S&P Global
Market Intelligence

The Scotts Miracle-Gro Company NYSE:SMG

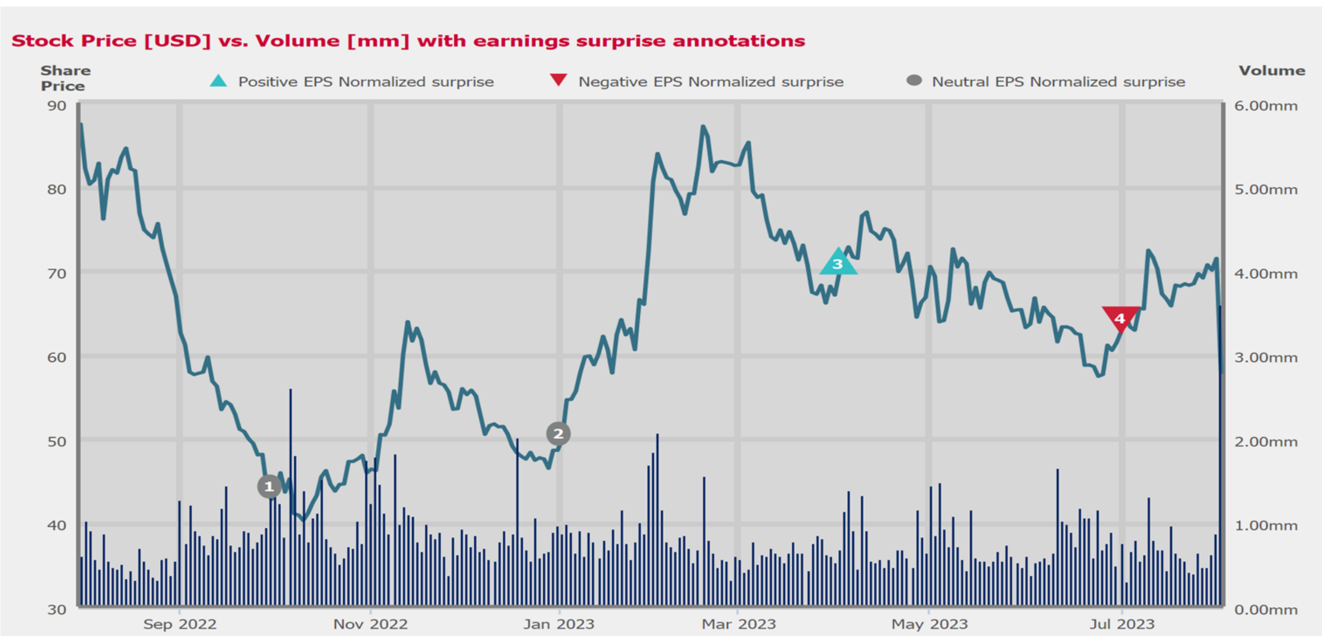
FQ3 2023 Earnings Call Transcripts

Wednesday, August 2, 2023 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2023-			-FQ4 2023-	-FY 2023-	-FY 2024-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.46	1.17	▼ (19.86 %)	(2.57)	2.48	NA
Revenue (mm)	1161.41	1118.70	▼ (3.68 %)	396.42	3573.77	NA

Currency: USD
Consensus as of Aug-02-2023 10:50 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2022	(1.99)	(2.04)	NM
FQ1 2023	(1.34)	(1.02)	NM
FQ2 2023	3.47	3.78	▲ 8.93 %
FQ3 2023	1.46	1.17	▼ (19.86 %)

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Call Participants

EXECUTIVES

Aimee DeLuca
Senior Vice President of Investor Relations

Christopher J. Hagedorn
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James S. Hagedorn
CEO & Chairman of the Board

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Presentation

Operator

Good day, and thank you for standing by. Welcome to the Q3 2023 Scotts Miracle-Gro Company Conference Call. [Operator Instructions] Please be advised today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Aimee DeLuca, Lead Investor Relations, Scotts Miracle-Gro. Please go ahead.

Aimee DeLuca
Senior Vice President of Investor Relations

Good morning. Thank you for joining us for Scotts Miracle-Gro's third quarter earnings call. With me this morning are Chairman and CEO, Jim Hagedorn. President and Chief Operating Officer, Mike Lukemire; Matt Garth, our Chief Financial Officer; and Chris Hagedorn, Group President of Hawthorne.

In a moment, Jim and Matt will share some prepared remarks and then the operator will open the call to your questions. As always, we expect to make forward-looking statements, so please be aware that our actual results could differ materially from what we share today. Please refer to our Form 10-K, which is filed with the Securities and Exchange Commission to familiarize yourself with the full range of risk factors that could impact our results. For further discussion after the call, you are invited to e-mail or call me directly at (937) 578-5621, and we'll work to set up some time as quickly as possible.

Lastly, please note that today's call is being recorded. An archived version of the call will be published on our website at investor.scotts.com.

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

James S. Hagedorn
CEO & Chairman of the Board

Thanks, Aimee, and good morning, everyone. We have 3 things to discuss: One, the state of the consumer and the performance of our lawn and garden business. Two, the moves we're making to strengthen Scotts Miracle-Gro; and three, the opportunities we're pursuing for shareholder value creation.

I'll get to the point. The first half was great. It met our expectations. The execution by our teams in support of our retailers on load-in could not have gone better. It's a challenging time in retail, and we're navigating it with our retail partners. As for the second half, so far, the season is not coming in the way we had expected because of lower consumer takeaway. We think this is attributable to the combined effects of post-COVID sentiment, declining retailer traffic, regional weather extremes, inflationary pressures and price elasticity. As a result, we will not meet our goal of plus 10% POS in our lawn's unit. The full year impact will be an $80 million EBITDA miss to our lawn's target. The other businesses performed more or less to expectations.

So what are we doing about this? We're attacking fall with double the investment in activation dollars, and our retail partners are in too. Remember, fall is roughly 1/3 of the lawn's business. We're taking out an additional $100-plus million in costs under Project SpringBoard Version 3. This work has already started, and our total SpringBoard savings will now significantly surpass $300 million. And we've amended our credit agreement with our banking partners to get maximum financial flexibility moving forward. We continue to make the tough choices necessary to strengthen the financial position of the company, all without impacting our core franchise.

We've improved cash flow by $700 million and remain on target to deliver $1 billion in free cash flow by the end of fiscal '24. We're directing this cash flow to debt paydown. By fiscal year-end, we will have reduced our debt by nearly $300 million. The current state of our capital structure is not optimal. We are carrying a significant debt load without the earnings we expected for our investments in Hawthorne, the cannabis space and expansion of our operational capacity to capture pandemic-level demand. Our mission is clear. We will pay down debt to achieve net leverage of less than 3.5x as quickly as possible.

I think it's valuable to provide context. Our consumer franchise has it all, the best brands, sales force, in-store execution, supply chain, innovation and high cash flow generating capabilities. And we have a major opportunity to get Hawthorne on track in the multibillion-dollar U.S. cannabis industry, along with a great partnership in Bonnie Plants. One thing we are missing is financial flexibility. This obviously will come with debt paydown. The amended agreement gives us the room we need to get through seasonal working capital changes and fully take advantage of margin improvement opportunities. We are maintaining our dividend at current levels and we do not foresee a need to issue equity.

Now let's dig into the details of what happened this year, and what we're doing about it. Overall, consumer retail sales across lawn and garden are up through Q3 with consumer spending $117 million more than a year ago. While these increases are largely due to pricing, it demonstrates that people are continuing to invest in their lawns and gardens. This is a reminder of the power of our consumer franchise. We outperformed retailers and competitors. According to major retailers, we gained share and awareness of the Scotts Miracle-Gro and Roundup brands is over 80% across all homeowners, including millennials. No one can drive consumer connection and attachment with lawn and garden better than we can. Lawn and garden, as a whole, is fundamentally strong. Household penetration is 6% higher than pre-pandemic 2019, a sign that the vast majority of consumers who came into the category during COVID have remained engaged.

Consumers who discovered edible gardening during COVID continue to garden. And we know over 10% of those who are gardening in '23 are new entrants. These gains solidify our confidence that the category will continue to grow. This year, retail traffic at home centers was down 6%. Our marketing and sales team drove people into the stores. We help Savage Spring for many retailers. Our POS volume outpaced foot traffic every month, often by double-digit percentages. Through Q3, gardens had POS gains in both dollars and units across key product lines. Today, we have a $200 million organic gardening business. It's the fastest-growing part of the garden's portfolio and this occurred without the full support of all of our top retailers. We believe that our new organic listings will be far superior in fiscal '24. In lawns, we've had a mix of good and disappointing results. I want to stress that the lawns business is healthy, but it has been impacted by macroeconomic weather and pricing factors.

Let me address fertilizers and grass seeds separately. In fertilizers, our branded POS dollars are up 11%, and we've had share gains of more than 5% at major retailers. While total branded POS units are down 3%, the gap between the performance of our products and private label is striking. Private label is down 20% in POS units. Consumers did not trade down, and they spent more on our brands. In grass seed, POS dollars are up 1%, but POS units are down 8%. We've experienced single-digit erosion of share largely due to the retail pricing at one major retailer. In fiscal '22, we said weather was the main reason for the decline in lawns. With the benefit of hindsight, we can now say that post-COVID consumer sentiment and inflationary pressures played a role too. People shift the discretionary spending to other places, specifically experiences.

This started in '22 as part of the post-COVID hangover and extended into '23. Our recent McKinsey report cited that most consumer spending declined in April right at the start of the lawn season for the first time since the pandemic. The only areas where it increased were entertainment outside the home and travel. These insights are supported by our consumer research. When asked why they did not engage in lawns, consumers said the economy and budget, spending money elsewhere. They also said their lawns look good enough. This has a lot to do with weather, mostly in the early spring, which is becoming more unpredictable and subject to weather events and extremes that impact our early seasons. We think this is a result of climate change. This year, the weather patterns in the Midwest and Northeast significantly reduced normal dandelion and weed pressures that drive consumers to our Weed and Feed fertilizer product. This lack of weed pressure had a similar impact on our Ortho selective weed killer business, which is down a similar amount in the Midwest and Northeast.

Gardens is more insulated from early weather because the consumer is not an on timeline. People plant when the weather is conductive to growing, and our numbers support this. This year, we increased spending on laws to engage the consumer early. In March, we launched the National Daylawn Savings Campaign, which timed well with favorable weather in the South. It led to significant POS unit lift in Texas, up 79% and in Florida, up 86% at the launch. This initial engagement drove sustained POS activity. For example, Texas, our single largest lawn state is now up 10% in lawn unit POS year-to-date. Florida is flat. This was not the case in the Northeast and Midwest, where consumers were still dealing with cold and wet weather during our early national activation.

Daylawn had virtually no impact on POS there. We know people respond when we market to them at the right time. So here's how we're adjusting. We're looking at weather differently. With spring less reliable, starting in fiscal '24 and beyond, we will diversify our marketing and promotions to work around weather extremes and elongate the lawn season. We will not give up on spring as it is our main activation point, but we will invest more in summer and fall for sustained growth. I've challenged the team to drive 10% more lawn's business into the fall. As for Q4 this year, I said earlier that we will attack this fall, which is an ideal time to fertilize and seed.

Retailers are joining us in fall campaigns to drive consumer takeaway and rightsize their inventories. I look forward to reporting the results of this effort during our fiscal '24 Q1 earnings call. We've also determined that pricing, especially grass seed, was an issue for consumers. There have been unhealthy price gaps between our products, competitors and private label. Some consumers took the cheaper option. We are addressing this by decreasing prices on certain targeted SKUs. These special programs with retailers will result in incremental volume lists and expanded shelf opportunities this fall and into fiscal '24.

Looking to the future, innovation is important in lawn and garden. Last month, we held our annual field day at our Marysville research facilities where we showcase new products for our senior leaders and board of directors. The pipeline is impressive. In lawns, we're developing products to simplify lawn care and creating combo products to make it easier for consumers to DIY with awesome results. We're also mindful of weather extremes with drought tolerance solutions and turf alternatives. These products will launch in '24. In gardens, organics, natural products and live goods are more important to consumers. Next year, we'll expand our robust line of Miracle-Gro organic solutions.

Now let's turn to Hawthorne. There has been a stabilization in this business in Q3. It held the line and the daily sales run rate has improved slightly quarter-over-quarter. It's a small win, but a sign there are pockets of recovery in this industry. I've said I want to get Hawthorne to profitability by fiscal year-end. We believe it's achievable, especially as we know that many seasonal professional horticultural sales come late in the fiscal year. We also continue to actively explore noncash partnerships with other industry leaders. We will only make such deals if they bring scale and expanded capabilities that contribute to Hawthorne's and the industry's long-term growth. Our discussions are ongoing with several interested parties. My objective is to move Hawthorne into a partnership or a separate entity from Scotts Miracle-Gro, one in which we maintain the controlling interest. I hope to report more progress on this front soon.

Moving to our total company outlook for '24. We have tailwinds coming our way that will contribute to margin improvement as we work our way through high-priced inventory and realize the benefits of lower commodity prices and easing of consumer inflationary pressures. Urea exceeded $900 at its peak, it's now in the mid-$300s. Other commodity costs like resins, corrugate and pallets have come down and freight rates continue to moderate. They're down mid- to high single digits this year, and we expect further declines in '24. All of this points to margin improvement opportunities and ability for us to remain flexible in our targeted pricing reductions for consumers.

We've been down this road before, and we've emerged in a better place. That's how we see this playing out now. The trajectory of our fundamentals is strong. We're improving cost structure, paying down debt generating cash flow and investing appropriately in our brands, marketing, sales, R&D and supply chain. I very much appreciate the support of JPMorgan Co bank and all of our banking partners. They've displayed tremendous trust in us, and we will not let them down. I also want to praise the work of our financial team. As we've restructured and optimized to align to today's realities, we've had to make difficult decisions. And that includes having to break ties with good and loyal people. We've sought to take care of them, and we wish them the very best in the future. It's equally important that I acknowledge the grid of our leadership team and associates. They are talented, battle-tested and world-class. Their commitment to winning and delivering exceptional shareholder returns is unparalleled. Thank you.

I'll turn the call over to Matt to discuss the financials.

Matthew E. Garth
Executive VP & CFO

Thanks, Jim, and good morning, everyone.

As Jim noted, we started the year with record level first half load-in. In the third quarter, it became apparent that second half consumer takeaway will run behind expectations, resulting in longer-than-anticipated margin recovery and therefore, a different deleveraging path. The credit agreement amendment was pursued as a result. We believe this agreement appropriately reflects SMG's core strengths and strong free cash flow while providing flexibility to maximize value going forward.

Now on to the financial review. Third quarter total company sales of $1.12 billion were 6% lower versus last year, primarily related to a 39% volume decrease at Hawthorne. Net sales in U.S. Consumer were $916 million, an increase of $12 million over third quarter last year. The 1% increase is attributable to both POS growth in the quarter and higher ending retailer inventories. Specifically, the most significant increase was from our growing media business with nearly $100 million in higher shipments in the quarter than a year ago, driven by consumer demand for appealing and productive gardens throughout the growing season.

As I shared on our last earnings call, we entered May with POS units at our largest retailers essentially flat and dollars up mid-single digits with mix favoring growing media. POS trends entering August are consistent with these results as gardening season is in full swing. We expect a more favorable POS mix in the fourth quarter as we launch our fall season media and retailer-supported promotions focused on our branded fertilizers and grass seed. Our total units are behind our original projection. They remain ahead of 2019 pre-pandemic levels, giving us confidence and our consumers' desire to engage in the category in the face of the dynamic environment Jim outlined earlier.

From a retailer inventory perspective, units are up approximately 3% versus prior year entering August. Retailers are expected to continue to lower seasonal inventories, which will reduce our shipments. As a result, we now expect full year net sales in the U.S.

consumer business to end the year 2% to 4% lower than the prior year. At Hawthorne, industry challenges continue, but we are seeing early signs of stability on the top line. There still a 40% decline from prior year. Third quarter net sales improved slightly from second quarter to $93.4 million. Customers are seeking value, and we have supported improved demand signals with targeted pricing actions.

Looking ahead, fourth quarter sales in the North America hydroponics business are expected to remain relatively flat to third quarter. We will see significant growth in the pro-horticultural lighting division driven by seasonality and the continued shift by growers from HPS to LED. For the full year, while total Hawthorne net sales are expected to decline 30% to 35% from prior year, the outstanding work the team has done to rightsize Hawthorne's cost structure will help deliver run-rate profitability by fiscal year-end.

Moving on to total company gross margin rate. There are several important drivers at play this quarter. The adjusted gross margin rate in the quarter fell 420 basis points below prior year to 21.3%, bringing the year-to-date rate lower by 200 basis points to 27.6%. For the full year, we now expect a year-over-year gross margin rate decline of 275 to 300 basis points. The rate decline is driven by these 5 factors. First, the largest was an approximate 190 basis point decrease from the write-down of pandemic-driven excess inventories in the U.S. consumer business that was $20 million higher than our expectations.

On a full year basis, those write-downs will drive a 120 basis point decline in gross margin rate. I view this as onetime in nature and will, therefore, add this back to the margin calculation when estimating underlying performance. While commodity costs have continued to moderate, the benefit of the lower cost will be more fully realized in the back half of fiscal 2024 given higher channel inventories and lower production volumes. Material costs account for gross margin rate declines of 175 basis points for the quarter and 430 basis points year-to-date.

On a full year basis, material costs are approximately 95% locked and are expected to drive a 350 basis point margin rate decline year-over-year. As previously detailed, we are running operations at lower levels to reduce inventories. Lower production volumes account for nearly 130 basis points of rate decline in the quarter and 300 basis points for the full year. These headwinds are partially offset by favorability from Project SpringBoard and net pricing. Net pricing equated to 130 basis points for the quarter and approximately 560 basis points year-to-date. We call that last year's pricing actions will anniversary this month. For the full year, net pricing inclusive of higher-than-planned volume rebates and promotional programs is expected to drive 500-plus basis points of gross margin rate improvement versus the high single digits net pricing we originally anticipated.

And finally, for the quarter, unfavorable product mix has somewhat been offset by favorable segment mix given greater volume declines in the lower-margin Hawthorne business. For the full year, mix will lower the rate by 60 to 70 basis points. Our pass back to gross margin rates above 30% is clear with a return to normalized volumes, continued moderation in commodity costs, targeted net pricing actions, more favorable mix and the full benefit of rightsized warehousing and inventories in both major businesses. Through our latest actions on Project SpringBoard, we'll achieve greater than $300 million in savings. Even with the impressive improvements our associates have delivered through SpringBoard, achieving our targeted margin levels will progress into fiscal 2025, consistent with the viewpoint we shared last quarter.

Our progress on Project SpringBoard is also evident on the SG&A line. Total company SG&A for the quarter was $129 million, 5% lower than third quarter last year and 34% lower than 2 years ago. It is important to note that these cuts were made without sacrificing our core strengths. For example, U.S. consumer media advertising, essential to driving consumer engagement, will be up 25% this year versus last year. As a percentage of sales, we still anticipate sustaining SG&A in a range of 15% to 16% of net sales going forward. Based on lower expected sales this year, we may end the year closer to the high end of the range. Taking all of these factors together, we now expect operating income in a range of 7% to 7.5% of net sales for the fiscal year and adjusted EBITDA about 25% lower than prior year.

Noncash adjustments to EBIT are anticipated to be $10 million to $20 million higher than last year, largely related to increased share-based payments. Below the operating line, we now anticipate a full year tax rate in the 28% to 29% range due to lower pretax earnings.

Interest expense will increase $60 million over prior year on higher average borrowing costs. It should be noted that this quarter will end the year-to-date trend of higher average debt levels. Average debt by the end of the fiscal year will be around $200 million lower than prior year. Equity income from the Bonnie business is expected to improve $5 million to $10 million versus last year. On the bottom line, non-GAAP adjusted earnings for the quarter, which excludes impairment, restructuring and other nonrecurring items, were $66 million or $1.17 per diluted share compared with $110 million or $1.98 a year ago.

Note that the EPS impact of the onetime inventory write-off that ran through U.S. consumer profitability is roughly $0.25 per share.

Let's turn to free cash flow. Free cash flow improved greater than $700 million year-to-date over the first 3 quarters of 2022 as we continue to drive down inventory. We continue to anticipate strong free cash flow generation of approximately $1 billion through fiscal 2024 and $300 million per year on average going forward.

Now let me elaborate a bit further on our recent credit facility amendment. The amendment allows for increases to our debt leverage maximums, modifications to adjusted EBITDA to better reflect underlying performance and adds a new fixed charge coverage covenant. Given the lower Hawthorne sales levels, we have agreed to reduce the size of the revolving credit facility by $250 million to $1.25 billion.

The amendment also raises our borrowing costs in our revolver and term loan A by 25 basis points with an additional 25 basis points when net leverage is above 6x. We ended the quarter with leverage at 6.15x adjusted EBITDA, including $41 million of allowable increases to adjusted EBITDA for nonrecurring E&O and warehouse closure costs.

The maximum net leverage glide path going forward provides ample room and flexibility to navigate seasonal working capital, weather and POS swings. The first 2 quarters of 2024 are the most acute periods in the outlook based on normal seasonal ordering patterns, and we have proper headroom to manage any outside swings. We remain committed to driving leverage below 3.5x as soon as possible so that we can return to a more balanced capital approach, maintaining balance sheet flexibility and delivering increasing direct shareholder returns. Until then, our cash flows remain earmarked for debt pay down.

Without a doubt, it has been a dynamic time for the company. I will stress that the results and guidance we've shared today reflect near-term conditions. 2024 will be upon us quickly, and we have laid out expected high points in the year ahead, broadened retailer partnerships, gross margin improvement, continued benefits from Project SpringBoard, significant free cash flow generation and improving financial flexibility.

As Jim stated, we are accountable for improving our results. I'm extremely motivated to create value at the levels commensurate with our market-leading positions. I'm inspired by the joy our products bring to our consumers, the pride our associates have in shaping the future of some of the world's greatest brands and the commitment to excellence across every facet of the organization. Our priorities are clear. And we are executing urgently against them.
With that, I'll turn the call back to the operator so we can answer your questions. Operator?

Question and Answer

Operator

[Operator Instructions] And our first question comes from Joe Altobello from Raymond James.

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

A few questions on pricing. You mentioned price elasticity in the press release and also in the call this morning. Is this the first time that you're really seeing that come to the 4, if you will? And I guess, how do we think about pricing next year? Obviously, commodities coming down, but could we see pricing down next year?

James S. Hagedorn
CEO & Chairman of the Board

I think you're going to see pricing down on service SKUs for sure. Joe, it's not an easy -- this is something we've been spending a ton of time. If you look at my whiteboard in here, we've been kind of all over what's happening. You look at the lawn fertilizer business, okay, where we gained like 5 share points, and we think that's a pretty conservative number. Certainly, the retailers, we gained a lot more than that. We just sort of dumbed the numbers down a little bit, just so it didn't like mess with our own heads. But no doubt, we gained share on the fertilizer side, but the category declined. So you see private label, we talked about being down. I think the number was 20% and call our units roughly flat. I think they're up a little bit on the branded side. So there's one where we didn't lose share, but the category declined. Now I'm not that nuts about that because when you go back and you look back during the financial crisis, we took the same kind of pricing.

Units declined after things recovered, but we made a ton of money. And so I think the future story for lawns, we need to fight this and work units up largely because we had such a large decrease last year that if you look back at sort of units sold over a decade, and we were looking at those kind of numbers, they are actually pretty flat, maybe up a little bit during COVID, but they didn't get the giant COVID increase that like gardening got, but pretty flat. And then there's a big decline last year, and we very much said, if you looked at Texas drought, California drought, really historically crappy weather in the Midwest, Northeast, we basically said it's a weather event.

We look at it now. And while, for sure, there was weather, and it's a -- this is -- I could talk for an hour on this one, I think, but I won't know -- yes, I think they don't want me to hear. But there's one where we think that the category is down in part because the pricing of products has gotten high even though we didn't lose share, we did the opposite, we gained share. Now if you look at grass seed, it's a little bit like the opposite and driven by one retailer mostly. And that was where we would typically see kind of a 30% difference between our products and private label and a lot of the private label we do.

So between us and the merchants, there's kind of a sweet spot there where retailers need the private label where they make higher margins to be healthy. And so we're cool with that. And I think compared to a lot of other marketing companies, we participate in the private label and think that's a healthy thing for us to do. One of the retailers we have, which was a major retailer, that differential, they sold our grass seed because they wanted the margin up above our recommended retail and the price gap then on the private label was about 50%. And there, we lost share there. So I think there's one where when you have a delta like -- and they're not going to repeat that.

So that's part of what we're doing when we talk about sort of specialized programs to deal with certain SKUs. So we're not going to see that big a difference. I think they recognize the sort of, I'm going to say, the damage they did by having that big a differential. So that's not going to occur again. But there is one where we do think the grass seed probably got more expensive than it should be. And the good news is the commodities are down on both the lawn fertilizer side and on the grass seed side that allow us to correct these prices. I don't know, Mike, would you add anything on this?

Michael C. Lukemire
President & COO

No, I think it's a balance of units and the right price for consumers, and we work with retailers, and we will get the -- I mean we've seen in one adjustment we've made already a 40% lift in units. And so we want to drive units, and we wanted to do it in a margin-accretive way.

Unknown Executive

I think that's a very important point. That margin accretive way, absolutely, Mike, because -- and Jim just said it, you're seeing commodities come down. You're seeing us manage our cost structure, I think, expertly and bringing our average cost down, that's margin accretive. And so we're going to stay ahead of the selected price reductions that we're giving with cost out and cost position to look to '24. And it's still early days looking at '24 for that to be margin accretive.

James S. Hagedorn
CEO & Chairman of the Board

Yes. I mean, Joe, this is, again, something that is fresh, but these price adjustments we're taking are not free. So we're not just offering across-the-board changes on grass seed or further anything else. What we're saying is in exchange for cost out, we're going into that because we kind of think that it's a good idea anyway. But in exchange, we get incremental listings and promotion that we did not have going into this year. So we are working very closely and carefully. And I think in a really positive way with retailers to offer opportunities for cost outs that focuses on certain SKUs that we believe have become expensive in exchange for other concessions from them on incremental business.

And so that's -- and when -- this is, as we were preparing for this call, this is just this morning, Mike was telling us about the benefit and the supply chain of that incremental load. Full utilization of your supply chain, which brings the cost and balance. And so -- and the effectiveness of our field service teams and really it's a win-win for retailers and us. And we want the halo effect of our products. You're not just going in to buy a promotion, one promotion, you're getting multiple products, and that's what we want to get back to fundamentally.

Aimee DeLuca
Senior Vice President of Investor Relations

James. Do you want to take Chris next?

James S. Hagedorn
CEO & Chairman of the Board

Yes.

Aimee DeLuca
Senior Vice President of Investor Relations

Chris Carey, please go ahead.

Christopher Michael Carey
Wells Fargo Securities, LLC, Research Division

Can you hear me?

James S. Hagedorn
CEO & Chairman of the Board

Yes, we can.

Christopher Michael Carey
Wells Fargo Securities, LLC, Research Division

Just a couple of maybe -- well, I don't know if it's quick ones, but here it goes. From -- so it's a pretty big earnings reset, right? And I think the obvious debate today is just what the earnings power of this organization will be specifically into next year. And I think that maybe just 2, maybe, key debates, right? So first, I know it's been touched on a little bit, but like what's your visibility that the excessive inventory that you still have will be clear going into next year. Said another way, is there any way you can frame the ability to enter next year clean from an inventory standpoint? That would be question 1.

Question 2 would just be, do you think there's a dynamic where because you had such good load in this year, you're really building through next year? I realize these are hard questions because we're so far from that outcome. But given the reset today, all are already next year. And so getting a little bit of maybe visibility on inventory and phasing, I think might help people today. So just any thoughts you might have on that would be helpful.

James S. Hagedorn
CEO & Chairman of the Board

Look, I'll start and then hand to Matt. This is something comparabilities are going to be hard, I think, because the last year has been one of sort of making quarters and dealing with leverage targets. And that's created, I think, sales within quarterly periods that where we've sort of incented to make numbers. And for those of us who've lived it, it was very much kind of week-to-week, day-to-day work where we start a quarter looking at how we want to end and kind of what we had to do to sort of get there. Coming out of that and going to a more natural flow, I think, is probably will result in discontinuities.

I'm not saying the negative, by the way. I'm just saying that it will create comparables that -- I think COVID did that by itself. And then I think our behavior through '23 probably will make it even more challenging to read. I don't think that -- so if you look at our inventories and sort of retail inventories, I think, by and large, there's not a giant retail inventory issue. Decisions we made, Chris, that when you look at how we are sort of talking about end of the year because remember, we're not there. We're still sort of working our fall season right now. I think for us to have come in below 4.5x leverage next spring. So I think it was like the end of Q2 was kind of when that our leverage went back under the old agreements went down back to 4.5x. It would have required a pretty exceptional year for us to get there. And I think we talked about it, for sure, we talked about it internally and with the board that -- but it was very much a different dynamic going back to the banks saying we made a ton of progress, but 4.5% is going to be challenging.

We made this quarter, and I'm not going to argue whether we could or couldn't have made Q4. That's not kind of where we were. Once we basically said, look, we're going to be going back to the banks for Q1 or Q2 anyway. And again, that's something we had talked about previously, for sure, with management and the board then we just said with the shortness in lawns, we're doing that, and I waited then for a recommendation from Matt and Mike, how they wanted to pursue the year, if we said the pressure is off, I'm trying to sort of make a certain number for a leverage calc.

How do we want to naturally allow the year to end. So what I wouldn't do is try to read too much into that because we were -- the recommendation I got from the 2 of them was, let's just let the quarter naturally end in Q4, and we'll build an operating plan to that. So I'm not -- this doesn't make anybody's job easier, but when you talk about the earnings power of the company, we could have struggled through Q4 and made a better number. There's no doubt that we could have done that and retailers were to work with us. We made a decision to sort of allow, since we're going to the banks anyway, let's just allow this thing to naturally sort of unwind. And I think it's a healthy thing actually. But -- yes, Matt, go.

Matthew E. Garth
Executive VP & CFO

All right, Chris. Let's frame this up this way. Let's start in third quarter. So you got $1.17, the inventory question, you saw us take a $20 million write-down on some inventory here in the third quarter towards $0.25 a share. So to me, I take the $1.17, I add the $0.25, I'm at $1.42. That's the underlying earnings in Q3. As you step forward into Q4, everything that Jim just said is tactically and strategically how we're moving forward that allows us to unwind inventory. The fall programs that we are putting into place, Mike and his team are executing to drive down inventories to clear out high-cost inventories as we go into '24. Now what I've said about '24 is that it's going to be kind of another transition year of getting margin back, and I'll talk about that in a minute, but let me finish on Q4. If you look at the full year in '23, Chris, frankly, you just said it, and I think we're in the same place. We're already looking at '24. The numbers coming out of Q4, we know that, that's a weak quarter for us just seasonally. You're probably looking with our guidance around $1 to $1.25.

Again, I'm adding that $0.25 back in to the underlying earnings of the company. So that's the full year. As you look at '24, everything that we're doing is around motivating gross margin accretion, and that's probably going to come in excess of 100 basis points. SG&A will stay tight everything that we're doing around driving cost out of the company are going to be supportive, but that inventory overhang is probably going to come through still in the first half. And so you're really now looking at a '25, 2025, where you have hundreds of basis points in margin as you release those high-cost inventories fully into the system. And as Mike said, you're getting efficiencies through the whole system.

What does that mean for '24? There's a pathway back here in '24, where we see $3.50 to $4 a share in earnings, where we see EBITDA in excess of $600 million, and where we see completing the free cash flow of about $1 billion over 2 years, that's going to be directed to debt pay down. That will end up with the '25 improved margins, continued growth given the share and shelf positions that we've gained over the prior 2 years and $300 million plus in free cash flow that again will go to strengthen the balance sheet. Can't really give you an EPS view on '25 yet. And also the caveat for everyone. These are early days, but we know the conversation is very much about '24 at this point, and that's why I'm giving you a little bit of a preview.

Christopher Michael Carey

Wells Fargo Securities, LLC, Research Division

So that was a really comprehensive answer. I won't ask another question, but just to clarify a couple of things that I just heard, you're going to be -- you're still working down inventory into the front half that might limit some gross margin expansion, which really accelerates into fiscal '25. On fiscal; '24, did you say the gross margins would be up 100 basis points, or you're just saying they would be a bit more under pressure and then confirming you just kind of said $3.50 to $4, I don't know if you're talking about a multiyear or if that was in reference to what you think the earnings power could be actually be in fiscal '24.

Matthew E. Garth
Executive VP & CFO

Chris, I was very deliberate in what I said. I practiced it for 3 days. The 100 basis points is what you're looking at going '24 versus '23, okay? There's a lot of activity that's left to go after for us to really point to what that's going to be. But Mike and the team through the power of Project SpringBoard plus all the optimizations that they are doing that feels good, plus what Jim spoke about growing those shelf positions, increasing our volume, that will all contribute. That will yield with the other potential items that we have in place a 2024 view that says you kind of have $3.50 to $4 a share in place. A lot to execute on. It's early days, but that's what we need to be targeting, and that's what we're going after. That then would lead to a 2025 of another opportunity for increased margin expansion as the full deflationary impacts in our cost structure move through. Our inventories are aligned with the much lower raw material costs we have now and that will help us move forward. And by the way, all of that is kind of what I was speaking to directly in that margin bridge discussion and the prepared notes.

Operator

Our next question comes from Peter Grom from UBS.

Peter K. Grom
UBS Investment Bank, Research Division

I guess I just wanted to ask about, you probably provided a lot of color on the '24. But I guess I wanted to get some color on the Hawthorne commentary that you intend to move Hawthorne into a partnership or separate it from Scotts. I haven't talked about for some time, but previously, it was kind of talked about from a position of strength versus where you stand today. So can you maybe just talk about that decision, and why now is the appropriate time?

James S. Hagedorn
CEO & Chairman of the Board

Okay, sure. I think we all feel this way, by the way. We've made a ton of progress in stripping costs out of Hawthorne. And on pretty conservative numbers, that business gets back to profitability, call it this year, I don't know. I think that's what we said in the script. My issue with that business is that when it had a great valuation within our equity when it was earning like nearly $150 million of EBIT, it was good. I think without a kind of significant recovery in that space and everything we're talking about here, I'm just kind of going back to the previous question a little bit. We're just working our initial operating plan for next year right now. And so I think for everybody who's got questions, the bank plan and the sort of initial operating plans are pretty darn conservative, okay, on purpose because of where we are, and we're not sort of going to try to continue to lead with our [indiscernible] here. But let's say, Hawthorne makes reasonable progress, they will.

We're already seeing, I'm going to call modest recovery in that business. I just don't think that it's with the assumptions we put in there, which I think are reasonable. It's so impressive that it can stay the way it is. I think it just looks like a kind of marginal part of the Scotts portfolio. And when you look at it and you say, it's created a lot of beta in our earnings. We haven't really talked about -- I'm sort of escape innovating around this question, I'm not trying to go away from it. But if you look where we are, we got Hawthorne making negative earnings, and we had deployed like $1 billion into inventory and other capital areas. And that's the issue that we're fundamentally dealing with, you can call it about half and half.

A lot of what we're doing in the operating side of the business is slashing burning on inventory, on the capital stuff that we invested in, in capacity on both Hawthorne and Scotts and wiping that out. But we're still operating with more than $1 billion, significantly more than $1 billion invested in an earning Jack ship, okay? And based on sort of the operating forecast that I've seen so far, it marginally makes money. It's a good business. Now I want to get to this part that is we've talked about hooking up with other people. And this is not new for me to create the sort of Ellis Island approach, which is -- there are some really good companies out there that were worth multibillions of dollars that are now worth zero. And a lot of that is investor sentiment. It's the challenges the business has had, it's the inability to bank. I mean, there's just so many things you can throw out there that are sort of negatives on that space right now. We're not going to shut it down.

We've invested the money. We've -- and so as we've talked to people, you all need to know that this is a very unique property, probably the best piece of that business. And when we talk to other partners, all of whom are worth zero, including us on this part of the business, Hawthorne has so much -- we really -- we collected well in that space. The problem is nobody is making money on the cultivation spot, and nobody's spending money on capital, and that's fundamentally the issue, and there's a lot of reasons for that. I've seen good reports even today on why that -- and I think -- I don't know, Aimee, who wrote that report that I saw this morning. But it's right. So we spent the money. We could just walk away from it. I think that's wasteful. We did this for one reason, growth. We looked at lawn and garden. Now we had like a 30% increase during COVID in lawn and garden.

But before that, we were seeing a couple of percent growth. And we looked at live goods, and we looked at cultivation supply in the cannabis side and said these are growing at a multiple of ours. So we invested that. And I think we continue and -- within our numbers to have -- I don't know what the number is, but call it $15 million of R&D spend, innovation spend behind the Hawthorne business today and we could walk away from that. But this is really the difference between the future and not.

We could cut that money and not spend that. But when we talk to partners, people in the industry recognize the power of what Hawthorne has. And everyone is in the same boat. So the question is, could you take people like more than one company, more than Hawthorne and put people together and create a business that has enough scale and enough earnings that is capable of being kind of a stand-alone business? And whether that's within Scotts or outside of Scott, but I would make the argument that, that business needs to be north of $100 million of EBITDA, I think it's the terms we use in the operating side. And I just don't see Hawthorne in the near term getting to that. And I see a lot of other people out there with really good exceptional businesses also floundering where getting together offers scale and it offers strategic impact that I think we're not going to get along. And I think for the Scott shareholders, I think the beta we've introduced into our earnings as a result of this investment is probably not healthy. We know one thing about Scott.

Scott is a high cash-flow business. And we've got to find ways to sort of strengthen the Hawthorne platform and offer, I think, other people who are in exactly the same boat and you all know who they are, okay, and create something that strategically is important. And I just -- I don't think that we can get there by ourselves. And the -- there are opportunities. And when we talk to those people, unlike maybe a little bit the conversation we would have with you guys on the phone today, where you say, nobody else is saying that. Everybody else is saying, no, no, you guys really put something great together. Chris, you got something to say?

Christopher J. Hagedorn
Division President

Yes. No, I just...

James S. Hagedorn
CEO & Chairman of the Board

It's your baby.

Christopher J. Hagedorn
Division President

Yes, I know it is. And it's -- look, it's tough going through what we've been through. And look, understanding what the investments on this side of the industry have done to the core business sacrifices that the North American business has had to make to support Hawthorne through what it's been through. I just want to just quickly touch on when you said making this decision from a -- in the past, you've talked about it from a position of strength and now it's different. And look, clearly, I recognize the maybe the irony and what I'm saying. Look, strength of a relative thing. And clearly, Hawthorne is not the business it was.

The industry is not the industry it was at the time being, but Hawthorne still within the industry operates from a position of relative strength. And I think that's giving us in partnership conversations are really good position to negotiate and work from -- as Jim said, there's a lot of really good businesses out there that have fundamentally strong assets. If we can put those things together with Hawthorne. And when Jim talks about partners that he has, he's not just talking on the cultivation side where we operate. But when customers of ours, I mean, the people who are actually using our products come to see what we do here at Hawthorne, come to Marysville here and see R&D and innovation, all the work that goes into that side of the business.

People are really impressed and they're extremely optimistic about not just the long-term outlook of the industry despite where we are, but the presence and the contributions that Hawthorne can provide to it. So look, I know things are tough right now. We are going to make a move. The work that the team has done to get the business back to a place where profitability is really within our reach has been tremendous. It has not been easy for anybody. But again, I think we are in a position of relative strength compared to a lot of the other folks in the industry. And we want to go this not alone, but together and there's a lot of...

James S. Hagedorn
CEO & Chairman of the Board

And I want to talk just a little bit, Chris, about the cost of that strength. Some of the people we've talked to theoretically know how they can cut expenses. We have absolutely blood all over us here, as a result of what we're doing. There was a whole another round of layoffs this week here, okay, as we have sort of proactively dealing with our self-help, okay? When we talk to some of these partners, some of the partners are living in the same world on Chris' side, and they have made some of the changes. With us, we show up with absolute certainty in our numbers because they are created through blood. And that blood has been let, okay? So getting Hawthorne back to profitability is something that was shotguns and knives. And we've done it already, unlike some of our partners who say, well, I could do this and that. We've already done it. So part of the strength in these discussions is from the certainty of we've already done it. I don't know, Peter, if that helps at all.

Peter K. Grom
UBS Investment Bank, Research Division

No, it does a lot. I appreciate all that color. I mean -- and then Matt, I appreciate all the color you provided to Chris' question on '24. Maybe just a couple of points of clarification because it just -- to get the $3.50 to $4, it seems like a substantial increase in earnings given what we're kind of what's implied for this year. So maybe first just on the 100 basis points of gross margin expansion, is that incremental on top of what you would get back from cycling, the write-downs? Because I think you mentioned that's 120 basis points, or is that a total number? So whatever taking 270 to 300, you just add 100 to it, and that would get you there. And then I guess what I'm trying to understand within that is just maybe what's assumed for leverage and kind of interest expense? I think it would be helpful to kind of just maybe bridge us to $3.50 to $4 with 100 basis points of gross margin expansion. I just think that would be helpful.

Matthew E. Garth
Executive VP & CFO

Yes, no worries. And I do think, one, you have to take into account there's top-line growth next year. right? And so kind of out of the gates, everything that Jim and Mike have spoken about is growing mid-single digits in U.S. consumer next year, which with the margin also going up kind of that 100 basis points. And by the way, that's kind of a year-end full year '23 to a full year '24 as I'm looking at it, and that's coming through, like I said, additional volume, additional cost outs, additional expansion of capability that we are bringing on to the shelf with innovation, all of that is going into play. So that leaves you with a pathway to gross margin, EBITDA, again, growing commensurate. And then as you move to sort of lower in the P&L. Yes, you're right.

We are going to do what we've done this year. You'll see a consistent debt paydown of about $300 million next year, that obviously will work towards the net leverage calculation on an average of about $200 million. Commensurate with that will be an interest expense reduction you can do the math there. You're kind of averaging 5.25% right now. Next year, you're probably going to be in that range, 5.25% to 5.50%. So I'll leave you to do some math, but albeit on a lower debt level, and then tax rate will probably improve a little bit next year. This year, we're seeing a higher effective tax rate as earnings are a bit lower as earnings grow higher. Some of those fixed tax items, we get more coverage. And so your effective tax rate will move lower. So kind of moving back into that 25% to 26% range is what I'm thinking. And therefore, you put all that together, that's what helps drive the EPS growth year-over-year.

Operator

Our next question comes from Eric Bosshard from Cleveland Research.

Eric Bosshard
Cleveland Research Company LLC

A couple of things. Jim, I'm curious what pricing the experience this year and your thinking for next year. I'm just curious where that goes and what your strategy is within that. You've talked a little bit about it. I just would love to understand a bit more. Are you at the point where you feel like the consumers have pushed back on price where in order to have volume growth, in order to have mid-single-digit revenue growth next year, the pathway there is a notable change in your pricing strategy? Just help us understand that a little bit.

James S. Hagedorn
CEO & Chairman of the Board

Listen, I'd start with what's notable is we're not taking pricing next year. So let's start with that one. Eric, I'm not sure we've seen consumer pushback. I said with [grass seed,] I think we all think we have -- I'm not sure that we understand that, well, look at the lawn business, you gained 5 share points. And again, I said that was conservative. The category got smaller. I think that's maybe the pushback. If you look at that research data we had that people said they were just kind of watching their pocketbook. I don't think it's just us. I think it's all kinds of products. So I think that grass seed was a pretty unique situation where we had a retailer actually price like our sun and shade above recommended retail and offer a private label product, 50% below us.

Yes, that one the consumer did vote, but that is a very unique situation that's not going to happen again. So I think we're -- we started on pricing and Mike, you can jump in at some point here is we're not taking pricing. I don't think the retailers would be real tolerant of it. And I think we do feel like some of our products have gotten pretty darn expensive. And those really were lawn ferts, the combo products, they tend to be expensive anyway and grass seed. Then we had conversations with retailers in the last couple of months that are -- and I think you can start with Depot, who is publicly, I think, when TED Talks looking for cost outs within their system, and they're talking to vendors about participating, and they talk to us about that.

And I think within that, the underlying part of the conversation is we actually were sensitive to pricing on lawn ferts and grass seed, where how we could participate with them, which I -- ultimately I gets a cost out as a price reduction. So we've sort of targeted these reductions in exchange for concessions on listening and promotional support that's incremental to anything we had now. So Eric, seriously, I'll view this as a conversation. It's a little different than what you're saying. So you guys finally saw there was pushback from the consumer, not really.

We basically said we're not pricing because we thought our stuff has gotten expensive. And the thing is agricultural products, food, we see it early because you're dealing with a lot of the same stuff, you're dealing with agricultural commodities, urea, various other nutrients, chemistry that goes into the products, pallets, plastic, transportation, all this stuff really pricing up, and we've seen a lot of giving price back on that. And so I think for us to sort of assume we could get pricing, I don't think we would have thought it was good for the business, and maybe that gets to what you wanted to say. But the ability to participate in cost-outs with retailers in exchange for volume increases that were incremental to what we -- and I mean truly incremental to what we have today, I think, which -- this is the whole question I had this morning as I was talking to Mike about this as we were sort of anticipating questions, these are margin positive for us, not only dollar margin positive, they're margin percent positive as -- remember, we overbuilt our supply chain as we were in COVID, not unlike other people.

And so as we've seen slack in that system, where the demand really hasn't been there, and again, we saw it this year, to have incremental business that further loads our supply chain, is actually super beneficial for us on a margin percent. So it even pays for itself in a percent basis. So I don't know, Eric. What do you think of the answer? And like we can talk about it. But I'm not -- no, I'm not trying to be stupid here. Like it's always good to talk to you, Eric. I mean it.

Eric Bosshard
Cleveland Research Company LLC

Yes. I'm just trying to figure out how you connect that, that's where your customer, Home Depot wants to cost out. Your consumer has said, like my lawn is good enough at that price. The units are negative. Your comment is it's great to load volume -- one path is to lower the price to solve all those things.

James S. Hagedorn
CEO & Chairman of the Board

And I guess, effectively, we're doing that. I think you're misreading what I said in my prepared comments, okay, which is my lawns good enough for the price. For those of us who live in the Midwest and the Northeast, you saw kind of real wet early spring, and lawns looked really great. They were not parched out. And I think that it was -- I'd like to save the money and my lawn looks good enough. A lot of that, from our point of view, good enough was weather related and that my lawn looks pretty green without doing anything. And that was true the spring. So I don't misread the data. Mike anything you...

Michael C. Lukemire
President & COO

No. I mean if you look at Texas, I mean, we over-indexed. The weather was right. We did the promotions and the advertising. We were super, I mean what was the percentage early on, it was a 90% low. We were really optimistic about it.

James S. Hagedorn
CEO & Chairman of the Board

Eric, I think in dollars in Texas. We're up like 25-plus percent. Year-to-date, in our largest single lawn market is Texas, and it's up in dollars like 25%. I don't know what we said like it's more than 10% in units year-to-date. And so -- listen, it's one of those things where I actually don't know what it all. I wish I could say I know exactly what it means. We spent -- Matt and I spent a ton of time this week on saying we need to actually have an answer here. And Eric, one of the things -- this is really for everybody. We become -- our spring season has become very much a weed and feed season. And when you look at that early Daylawn Savings program we did, which coincided really well with Southern weather. And I just -- I know this data really well now. It worked really well, weather was good. And we talked about before, whether weather is not good and you promote it doesn't do much. We didn't see like the needle even move for Daylawn Savings with national promotion.

It got a lot of load in, which was good. Even in the North, retailers were prepped, but then since you saw nothing really happened in Daylawn in the northern markets, it really became like a Black Friday, a single Black Friday event where your -- the peakiness of the lawn season in like the Northeast was one week, okay, which is when the stuff was on promotion. And that's partially our fall. We, together with the retailers, have got very focused on weed and seed. And then you say, so what is it that the people really want? Do they want green, or do they want [indiscernible]? So lawn took this position, the brand people lawn saying, the weed season was just kind of screwed up in the Northeast. And we said, yes, so you say, okay, I assume we sound a little bit like you, so you say.

And then we went back and pulled the Ortho data, and it basically was exactly the same, Ortho selective weed, almost exactly the same. So I think part of what's happened in lawns is we've become very much in the spring season, [indiscernible] plus weed plus dandelion. It's become kind of [indiscernible] plus 2, one big [mondo] promotion. And if the weather interferes with that, it's just -- it's pretty disruptive. And so I think that's a little bit how we look at these -- the differences in the country because you have the biggest state in the union from a lawn point of view, like plus 25 in dollars plus 10 in units and pretty bad numbers in the Northeast. And so how do you get to this whole issue of pricing, where you got one state, the number is -- but it goes bananas, and then we get into this whole weed thing and then we look at Ortho and it's the same numbers.

So Eric, I don't know what it all means except to say that we're not chancing this because I think the retailers believe, and I know you have a great relationship with them. I think the retailers believe pricing was a factor. And so we're dealing with that. But we're dealing in a way of, I'm going to say, strength meaning we will work with you on this in exchange for x, y, z, which is all incremental. And I think what will happen is next -- look, first of all, nobody has anything to go on with spec and Central other than their first half numbers, then they sucked, okay? Not our first half, okay? That's part of what we're talking about here, okay, is -- the work we did and the friendships we had with our retailers really helped our load, and that helped our share, okay? The -- I'm not going to say concessions. The actions we're taking to deal with seed and lawn crisis are going to have effect on our shelf presence and our promotional sort of percentages. And I think you'll see that next year. Those programs are being put to bed now. But I think we're very confident on what's coming out of them.

Eric Bosshard
Cleveland Research Company LLC

Second thing, probably maybe a little bit easier. Just from an inventory perspective, you commented about you managed this year a little bit quarter-to-quarter for the covenant, which makes sense. And now you've created a breathing room around that. Doing that obviously involves some pushing inventory to retail. You've talked about this bigger bet on fall lawns. The question is like is the risk that you end this year with more inventory retail than there should be, and that's a limiting factor for next year, or am I connecting the dots incorrectly?

James S. Hagedorn
CEO & Chairman of the Board

Yes. I don't -- listen, I don't think it's a limiting factor. I do think that to people where we fell short on our lawn numbers, there probably is higher lawn inventories. I personally have had conversations with retailers, not that there's a problem, but they bring it up. And so fall is pretty important, I think, to everybody. I don't know the exact percentages, Eric, but our spend for marketing in the fall is nearly 250% higher than it was last year. And we're not destocking, so the big fall promotional items that happened with grass seeds, lawn ferts and Tomcat, our rodenticide line. They're all going to get pushed hard. Now I wish I could tell you next quarter, we can tell you what the answer is, but a lot of these occur in that transition between the fiscal year. So a lot of this happens in November. So our first quarter numbers should say how successful we've been in both POS or sales and also in Tomcat. Mike, anything?

Michael C. Lukemire
President & COO

No. I think you're going to see retail inventories down versus the previous year, Eric. The question is, how far down based on that fall program. So...

James S. Hagedorn
CEO & Chairman of the Board

Yes. So I think that's an important thing to remember. We ended last year, not saying we had inventory problems. We said inventory was, I think, either lower or about where it should be. This year, inventory is going to be lower. Okay.

Michael C. Lukemire
President & COO

That's going to be lower, just how much and what's the promotion and what falls in the fourth quarter versus the first quarter on shipments.

Matthew E. Garth
Executive VP & CFO

Those were retailer inventories, absolutely. From our inventory position, Eric, we did say part of that $1 billion in free cash flow over 2 years, the $400 million of it was related to excess inventory. And the plan is and was to take about half of that this year, half of that next year. As Mike detailed earlier, trying to gain some momentum here in the fall will help bring in some of that inventory reduction into 2023. So as Jim just pointed to, a lot to report on kind of Q1 of '24 on how this is all going to play out.

Eric Bosshard
Cleveland Research Company LLC

And then if I could just ask one last one. The obviously, everything was on the table. You add it to the restructuring, you're talking about, I think, a notable change with Hawthorne. You made a change with the debt covenant, and the board decided to keep the dividend, even though you're not going to earn the dividend this year or probably through the first half of next year, why? Why that position or strategy around the dividend?

Michael C. Lukemire
President & COO

Listen, I think we -- I'll speak from -- with 2 hats, okay? And start with the family hat. And that's not because it's more important. It's just the easier one to say. While the dividend does matter to the family. [My little sister,] Susan, who's the Chairman of the limited partnership, we have -- Sue and I have been real tight on this. And our view is whatever best for the company is the right answer, okay? So let's just put that one, which was not some weirdo move by the family to keep the dividend. As we looked at this from other companies who have either suspended or cut the dividends, the destructive effect on the value of the equity is so striking that it was something that in the discussions that Matt and I have had, and we have all had with our banking partners, it just didn't seem like it was worth it. It was really seemed like it was a kind of a third rail issue. And it didn't really move -- it doesn't really move the leverage numbers enough to sort of take the risk on the signal sent to our equity partners, okay? So -- Matt?

Matthew E. Garth
Executive VP & CFO

No, no, no, 100%. In the first year that you cut the dividend, it's kind of worth 0.1, maybe 0.15, second year, it aggregates to like 0.3 on the impact to that leverage, Eric. So it's not going to move the needle in 2 years versus what we're going to do in the denominator of the net leverage calculation and also on the cash flow side of what we're going to be able to achieve and direct that to debt pay down. The other thing is, and Jim sort of glanced off of it, in our conversation with our top shareholders, everyone is agreed that they highly appreciate the dividend, our commitment to the dividend and keeping it in place as we manage through this. I'll use the direct quotes, "don't solve a near-term issue with a long-term structural impact." And impacting the equity in the short term to the significance that you've seen with some of the other companies that have cut their dividend would be significant.

Operator

Our next question comes from Jon Andersen from William Blair.

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

I'm sorry if this has been already addressed a couple of times, but I just did -- I do want to see if I can get some more clarity on the 2024 commentary that Matt gave. Maybe if you can just walk us through again the thinking or the baseline assumptions around sales growth and in particular, on gross margin, is that 100 basis points of year-on-year improvement, is that on an adjusted basis, meaning, is it excluding onetime adjustments in both years, such as the inventory write-downs this year? And then again, how much debt reduction are you assuming in 2024 relative to 2023? And I guess lastly, I think I heard EBITDA referred to $600 million in 2024. Did I hear that right? Is that -- what's implied by the EPS of $3.50 to $4?

Matthew E. Garth
Executive VP & CFO

All right. A lot to go through. One, early days looking at 2024. So the reason that we are talking about 2024 is to give you all a viewpoint on how we think we can navigate over the next year, okay? So things will change. But these are kind of the way points that we're laying out. Mid-single-digit growth. You heard Mike and Jim talk about our broadening relationships with retailers. All of the factors that are going into that to improve our positions across the shelf, to improve our positions with the consumer so that they are activated and that they are motivated to continue to participate in the space, mid-single-digit volume growth. On the gross margin line, and I think Eric hit it directly. We are managing what is in our control. So another $100 million of cost out. That is incremental. And as Jim said, that's already started. So that will be in next year's earnings.

On the pathway to all of that, that means that we are getting more efficient -- that means that there is additional profitability to come out. And we told you this year we're about $100 million behind in U.S. consumer that will come back next year, on top of the efficiencies that we are gaining. That's where you get the delta and kind of your low 4-ish type $400 million-ish EBITDA this year to getting back to that $600 million type EBITDA next year. From there, you look at the balance sheet, and what we're able to do considering that this $1 billion over 2 years, we've said it's kind of going to be equal weighted between '23 and '24.

This year, we're going to pay down $300 million of debt. I think it's good to assume next year, we'll pay down $300 million of debt. You can then what I've said, is use an average interest rate in [5.25 to 5.50 lend,] can work that through on the EPS side, also took a look at the tax rate and said, hey, this year, we're running a little bit higher next year, pathway to 25%, 26%. All of that contributes to an EPS delta that gets you to that kind of $3.50 to $4 range. One thing that I didn't answer. Your gross margin rate.

I look at things on an adjusted basis. Let's get back to what is happening. There is $20 million in this quarter that is running through our P&L in the U.S. consumer business. To me, it's a restructuring item. And I know that I am the accountant here. But at the end of the day, I don't -- the true underlying power of the earnings of this company, you remove that. It's onetime, it's a write-down. So I do that. I got $1.42 in earnings in Q3. I think that's just off of where the consensus was. I look at the $20 million add back to gross margin, and I build from there. So it would be incremental when you add that back. And by the way, the adjusted margins that we report -- sorry, the margin that we report and talk about are adjusted.

Operator

And our next question comes from Andrew Carter from Stifel.

William Andrew Carter
Stifel, Nicolaus & Company, Incorporated, Research Division

I guess just real quickly, like taking holistically, thinking about this year, there's been a lot of weather headwinds. There's been loads, channel loads. You mentioned the isolate -- what you -- which you consider an isolated incident or on grass seed. Do you feel like you still have the position of strength with your retail partners and like in terms of kind of the category leadership. And -- or has that gone backwards? And kind of remind us on private label, at the retailer level, do they make more margin dollars than your branded product? What's the trade-off there for influencing private label?

James S. Hagedorn
CEO & Chairman of the Board

Okay. I'm going to leave the -- how much do they make on private label and our products. I'm quite sure it's more on ours. But I'll leave that to people who know better than I. Let's talk about our position of partnership or authority in the relationship with our retailers. You have no idea how much stronger it is as a result of what we have all been through, and I'm talking about at the most senior levels of our biggest retailers. I view them all as kind of personal friends. And it's not because we don't matter. It's because we all matter to each other.

I will put it this way, not expect anybody to feel sorry for me. It has been a really long kind of year and a few months, like really long. Like one of the few people I can actually talk about this is senior execs at our retail partners. And when we are trying to make quarters, we -- I have to go visit them and so does Mike. You know what we learned that not only are we like personal friends with these folks, but they need us, and we need them. And they view us as not less important, more important, and when we're talking about the selective price adjustments we're making that will result in incremental listings at our top retailers, you do know what that means.

That doesn't mean diminishing power. That means increasing relationships with our most important partners and the biggest retailers in the world. And so I would say right off the bat, as we have really -- Mike and I have had to make sales calls this last year, it has been one of the really great experiences in my life, and I want to thank any retailer who's listening to be able to sit with them and share what's happening at this business, and how we needed their help and they gave it without having to really beg. And so I can't tell you how much Mike and I appreciate it. But that is not a sign of a diminishing or weaker relationship. Mike, anything?

Michael C. Lukemire
President & COO

No, I would say the relationship is even stronger than ever. And so we're dependent on each other, and we're going to work together so we both win. So -- and I think that's what...

Matthew E. Garth
Executive VP & CFO

I think if you look -- look, I'd have to go with the numbers. I think if you look over the last 5 or 6 years, so my data is dated between sales and finance who are all in here, they can probably answer this question better. Over time, we have definitely been taking share in, I think, all categories we participate in. If you look over like the last decade. My numbers are a little dated. But I think if you looked and said, what would be pretty typical would be -- maybe 50-50 in units, but within that 50-50 in units, probably 60-plus percent of the dollars are branded products within that mix. So they make a bigger margin percent for sure, but I'm sure on the dollars it's the random side where they make their -- lot of their money. So I think those numbers are pretty right, which is, call it, 50-50 units, that's probably 60-plus percent our business and 40% private label dollars. The margins are better, but the dollars I'm quite sure are higher in our space. And they're all not in yes to that, Andrew. So I don't know if that answered your question.

Operator
This concludes today's conference call. Thank you for participating. You may now disconnect.