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The Scotts Miracle-Gro Company
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Company Conference Presentation

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EXECUTIVES

Cory J. Miller
Executive VP & CFO

ANALYSTS

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

Unknown Analyst

Presentation

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

Okay. Good afternoon, everybody. My name is Jon Andersen. I'm the research analyst at William Blair that covers Scotts Miracle-Gro. I want to welcome you to the Growth Stock Conference and the presentation by Scotts. We are pleased today to have Chief Financial Officer, Cory Miller; Chief Communications Officer, Jim King; and in between them, Vice President of Investor Relations, Kelly Berry.

Scotts is an innovator, manufacturer and marketer of branded lawn, garden and controls products. Its brands are shared leaders and typically synonymous with the categories in which they compete. The business benefits from strong consumer engagement and gardening as one of America's most popular leisure time activities. Through the company's Hawthorne division, Scotts is also a leader in the hydroponics products industry with a broad portfolio of solutions for growers, including lighting, grow media and liquid nutrients. Hawthorne also provides consultative services to help customers design, construct, equip and operate their grows to increase yields and lower costs.

Before handing it over to management, I have a couple of quick housekeeping items. First, recall immediately following this presentation, there will be a breakout session with the team in the Adler room. That's the Adler room on the second floor. Second, I must inform you, a complete list of research disclosures and potential conflicts of interest can be found on the William Blair website. So thanks for your patience. And with that, I will turn it over to Cory.

Cory J. Miller
Executive VP & CFO

Thank you, Jon. So again, thank you to Jon, and thank you to the entire William Blair team for allowing us to speak today. Appreciate the people that I talked to earlier in the sessions and look forward to continued conversation in this half hour as well as, as we get to breakout session and the one-on-ones that follow.

So I want to introduce Kelly Berry. Thank you for Jon for pointing her out. She is VP of IR. After several roles within our finance organization, she's taking over this role, and you're going to see a lot more of her in the future. I also want to recognize Jim King. Jim has been leading our IR function for 50 to 60 years. So I personally want to thank Jim for all his time that he and I have spent together over my time at Scotts as well as my last 1.5 years in this role. So he's been great to work alongside. And as he's looking to transition out, we'll be seeing a little less of Jim, but I know that he'll be working on the next stage of his life.

So as most of you saw, we had a press release that went out yesterday. We had an 8-K that went out last night. So today, I want to add some color to the information that went out. And I also want to spend some time focusing on the long-term opportunities that we have at Scotts. The U.S. consumer business has a lot of tailwinds behind it. We're coming off of 3 record years. And we think the consumer is engaged, and we think we have an opportunity to drive 2% to 4% continued growth going forward. As we think about the adjusted base that we have in '22, we think this is a good starting point for that 2% to 4% growth going forward.

Also in Hawthorne, we've had challenges this year with the cannabis industry. It's been well documented at this point. There's an oversupply of end product, which has caused growers to not grow as much. We sell product into those growers. And as we're selling products into those growers, their margin is a little tighter, it's making it less attractive to grow, and that's obviously affected our business. But we'll touch on that a little bit here as well.

This year has shown the situations that we've not seen in the past. Many of them are out of our control, but that's kind of the hand we've been dealt. We've had record inflation, cost increases, an international war, the world coming out of a global pandemic, where we had kind of 2 record sales years and how would we react to that. So that is kind of what we're facing as we come into this year.

And I'd say the most important impact on the business this year was a delayed start to our spring season with weather in March and April that were just not cooperating with the business. April and May are really the key months that we have to drive our business. The results in these months this year would have been considered near record. I think May POS is a near record month for us. So really good results, but we're still calling down numbers. So we're going to get into that a little bit more, but I just want to put that out there. When we think of POS and the consumer engagement, we're seeing near-record POS, and we feel really comfortable about that. When the weather broke, we had a lot of good clawback of that shortfall that we brought into May.

And if you look at the numbers, you can kind of see the POS dollar milestones on the right side of the page. In March, POS dollars, we were plus 5%. We felt really good about where we were at. Coming into March, we don't have a lot of sales happening at that point of the year, but everything that we had was really positive. By April 1, we were down 7% in POS dollars. By May 1, we were down 12% in POS dollars. So March, April fell back. And then beginning of June, we closed that gap and we cut it in half. And May POS was really strong for us. Like I said, it was a near record for us.

And I'd say leading it up to today, every day that we're seeing is a good day, is a positive day, and our results continue to get better. If you look at some of these -- the individual markets on here, it's really interesting, Detroit, minus 39% at Easter, and now it's minus 8%. Chicago was minus 29%, now minus 10%. So a lot of movement during the month of May that allowed us to get to claw back some of that POS to feel confident in where we were from the consumer aspect and show us that the consumer is engaged and we can feel confident about the consumer showing up again this year and into the future.

Where we likely have missed sales because of this late season break and may not be able to make it up is in our fertilizer category. If you look at the slide, you can see the different categories and where our POS dollars and units are. The consumer is entering the category to participate in our gardening products more than our lawn products at this point. You can see in soils and mulch, POS units are kind of minus 7. POS units for fertilizers are minus 19. And we think that late breaking season caused a lot of the consumers to skip over one of the micro seasons within the lawn and garden business and skip that first application of Turf Builder. The bag that's presented on this slide, the blue bag is the Turf Builder with halts product. That's our earliest season fertilizer, and that's the one that we think they may have skipped, and we're still seeing positive results every day in our fertilizer business, but we likely missed that micro season, and it's going to be tough to make that gap up.

So as we look at total units across the business with a shift out of fertilizer and into soils and mulch, every unit is not the same. I would much rather have a $50 bag of Turf Builder be sold where we make high margins than a $2 to $3 bag of mulch. But the consumer has chosen the $2 to $3 bag of mulch this year as gardening has become the bigger part of their project focus versus lawn and garden -- versus the lawns, excuse me.

Just as the season is finally breaking, our POS is making up ground, overall retail has had a lot of volatile results and a focus on their inventory levels. This focus on inventory had an impact on the ordering that we saw in the back half of May. So while our POS was at near record levels, the consumer reorders have been soft. The result is lower sales for us and lower inventory for the retailers in our product. We missed our internal target by about $300 million in May, which is kind of leading to the decrease that we had in our press release yesterday.

Because our sales were already off to a softer start than what we had planned, the negative fixed cost leverage is more impacted by the lack of these orders. This, coupled with the commodity cost increases, continues to pressure our gross margin rate. The good news is that we're now seeing some easing of the commodity costs. The bad news is that we purchased or produced the vast majority of our need for this year. It should be good news as we go into next year.

We had been seeing some light -- signs of light at the end of the tunnel as we entered May in the Hawthorne business. But during the month, we saw daily sales lower and now feel that we will not see the rebound in the fiscal year that we had been expecting. This is a new industry, and volatility is something that we've been struggling with as we go through the years, and it's something that we need to improve visibility on.

We now expect the U.S. consumer shipments to be negative 4 to negative 6 versus prior year. While POS continues to come back and let us know that the consumers are engaged in the category, they're ready to buy where the conditions allow, we are just not getting the reorders to allow shipments to keep pace with POS. This should have us at an improved position as it comes to retail inventory, but it does cause us to have excess inventory of our own. Expectations for the Hawthorne shipments are now minus 40% to minus 45% versus prior year. Like I said, we're just not seeing the daily order intake that it takes to get to our previous guidance.

There had been anecdotal information that we would be seeing order intake increasing in May. We just did not see this happen. Some of that has to do with the outdoor market and the outdoor growing season that the cannabis growers usually go through. We're going to take a more conservative view at the rest of the year and continue with our rightsizing efforts in this business to control costs and make sure we're rightsized with the volume that we're seeing. The decrease in expected volume then causes more pressure on margin rates because of reduced fixed cost leverage. We're now expecting gross margin rate decline of 400 bps by the end of the fiscal year.

SG&A will decrease for the year. With a shortfall in sales, we'll be reducing costs on the SG&A line to offset as much as we can. The largest component of that this year will be variable comp. All these changes now take our EPS estimate for the year to a range of $4.50 to $4 per share. The highly seasonal nature of the business and missing volume in the peak of that seasonality caused the changes to add up rapidly as the high margin on those missed sales kind of drops straight down through to EPS.

Looking at cash flow, we are expecting free cash flow to be about 0 for this year. The use of cash this year comes from a couple of different areas. First is inventory. This is the inventory that we're holding and we expect to be holding as the fiscal year comes to an end. This increase was something that we intentionally drove up during the early years of COVID. We are making sure we had supply of inputs. We are making sure we had the product on hand to meet the retailers' needs. And we intentionally took our focus off of cash flow to make sure we had enough inventory to sell into the season. At this point, we have plenty of inventory. And of the inventory increase that we have over last year, about 1/3 of that is related to the cost increases, 2/3 is related to the number of units that we hold.

The second area where we had a use of cash is our capital expenditures. With record years in 2020 and 2021, we were looking to complete some larger products that would benefit us in years to come. These projects are being finished late in this year and into next year and are mainly in the areas of manufacturing and IT.

Cash flow will be my main priority over the next 2 years. We are going to get back to the levels that are more in line with what we've seen historically. This will be a focus that we have as a company over the next couple of years to generate as much cash flow as we can, pay down debt and put ourselves in a position that we think allows us to win going forward. The cash flow that I'd be looking for over the next 2 to 3 years is about $1 billion. So I don't want to zero this year to make anybody think that we're unable to meet cash flow going forward.

We take all these results personally, and we are not satisfied with the numbers that we are now posting. It leads us to 3 focus areas that we have within our team. We have to get margin back to where we need it to be through pricing and cost reductions. We have another round of pricing that's going in place in August, and we're actively reducing our costs across the entire business as we speak. We have to get cash flows where they need to be through rightsizing our inventory investments and our capital expenditures. Zero free cash flow is not an acceptable result for our business. We are going to generate $1 billion of free cash flow over the next 3 years. And we've worked with our banking partners to create the financial flexibility to allow all of this to happen. This is what was mentioned in the 8-K yesterday afternoon.

We've been working with our banks to create this flexibility within our leverage covenant, taking it from about 4 -- well, the covenant itself was 4.5x to up to 6.5x for the next 7 quarters, including Q2 of fiscal '23, which we see as the high watermark. This amendment to our credit facility that closed yesterday, and we thank our lenders for working with us to get this completed. While we've created this flexibility, we are still committed to reducing debt and leverage as quickly as we can to live where we think is a comfortable limit at 3.5x. We've created an internal team called Project Springboard to help focus the entire organization around these areas, and we'll drive this hard over the near term to make advances in how we operate and move ahead.

I want to transition to talk about where we see the future in the U.S. consumer business. I've been at Scotts for over 20 years and feel that this resetting of expected sales level is a positive turning point for us. We no longer expect 0% to 2% growth in this business, and we feel that we have the right to get 2% to 4% growth every year. That was not always the expectation, but I can tell you now it is, and we're going to be working hard to make it happen.

The brand shown on the screen are the key to the lawn and garden business. We're going to ride them as hard as we can, focusing on improvements, and we're going to get results. The lawn and garden category is a great business to be in, and these brands are the cornerstone of the industry. They are each #1 in their respective segments and #1 by a mile. Our retail partners appreciate this part of their store and use it as a traffic driver for the entire store. As we refocus to driving free cash flow and improving our operating leverage through increased sales, these will be the brands that we continue to push to consumers. They've been around for decades, and it's because the consumer understands what they stand for, and they know that they work.

This slide starts at 2018, and it shows good growth over the last 5 years. The truth is if the slide started at 2010, the first 8 years would look pretty flat. And that's because we were at 0% to 2% growth during that time period. COVID provided us with a great opportunity to take this business to the new level. Consumers had the demand and we met that demand. We've talked a lot in the last 18 months about the benefit that we saw during COVID and the reaction in the category as the world opens up again.

But here we are, the world is opening up. And this year, I think the consumer is speaking again because they're showing up for the category. We said that in 2020, we captured 21 million new consumers, and we grew our sales by 24%. In 2021, we held on to the vast majority of those users and they chose to participate at an even greater level than in the past, and the business grew by another 10%. The big question has been, if we can count on them to remain in the category.

Even though 2022 is not going to end up where we originally hoped, I think that we can say we held on to most of them. As I said earlier, the slow break in the season makes it hard to tell for sure. We think that a normal break in the season shows that we maintain the vast majority, even with additional challenges related to costs, consumer inflation and other available ways for the consumer to spend their time. In the next 5 years, if the results of our business look as strong as the last 5 years, we'll be very happy with the sales growth.

As we think about the drivers of our business that give us confidence in the future, the millennial consumer is key to us. Millennials and their push into the housing market are consumers that we expect great results from. They are buying their first homes and entering our category at rates greater than those leaving the category because of age. We're focused on winning with this group at the shelf, and they are proving to be the type of consumer that we want. They know the SMG brands, they trust them to work and they rely on them to help their success in the yard.

Looking at this slide, you can see how this consumer group is participating in the category even higher than the baby boomers who are aging out of the category. Almost every category in here shows growth. And as they get more ingrained in our business, we're going to hold on to them for as long as we can.

I want to now transition to talk about the Hawthorne business. Prior to my current role, I was the Head of Finance for Hawthorne going back to our first acquisition of General Hydroponics in 2015. I think that first year, we did about $45 million in sales. While most of our time this year is spent talking about the sales decline from 2021, it's sometimes good to put the business in perspective. We knew that this was going to be a volatile path that we're going to follow. This year is proving us right on that prediction. But we know now what we know then that grouping together powerful brands will provide us with the strength to lead this category as we turn it into a new industry.

You can see that Hawthorne is made up about 1/4 of the total company sales in 2021. That number will be about 20% for this year. Within that Hawthorne business, there are lots of products that make up the sales volume. Lighting and nutrients are the leading segments within Hawthorne business with roughly 25% each. Growing media and growing environment make up another 20% each. Growing media is the material that the plant actually grows in during its growing cycle. Obviously, this is an area we know a lot about from the lawn and garden portion of our business.

Growing environment consists of dehumidification equipment, fans, controllers, et cetera. And the rest of the business is primarily other hardware needed to grow product indoors. Our competitors talk about being focused on consumables. We are the largest consumable company in the space. We also just happen to be the leader in the durable side of the business as well. We continue to drive all aspects of what the grower needs. Our goal is to focus on all the needs of the grower, and the portfolio that we've created allows us to do that and with a broader assortment than anyone in the industry.

With 75% of Americans living where cannabis is legal in some way, only about 12% of the population currently participates in the category. This percentage is rising with consumption increasing by 5% to 7% annually, and there's room for it to keep increasing. There's a lot of runway left in the industry as we go through the peaks and valleys of establishing a new category. The conversation of the industry from traditional growers -- I'm sorry, the conversion of the industry from traditional growers in distribution channels to fully legal growers and dispensaries is a journey that will not happen overnight. Consolidation will play a major role in this process, and we are in the driver's seat to help lead that.

Looking at the right side of this page, you can see that the path forward is going to color this map blue. As legalization continues, we will play a big part in the expansion with the tools needed to supply the industry. This slide is important to see the movement that's already happened, but more importantly, the movement that still remains and the opportunity for us that comes with it.

As we saw in the previous slide, the shifting of the map to blue will also grow the blue line at the bottom, which is legal usage of cannabis. This slide lays out the consumption of cannabis with the bottom being the split between legal and traditional usage. There is a shift from traditional to legal usage that is happening. But when combined, the total usage continues to increase by about 7% per year, and that's the top yellow line.

As more consumers engage in the category, the underlying need to grow will continue to increase. The more legal consumption that we have in the country is good news for Hawthorne. This is a trend that has remained very consistent since my early days in 2015 at GH and does not have the volatility like we've been seeing as we're selling into the growing side of the equation. The total cannabis market will get to $100 billion in sales as we get to 2028. This continued growth gives us confidence in our plan. This has been 7%, and while we expect the growth to decrease a little, we still see it growing about 5% moving forward.

Much like the earlier slide that laid out the key brands in the lawn and garden market, this slide shows the market-leading brands that we own in the hydroponic growing space. These are the market leaders in their category. We purchased these brands as we collected the parts for what is now Hawthorne because of the strong presence that they have in the space. That has not changed. They are the market leaders.

As the market continues to expand, the breadth of the Hawthorne portfolio sets us up well to capture this expansion. We will continue to drive these brands hard with retailers and growers. Hawthorne remains focused on long-term opportunities that we have ahead of us. The majority of cannabis is grown by professional indoor growers, and we have been focusing on cementing these relationships by being a part of their growing decisions. There will always be home-growing that occurs. We have the products for that consumer as well, but our focus as a business is to work with the professional growers to be the partner that they need as they grow in the space.

Being that trusted partner is not just an item and a price. We have and continue to invest in the future products through the work that we have been continuing on with within R&D. We also have invested in technical sales, a team that allows us to take our heritage as a growing company and apply it to the cannabis industry that is evolving. The sales team at Hawthorne has these growing experts embedded in it, and we are using them to help create relationships that we need with the professional growers.

We've covered a lot of ground in the last half hour. Despite the results that we are posting for the current year, we are very bullish about our future. The demographic shifts are going to be a tailwind for us, and we're working to lock in these millennials for years to come. The change that continues to happen across the country as we look at the legalization landscape will benefit our business. We are working hard to own these relationships and the needs of the growers. We are going to be laser-focused on cash flow and debt repayment. This will be the focus for the next couple of years, and the entire organization will be focused on this in a big way. Inventory reduction and a very strict view of capital will be the largest movers in these areas.

Margins will be an area of focus as well. Coming out of this input increasing -- input cost increasing period, we have to get our margins back and we will. This will also be an area that will be a key focus of ours. I want to thank all of you for your time. Again, I appreciate the time spent this morning and the one-on-ones and look forward to the conversations that remain today. Jon?

Question and Answer

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

We have a couple of minutes. If anyone has any questions, happy to take them.

Cory J. Miller
Executive VP & CFO

One in the back?

Unknown Analyst

[indiscernible] giant disparity we're seeing on home centers and the retail POS is always better, like why are they [indiscernible] inventory?

Cory J. Miller
Executive VP & CFO

Well, the improvement of POS that we've seen since Easter to now is really due to the market -- the season shift. So as the season broke, it broke a little late, we were able to get that POS moving. We clawed back a lot of that decline or about where we expected to be for the year from a total POS perspective. When you think about how that affects our shipments, our shipments into the retailer have been pulled back because retailers are feeling a lot of pressure right now. They're feeling pressure on the amount of working capital they have in the business. The cost of everything that they inventory has gone up 10% to 20%.

And if you look at some of the retailers, at their financials, you can see that their inventory levels are up along with those cost increases. They're just feeling the pressure, and they're feeling the pressure of footsteps coming into their store to move that product out. So I think they're making moves to dial back inventory where they can. And we've been falling into that movement. I don't think that -- when you look at our inventory at retail, our inventories don't look that heavy. It's just that the total store is heavy. And we deliver in 3 days, and we have pretty short lead times. So I think they're taking advantage of that a little bit and trying to dial back every dollar of inventory that they can.

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

Given that, are you concerned or are you hearing any feedback from retailers that they're just holding back on their commitment to the category, either this year or even longer term...

Cory J. Miller
Executive VP & CFO

No, I'd actually say the opposite. We've had a lot of top-to-top conversations in the last several weeks as the season is breaking. And they've been more bullish about the category and very committed to us. But they have talked about the demand that they have across their entire store. And within the lawn and garden section, the consumable products are not the products they're having problems with. It's more of the larger durable products that come in and kind of sit and take up a lot of space and a lot of their inventory dollars. But they've been very good partners with us recently. And a lot of the conversations we're having with them is to double down on the commitment they have in the space.

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

Okay. And on Hawthorne, I think the thought originally when the oversupply of cannabis kind of came to everyone's attention is that, that would be kind of sorted out. And by midyear, things would be on a better path, there'd be stronger demand at that point. What's really changed in your view since that initial look at it? Because now, I think you and others are kind of calling the balance of the year as much more challenging, frankly, than you initially thought. What else does it work here? And is there anything we can look to, to kind of predict the end of this kind of trough and maybe the beginning of a new cycle?

Cory J. Miller
Executive VP & CFO

Yes. I agree. As we looked at the year, lots of people expected kind of a rebound to occur in the May time period. And part of the rebound reasoning for us was the outdoor growing season that would start. And as we got into May and started looking at everything we're seeing with our retail partners and growers that we connect with, they were skinnying back their outdoor growth cycles. And if you don't put the plant on the ground, you're going to have fewer opportunities to feed it in the product that we provide to them on an outdoor growth situation.

So the outdoor grow not happening to the level that we expected will help the inventory situation. So it will help that the inventory of end product bleed out sooner, but it does create a short-term shortfall in what we can sell to those outdoor growers.

And the other aspect I'd say is if you look at the capital markets, capital markets are tight right now, and the available capital to invest in a new indoor grow is just harder to get than it was a couple of years ago. So those 2 things are the biggest reason for this year. And we've been looking at different information sources in this space. None of it is that great, to be honest. I think we're finding that we may know as much about the industry as anybody that's pulling information together. And we're not seeing the daily order intake that we think we're going to have to get to, to get to our old guidance levels. So we said we're going to be conservative about our view. We're going to call the number down for the year and focus on hitting that number.

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

Okay. We'll have to stop there. The breakout room is Adler. So we'll head there now. Thank you.

Cory J. Miller
Executive VP & CFO
Thank you.