019, so the net earnings improvement next year in fiscal 2019 essentially reflects 12 months of operating income, including synergies. Once we close, we'll take our leverage ratio to about 4x. I've said in the past that I'm willing to go above 3.5x leverage temporarily for the right deal and this is that kind of a deal. We will work hard to get back to 3.5x as soon as possible.

Until we get back to 3.5x leverage, which should be later in 2019, we're likely to slow our share repurchase efforts. But this is only a temporary action. We remain committed to returning cash to shareholders. I would just like to see a little less leverage before we resume.

All in, I am a supporter of this transaction, and I believe it's a giant step forward for Hawthorne. I share Jim's thoughts about the current state of the business. I'm frustrated too for all the reasons he stated, but I'm also bullish on the opportunities for this business down the road. We've clearly established ourselves quickly as a leader in this space that I believe is likely to grow for years to come.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Joe Altobello from Raymond James.

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

I guess first question for Jim, sort of big picture, given the experience that you've had in hydroponics in California the last few months, how has that impacted your long-term view of the opportunity in hydroponics? Is this still a business that you think can grow double digits and a business that can still generate EBIT margins north of 20% over the next few years?



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

Maybe I'll start with the latter part. Do I feel good about the margins? Yes. The first part, if I was to go back and sort of say what would I not want to say going forward, is sort of make a commitment to you guys of double-digit growth rates. I think that if you look at what we've been doing with what we've called Project Focus, it was really a reconfiguration of our sort of commercial portfolio to higher growth rates, particularly when you start with saying that the consumer lawn and garden business is just another one of those, like years with -- at some point you say, maybe it is the environment from a weather point of view, has been in that sort of 0 to 2% growth rate. So everything was about going domestic and increasing our -- buying businesses that have just basically a growth rate 2x to 3x what the core lawn and garden consumer is. That doesn't require us to have, call it, 15% growth rates.

I don't think we -- I think the prices we paid for the business has been fair, Joe. So I'd start by saying, if I was to go back and sort of say, I wish I'd never said that, is this idea of sort of 15% growth rates. The business cases that we've done for all these deals, and they've all been double-digit IRRs, at least, have never been at that level. They've been pretty much half that level. So I think we've been -- with the Sunlight transaction, we've been very conservative on what expectations for growth are. And it's not, Joe, because we aren't hopeful that we can get double-digit growth rates, it's just that it goes back to the sort of underpromise and overdeliver ideas. It's been a tough, call it, fiscal year, really calendar year in the hydroponics business. We've spent a lot of time working this issue and trying to understand it. There were people who were critical that we didn't know more at the last call. If I was gesticulating now, I'd say, well, you should be in my shoes, which is that -- California put out there -- they went legal for rec on January 1. The rules didn't come out, which all had to work through counties and cities, until mid-November. And maybe we could have understood better the implications of it. But honestly, I don't think anybody saw it any sort of better than we did.

We have spent a lot of time since then working on -- we have board meeting on Thursday, Friday of this week, and so we've been working really hard because we're going to have an in-depth conversation on just what's happening in the marketplace, just the same sort of things you guys would be interested in. To me, I come down to -- so I guess the headline would be, I am not concerned about the commercial aspects of the hydroponic business and the sort of legal marijuana market on a go-forward basis, not at all. I think we continue to see it the same way. The question then is what happened, and I have sort of 2 views. Clearly, there was a little bit of a kind of gold rush, rush into the space, particularly in the -- on the production side. And I think that there was quite a bit more production than is necessary that has sort of affected wholesale prices, which has affected people's willingness to continue to supply product into that marketplace until prices correct and that has been part of it.

But I think the biggest part of this is just a completely botched legalization, and not just in California. I think that what we're seeing, which is -- I guess it's the way of the world, is a lot of what's happened in California is really -- forget the fact that most counties still have -- do not have rules out, they have been extremely open with this idea that if you're supplying into the black market, it affects your ability to be legal. The tax rate is sort of ridiculous, like, call it roughly 40%. And I think that, that's sort of affected it. But the move on -- we talk about the zoning aspects of this, which is taking out of residential neighborhoods, which on the face of it sounds like a really good idea. But people who have traveled out to the West, northern California, Oregon, Washington, Colorado, what you'll see is that this business was based on mom-and-pop growers who were -- this was not, like always full-time job. This was working-class people growing product indoors, attached to their houses.

That market has been completely disrupted as counties and cities have basically said, we don't want this occurring. So you're seeing a massive turnover, which I think is an opportunity long term as a move toward more kind of professionalized and to some extent, financially backed grows. And I think that's where it's going. Listen, we -- from day 1, you guys have asked a lot of questions about, like, does this screw you up as it goes more? We built this whole business based on the idea that this market will go professional, but it is really disappointing I think to see the amount of mayhem that's been caused with a lot of the people who were not like criminal enterprises, but were people earning secondary incomes, growing and having relationships on the -- informal, trusted relationships on the dispensary side. So I think it's a long answer, Joe, but it's everything we've been working on lately to get sort of smart in this issue is I think a little bit of overproduction but massive disruption and a -- and I'm going to say, almost nationwide that -- and I've had this conversation with very senior political folks in D.C.

Is -- one of the really nice things about this industry has been basically that it's off everybody's radar screen, so it's grown up in a really entrepreneurial way, naturally. The maturation of the marketplace as it goes legal has been pretty disruptive. And I think that, that's a lot of what we're seeing and it's just going to have to work its way through. So we continue to believe that we're going to see growth rates in this business long term, multiples of our consumer business. We continue to believe in the investment. We're not counting on sort of 15% growth rates. We do believe that the market



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can justify those, but we're not counting on it and we don't think we paid for -- and just remember, we didn't pay for any of the synergies in the Sunlight deal. So I think we're in a pretty good place.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

Hey, Joe, this is Randy. Let me jump in with a few more specifics around both the top line and bottom line. So on the top line, you think about while there is a short-term supply and demand imbalance but your -- or, excuse me, consumer demand continues to increase mid- to high single digits, plenty of research to validate that. So that's going to be helpful in the long run plus it's a favorable mix. As outdoor growing moves to indoor growing east of Colorado, we'll continue to see that. Increasing social acceptance and then just looser regulatory environment in the states east of Colorado as well. So top line, we think long-term demand is there.

And then on the bottom line, one consideration is Sunlight's business is about half manufactured products that have really nice margins, similar to what we've purchased in our Hawthorne business in the past. The other half is lower margin because it's more of a distribution business. But all in, still nice healthy margins. We expect that to improve over time, with integration, all the synergies that we've talked about are -- the great majority of that will be gross-margin related. Once we expect volume to return, the absorption benefits will increase. So we've laid out a goal of 18% for Hawthorne operating margins by the end of 2019, and beyond that point, when we expect volume to start getting back to growth rates more similar to what we've seen in the past versus what we expect for this year, we'd expect to keep trying to get to that 20% goal that we've talked about the last couple of years. So we're still bullish on the long-term here.

Operator

And our next question comes from Chris Carey from Bank of America Merrill Lynch.

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

So I just want to follow up on that and then I have a question on the core as well. But I think you mentioned you modeled Sunlight's by losing ground for several years in your worst case scenario, correct me if I heard that wrong. And I understand building in better scenarios, but it would seem a little aggressive to me. But so I guess can you just talk to near- to medium-term visibility on the industry? You did mention expectations for mid-single-digit growth in that business in fiscal '19, but I guess, like, what gives you confidence that's doable? And Randy just mentioned consumer demand is mid- to high-single digits. So perhaps you have some incremental earnings on the amount of excess trade inventory. So maybe you have improved visibility on when the sell-in versus the sell-through can better match. And I know it's a lot, but just big picture, can you help us just get a little more visibility onto the near- to medium-term dynamics in that business? Because even in the back half of this year, your kind of guidance for at best being flat, would imply quite a bit of improvement versus the first half.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

A lot of questions there, Chris. I'll try to cover as much of that as possible. But as far as the valuation modeling and the way we thought about this, we pressure tested this in lots of different ways. But if you think about the worst case, if the rest of this year turns out to look like the first 6 months and it doesn't get any better next year, and we realize the synergies that we've outlined, which we're very confident about, we'd get our money back plus a little bit. So we don't expect that to be the outlook, but let's just say that could happen. We'd still walk away and say we've greatly improved our business and we really like where we're positioned and we can break even or do a little bit better.

So I'm not saying that's our outlook, but it made us feel confident that moving forward, the transaction made financial sense. And expectations for the rest of the year, difficult to predict the exact timing of when things will turn around, but we do expect to get better in the next 6 months. We do expect 2019 to begin to improve and things start to turn around. So we're not going to lay out specific numbers at this point, but we're not expecting that worst-case scenario to be realized. But we trust -- trust us, we've pressured tested this in multiple ways and feel good about where we're at. I think that answers the questions.



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

Okay, yes, it's just I can't tell you how many questions we've gotten just on visibility in the near term, but I guess what you're saying is, it remains an issue, but you're working through it and do expect some improvement as we get through the year. So that makes sense. And then just secondly, on kind of, like, the back half of the year, are you still expecting SG&A to be about flat? I think you mentioned that in the prepared remarks. And if so, can you just talk to maybe the puts and takes that you would need to see in order to approach the guidance, which you're sort of leaving untouched today?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

Sure, so I don't want to mislead anybody in saying that the guidance we have out there right now won't necessarily change. But you look at back over the last 20 years here, and we've had late starts in the past and trying to predict at this point where we're going to land, I think would be foolish for us to try to lay out new expectations right now. So we'll have a lot more visibility in 2 weeks, in 4 weeks, in 6 weeks. And by the time we're in mid-June, we'll have enough confidence that we can lay out where we're going to land the plane here. So I think that was one question. The other one was?

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

I think SG&A was...

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

SG&A. So regarding SG&A, when we've closed our books for March and what's baked into the numbers we reported, we're still assuming target incentive performance at this point. So if things don't improve, as we have done in years past, we'll come back and we won't be paying out at that same kind of a target level. So I'm pretty confident that our SG&A's going to be -- it was originally 0 to 2. It's going to be a decline year-over-year if things don't improve here in the next 6 weeks. But really good visibility to SG&A. We're actually doing better than where we planned for the year. On the other hand, we're not going to be so short-term that we're going to try to add a few pennies of EPS this year and not do what we need to do to make sure we're taking care of business for U.S. Consumer next year or things we need to do in the long run for Hawthorne. We'll still be doing those kind of things, but we're also not going to waste our money. So I've got it under (multiple speakers) in our SG&A line for sure.

Operator

And our next question comes from Jon Andersen of William Blair.

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

My question, just a two-parter on Sunlight. How does Sunlight play into the change in the market in terms of grows becoming more professional? In other words, does Sunlight and the vertical integration that, that brings help you pivot and better serve large-scale growers? Or is Sunlight, as a distribution business, more oriented around the small-scale grower? But if you could just talk a little bit about that. And then also, Sunlight, as you pointed out, Randy, has a branded, or a product business and a distribution business. I'm assuming they are distributing not just Hawthorne brands but other manufacturers' brands as well. And is there the potential here for some disruption? Is that the disruption that you're talking about as you kind of take ownership and make this really kind of Scott's distribution arm into the hydroponics market?



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

Well, I can answer the question on the distribution. Whether you're going to the grower or to the retailer, this actually sets us up better because it's a consolidation of a complete solution. And so to me, you have to have distribution of those products. You need to have the order size to get there. And so whether it is grower direct or retailer direct, you need to have that distribution. And so we're pretty confident that, that's actually going to be an advantage for us, not a disadvantage. Either way, we're prepared to go.

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

Let me just -- I'll throw some points out there. While having sort of the complete supply chain solution, I think, is important, one of the things that was a giant sort of item of discussion between myself and Craig when we first began this discussion well over a year ago, was that the distribution of today is not the distribution of the future. And that as this business matures -- and I don't think just hydroponics, but I think just in general, if you just look at how products are distributed today -- we can either be kind of behind the power curve on that or we can be out ahead of it and use this transaction, both from the Sunlight point of view and from the Hawthorne point of view, to build really a distribution system of the future. And I think we've got a lot of ideas. I don't want to spend a lot of time because I'm just going to be -- I'll be ahead of Christopher, I might be ahead of Mike on this. I'll be ahead of the discussion with the board and ahead of sort of discussion with a lot of our partners on this.

But I think that when people talk about this internally, we tend to -- supply chain is an important function here. I just say, "Look, guys, we didn't do this to buy a distributor." We're buying brands, we're buying good brands, a brand-new manufacturing facility and a brand-new distribution center that allows us to do a lot of things with it that haven't been done today I think in this industry, and that would be our sort of plans forward. In regard to strategic vendors, which I think I mentioned in my speech that we put online, it's important. And Craig and Doug Hargreaves and Christopher Hagedorn and Mike have been on the road, working with our most important -- and discussing with our most important strategic partners on -- of non-Hawthorne, non-Sunlight products that run through that system. And those meetings so far have gone very, very well.

We were very strategic in how we view this. We -- if you look at what we've done on the consumer business over the last sort of 1.5 decades or whatever it's been, of sort of consolidating the supply side to retailers in the consumer lawn and garden business, we intend to do that here. And so for people who have important brands that both want to stay with us and we want them to stay with us, they're joining the right team. And so we think we can represent them really well, and do a great job. And if they add value the same way Roundup does to us today or SC Johnson products do for us today. So I think Randy mentioned this, the possibility of some dissynergies. We have not run into any refusals yet and I think in fact, they've been actually very positive and enthusiastic as we've reached out to them. Mike, I don't know if you want to add anything on that.

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

No, I think it's been very favorable. We certainly have to wait until we close, but the indication is we're not seeing any defections anywhere. And Chris has been out and hit the top 50 retailers on our transition, and then that's been very favorable. So I think the -- I think we're set up to -- I think they're looking for us to lead the professionalism of the industry, and we're going to do that and we're going to provide solutions, and we're going to work with the right partners to drive the benefit, ultimately for the retailers and the growers. The growers need solutions. You got to remember, this is a technical business. It's not as easy as just going and buying it off the shelf. A lot of growers need technical support. We plan to be there.

Operator

And our next question comes from Bill Chappell from SunTrust.

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

Just on the core business, any update kind of how -- I know it's compressed and early in the season, but kind of, by channel, have you seen any improvement in the mass channel this year in terms of sales or if there's been anything different from that or other channels that's positive, negative if you kind of look across the spectrum?



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

The mass is about flat for us. I would say we're seeing upside continue with hardware, home centers, farm and fleet. There are some huge upsides there. I mean, we just need the season to come in, so -- but I would say other than mass being flat and they're running their play on private label. I'd say we're bullish if it will come back.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

And Bill, I want to clarify, when Luke's saying flat, he's talking about versus our expectation or plan for the year. So we're down year-over-year like we expected, but there aren't any surprises different from what we planned months and months ago.

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

Right. We're calibrating against a year with the major adjustments to be out of the season and be a big private label player.

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

Well, and I guess a follow-on to that (multiple speakers). I was just saying, as you say, you talk about the play on private label if you've seen that expand to other retailers? Or is it still largely just at mass at this point?

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

It's at mass, and they have lost category share, about -- we're seeing about 5%, 6%. So I don't think that -- I mean, there's always that right balance but we're not seeing it as a huge play. I mean, there's -- all retailers are concerned about their private label, to keep that in balance. I would say they've not gone to the extent of what mass has.

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

Okay. And then since I don't think you can get through this call without asking a question on Hawthorne, what holds -- as we look at what's going on in California, what's the risk of the same thing happening if New York goes or Florida goes or other states go in terms of regulation tying up the business or postponing sales or creating disruptions? Or is there any? I mean, is that just kind of a -- do you think the path is easier after we get past California? Or are you going to run into these bumps, not by your own doing, for the next few years?

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

No, I think California is just so mammoth in sort of the production of all U.S. product. The question is, and I recognize that this is one thing that both, I think, the federal government and state governments that have basically changed their laws on this in a good way, is how much of the product leaves the state. And so I think there's a pretty high percentage of that in California, which is part of the problem, which is so people want to register, there's a real -- there's a lot of pressure. And the same is true in Colorado, by the way. It's just again, California is so huge in this marketplace that sort of the reactions to these kind of issues are just -- they are outsized. But there's a lot of pressure then if people want to become legitimate within the state of California, to not be exporting product. And that becomes -- and the threat is, if you get caught shipping stuff out of state illegally, your ability to become legal is inhibited.

And so there's a lot of dynamic to what I'm telling you. And so I don't think -- I think what you heard, at least I think what I said is my view is almost nationally. I think Colorado has done a really good job of moving this market to a pretty regulated, legit market, with -- and I think we've seen numbers of like less than 5% of the output of Colorado is actually leaving the state. That's not the case in California, so there's a lot of correction



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as people try to do it. But I think generally, the legalization has been pretty disruptive to the market and because California is such a large supplier to the national market, it just created kind of mayhem on the production side there. So I don't think you could see this happen in the other states because of what I said. And that's one of the reasons you say, look, I understand what they are trying to do, move it out of residential neighborhoods, significantly reduce the amount of product that's kind of off the books, collect tax revenues.

You can sort of see that this is a move toward Colorado. The difference between California and Colorado is Colorado took a very much a statewide point of view. They didn't give a lot of authority to cities and counties. And it was sort of statewide preemption on how they operated. There were, as I understand it, there was a lot of business focus within the state on trying not to, as they bring in regulation, to be highly disruptive to a multibillion-dollar marketplace. And I think that Hickenlooper and his team in Colorado and the industry have done a good job making that transition.

California is just -- it's bigger, it's more complicated, I think there's very much less business orientation on the planning side, very late announcement of what the rules were. And you had this very significant amount of product that was leaving the state, which I think is of concern to everybody, including us. So I think ultimately, this is a good trend, but I think it would be impossible for any other state to be as disruptive as what California -- California was the market, okay? And therefore, I think as other states come online, even if they kind of foobar their regulatory schemes, I -- it couldn't be as disruptive as what's happening in California right now.

Operator

And our final question for today comes from Eric Bosshard from Cleveland Research Company.

Eric Bosshard - *Cleveland Research Company - Co-Founder, CEO, Co-Director of Research & Senior Research Analyst*

Two questions. First of all, historically, you've given us a little bit more specificity on the POS. Can you help us on through April? Is it down double digits? Is this down 10%? Is this down 15%? Is this down 20%? Can you help us with that at all?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

Sure, Eric. This is Randy. We're down about 12% today versus prior year on POS.

Eric Bosshard - *Cleveland Research Company - Co-Founder, CEO, Co-Director of Research & Senior Research Analyst*

Okay. And then secondly, Jim, a question for you. When I look at Sunlight, it looks like a large professional company, smart guys running the business, a professional, well-established business. When I look at the purchase multiple that you paid or the purchase multiple that they accepted, can you help me square that with where they are? It just seems like a relatively low multiple for a business with a lot of opportunity in front of it. And so can you help me square those 2 things, please?

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

Yes, I guess. How are you, by the way? We were visiting the state of Colorado early this year, and we were talking to the government of the state just about their thoughts on the disruption we're seeing in California. And I think, if you say that -- I think the most professionally run business in the market is Hawthorne, and I'm not saying that just because I'm full of (expletive). I think we take a lot of pride in what's happening there and I feel bad for them, us, you all, whatever. That what's happening largely in California is just -- is happening. But the amount of disruption to Hawthorne is in spades was happening, I think, at Sunlight. This is one where, I think the evolution of distribution, if you looked at sort of some of the companies we have purchased just as an example, moving more and more to direct sales, away from going through distribution. I think a deal without us would have put Sunlight in a very challenging position.



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And it's one of those things where you say, I don't know, total valuation on this deal, plus or minus probably \$25 million, is like \$450 million to one guy. I would say that I think it's a good valuation. We -- I'd start with what you said to begin with, which is that, I agree, very professional business. I think we've talked about -- I talked about this before, which is that it's a warrior culture for sure. I think there was -- we've said internally that to take down Craig Hargreaves in his business and his brother, you'd have to burn the house down. Burning that house down -- what he has built is an Amazon-like distribution center. No joke. Absolutely state-of-the-art. There is one thing it needed, okay? Remember, if we left, it just makes that way worse. Okay? Meaning, he needs volume in that plant, okay? We start day 1 where -- honestly, my view of sort of day 1 is we're at full capacity at that Vancouver plant, like Day 1. And so I think it's -- this is really a marriage, and I wouldn't only -- a partnership but since we're buying it all. But the marriage of Hawthorne and Sunlight is perfect, okay?

And again, we've used very low numbers. Randy's -- it's hard for me not to sort of read into questions. But Randy did exactly what he's supposed to do, by the way, not assuming that we are flat to down for 2 years in a row because we think it's going to happen, which is what happens if that does happen and we get sort of midrange of our synergies, can we make this still look like a reasonable multiple? And the answer is yes. Okay? Not because we think it's going to happen, but because we say, if we can do that, then we think we've paid a very fair price, okay? And Luke has substantially more synergy opportunities than we've counted on, but we've used -- even in our go forward, and this is not just in this deal, but our past deals.

We're using like probably notion like 8% growth rate. So I think that's what we have been using in the past for the approvals we've gotten from the board. So do I think we've got a -- something very valuable here? Yes. Do I think it's a well-run company? Do I think the Hargreaves are awesome? Yes. I mean it. I mean it's not -- for all Craig's reputation of being like a fearsome warfighter, he's been an absolute pleasure, not just for me but for mostly -- where it's most important is Christopher and Mike. People have come back and said, damn. But what I would say is, were they stressed over what's happening in California? Yes. Did they need volume? Yes. And if we left with our volume, that would be pretty (expletive) bad for them. So I think those are the dynamics that sort of led to what we think is a pretty fair valuation. I hope that answers your question.

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

All right, Savannah, I think that wraps up the Q&A portion, so I want to remind everybody we'll be at the Blair Conference in mid-June. We'll issue a press release in advance of attending that event. That will be a webcast event, and we'll also likely issue a press release that day. In the meantime, anybody who wants to follow up with me directly, please call me at (937) 578-5622. Thanks for joining us. Have a great day, guys.

Operator

And this concludes today's conference. Thank you for your participation, and you may now disconnect.

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