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SMG - Q1 2018 Scotts Miracle-Gro Co Earnings Call

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OVERVIEW:

Co. reported 1Q18 GAAP loss from continuing operations of \$20m or \$0.35 per share. Expects FY18 adjusted EPS to be \$4.60-4.80.



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PRESENTATION

Operator

Good day, and welcome to The Scotts Miracle-Gro 2018 First Quarter Earnings Conference Call. Today's conference is being recorded. And at this time, I would like to turn the call over to Jim King. Please go ahead, sir.

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

Thanks, Yolanda. Good morning, everyone, and welcome to The Scotts Miracle-Gro first quarter conference call. With me this morning in Marysville, Ohio is our Chairman and CEO, Jim Hagedorn; our CFO, Randy Coleman; and also joining us for the Q&A session is Mike Lukemire, our President and Chief Operating Officer. In a moment, Jim and Randy will share some brief prepared remarks. Afterwards, we'll open the call for your questions. I see that we already have quite a number of people in the queue. So in the interest of time, we ask you to stick to 1 question and 1 follow-up. I've already scheduled time with many of you today to fill in some of the gaps, and anyone else who wants to set up some follow-up time can call me directly at (937) 578-5622.

With that, let's move on to today's call. As always, we expect to make some forward-looking statements, so I want to caution everyone that our actual results could differ materially from what we say this morning. Investors should familiarize themselves to the full range of risk factors that could impact our results. Those are filed in our Form 10-K, which is filed with the Securities and Exchange Commission. I want to remind everybody that today's call is being recorded, and an archived version of that call will be available on our website.

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

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

Thanks, Jim. Good morning, everyone. By now, I'm sure most of you have seen at least the headlines from our press release, so it's obvious we have a lot of ground to cover. Before I get into the results, I want to provide some context for my remarks, and it has to do with the story I read last week



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in the Wall Street Journal. The piece focused on the challenging growth environment for companies in the consumer products universe. It challenged companies for not investing enough in growth, saying they can neither save their way to prosperity, nor buy enough shares to satisfy investors into perpetuity. I couldn't agree more.

Our goal in designing Project Focus was to embrace the truth about the slow growth of our core categories, and that's why we decided to invest wisely in adjacent categories, like live goods and indoor gardening, as well as to make transformational investments in areas like hydroponic-growing products. Our primary focus since then has been to use our cash and balance sheet to fund growth, to improve our margin structure through reconfigured portfolio that require both acquisitions and divestitures, to increase our commitment to driving free cash flow and to supplement our shareholder returns, not drive them, by repurchasing shares and paying dividends.

We've never been a company that manages from quarter-to-quarter. We try to take the long view. We don't get too excited about boom years or frustrated during downturns, but Project Focus went much farther than that. To a large degree, we reinvented ourselves. So when I read that story last week, it reinforced to me that the path we're on is the right one, one that will allow us to continue to enhance shareholder value in 2018 and beyond.

Enough for my set up. Let's take a look at Q1 results and dig a little deeper into the stories behind the numbers. In our core business, things remain steady, and we're tracking exactly as we would have expected at the end of Q1. Our performance is consistent with the trends we saw last year. Right now, we're mostly focused on being ready when the snow melts and the season breaks.

Hawthorne obviously saw a different outcome in the quarter than we were expecting. The entire hydro segment is seeing a logjam in California due to changes in state law and the downstream impact of the implementation of new rules at the local level. We told you in the past that this business could see significant quarterly short-term swings and this is one of those times. I'll come back to discuss each of the business segments in a few minutes with a particular focus on Hawthorne. As always, I'll leave the meat of the numbers to Randy, and I'll focus on broader strategic themes.

Before I do that though, I want to talk about the revised EPS guidance we provided today related to our expected lower tax rate. If you haven't seen the press release, we've moved our guidance for adjusted EPS to the range of \$4.60 to \$4.80 from a range of \$4.15 to \$4.35. As most of you know, Scotts Miracle-Gro had the highest effective tax rate of any company in our peer group. As we said in our press release this morning, we expect a roughly 700 to 800 basis point decline in our tax rate.

Many of you have asked what we'll do with the tax benefit, so let me touch on that. During the tax debate, President Trump said he hoped that corporate cuts would be shared with workers, and that's part of what we'll be doing with these proceeds. We've always prided ourselves on innovative compensation and benefits program as well as our ability to maintain a family culture in a publicly-traded company. When I walk the halls and talk to our younger associates, essentially those who have been out of college for less than a decade, I'm troubled by the burden that many of them are carrying from student loan debt, so the proceeds from a lower tax rate will allow us to explore new programs that will help relieve that burden.

Also, many of these same people are at a stage of their lives when they're starting a family, so they're challenged by trying to find the right work-life balance. So we're going to also explore the possibility of investing in subsidized on-site daycare.

More broadly, I'd like to see all of our associates save more for their retirement. While I believe we already have a generous 401(k) match, we're going to look to expand it further. Like many companies, we'll also share the proceeds more directly through pay raises, targeting many of our hard-working hourly associates, as well as some of our up-and-coming leaders. On an annualized basis, I will expect these investments could equal about 20% of the total benefit. We'll hold some funds back for these purposes this year, but I suspect most of these investments will come in 2019.

Frankly, I'm glad to see so many CEOs making public statements about reinvesting in our people. It's an obligation too often overlooked by Wall Street. Not all of this money should go directly to our shareholders.



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As you can see by our guidance, shareholders will benefit the most. We won't necessarily do anything differently than what we've laid out in designing Project Focus, but we'll benefit from having more cash at our disposal to help fund U.S.-based acquisitions and share repurchase activities. So let me shift gears and focus on our business results. I want to start with Hawthorne.

When we decided to begin investing in Hawthorne in 2014, we never thought we were chasing a 1- or 2-year fad. We believe the long-term trends remain favorable, and we're confident that they will help drive Hawthorne's growth. That said, we've told you in the past we expect some choppiness from time to time, and we saw that in Q1. Hawthorne reported 20% growth in the quarter due to acquisitions. Excluding acquisitions, sales declined \$12 million in the quarter. We have continued to see negative pressure on sales throughout January, a trend we now expect to see continue for at least another month and perhaps longer.

Let me explain what we believe has occurred. There were a lot of headlines in the last few months about California's new system for authorizing and regulating production and sale of cannabis. Many of those same stories also reported that county governments are behind schedule in setting up their local rules for issuing licenses for growers and retailers. It appears this has contributed to a short-term slowdown, aggravated by some natural disasters that worked its way into our pipeline late last year.

Given the size of the California market compared to the other states in the Hawthorne sales mix, this issue clearly impacted our results. I can't tell you with certainty when we'll see the numbers reverse. Obviously, we didn't expect the softness when we provided our full year guidance on our last call. I can tell you, we no longer expect to see 10% volume growth for Hawthorne that was outlined in our original guidance. For now, you should assume that number to be flat, perhaps even down from last year, depending on the second half of the year. Obviously, we continue to expect year-over-year growth from acquisitions.

From a bottom line perspective, Hawthorne team is accelerating some of its integration efforts and contingency plans to offset the shortfall. As always, we have other company-wide contingency plans if it becomes necessary, so I'd encourage you not to overreact here. In fact, there's likely a silver lining for us. Given the breadth of our product line and our financial strength, we are better positioned than anyone in the Hydro growing supply space, not just to weather a temporary downturn in the market, but to potentially benefit from it. I'm not going to predict the future, but I will say that our competitors simply don't have the kind of capital structure that we do.

Additionally, recent trends could actually make the M&A environment more favorable. Because of our long-term optimism about the hydroponic business, we'll be opportunistic if the right deal presents itself.

A final thought before I move on because context does matter here. California clearly has stumbled a bit, as they've tried to put more structure around an industry that was pretty loose in the past. But in the long term, that structure will add legitimacy, and that legitimacy ultimately helps drive the overall market higher, both in California and throughout the United States. So even if the slowdown lasts a couple of quarters, we're still confident in the long-term opportunity.

Let's move on to the core business, which as I said, is performing in line with what we expected. The first quarter usually represents 5% to 7% of our full year results. Because the numbers are so small, you often see large percentage swings from year-to-year. This year, however, sales remained in the quarter flat, which is what we have expected. And the trends we saw through fiscal 2017 remained in place in Q1, which really represents the end of last year's lawn and garden season.

When it came to consumer purchases for our products, we continued to see modest single-digit growth in home centers and hardware collectively. And we continue to see double-digit decline at mass retail, so the net result was flat POS in the quarter. But as I said, those numbers marked the end of last season. As we look ahead to this spring, we believe the trend in mass retail, while still negative, won't be as big a drag as it was last year, and the support we continue to get from the rest of our retail channels gives us confidence that POS will be a positive number this year.

Part of the retailer support comes from the extremely strong lineup of new products. I've told you on past calls that our R&D and marketing teams were better aligned than ever, and that our new product introductions this year are evidence of that. When we extended the Roundup agreement in 2015, we told you we hoped to bring our first brand extension to the market by 2018. We were ahead of that goal when we introduced Roundup



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For Lawns last year. This year, we're introducing 2 more brand extensions: Roundup Weed Preventer and Roundup Bug Destroyer. I think the names are pretty self-explanatory. Both of these new products have strong listing support in 2018.

We also have strong support from a variety of new lawn care products. Our triple action fertilizer products are regionally specific. In the south, it's a combination of fertilizer weed control and fire ant control. In the north, it's fertilizer, weed control and crabgrass prevention.

As we move closer to the season, our supply chain efforts are ramping up. Shipments are beginning to gain momentum with each week of this year being bigger than the previous one. As always, we expect retail displays to be set in all parts of the country by early March, and then we'll begin to replenish as the season kicks in.

This is the time of the year when we're finishing up our new marketing campaigns, locking in media buys, conducting sales training and ramping up our manufacturing efforts. So while the peak of the lawn and garden season is still a couple of months away, there's plenty of activity going on around here. We only need the weather to cooperate.

As Randy told you on our last call, we expect to see modest growth in our core this year, and strong G&A control. Higher trade program expense, commodity inflation and the impact in M&A will put some pressure on our gross margin rate, but we don't see these as long-term issues. I'll leave the details to Randy.

As I close, I want to come full circle where I started. A little more than 2 years ago, my team and I shared with you a new vision for Scotts Miracle-Gro based on the realities of the marketplace, the current configuration of our company and the opportunities we knew were on the horizon. It was the right plan at the right time. And in a total return basis, shareholders have nearly doubled their money since Project Focus. Yes, the stock market is stronger, and yes, we've shared in that benefit, but today, our growth outlook is stronger. Our margin structure is better. Our free cash flow is at record levels, and our team is having one hell of a good time running this business. Randy?

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

Thank you, Jim, and good morning, everyone. I'm not going to spend too much time on the numbers this morning. For the first time in a long time, we don't have to worry about the impact of reconfiguring our business or changes in our segment reporting. The numbers are pretty straightforward this quarter, and I'm sure you, like me, will find it easier to follow along. The tax benefit and the slow start of Hawthorne are requiring us to refine our guidance in a few places, and I'll point that out along the way.

Looking at Q1, Tim already explained that it's a small quarter, and he shared with you already the story behind what has been happening with the top line in Hawthorne during the quarter. He also explained that the U.S. Consumer segment is right where we expected it to be. So I'll just say that on a company-wide basis, we're up 7% for the quarter, which is only a little behind what we expected because of the backlog at Hawthorne. On a full year basis, we originally guided for sales growth of 4% to 6%. We now believe 2% to 4% is a more reasonable expectation.

So let me move on to the gross margin story. Remember, we said we expected the gross margin rate for the full year to decline 50 to 100 basis points due primarily to higher trade program accruals, higher commodities, slightly lower multi-pricing and the first year dilution from the impact of M&A. All of that remains true, but the impact is magnified in Q1 simply because it's a small quarter. We saw a 240 basis-point decline in the gross margin rate for the quarter to 15.3%, largely due to the volume and mix impacts from our Hawthorne business. The rate will get better as the year progresses, and we see more leverage out of our fixed cost, and as the higher gross margin U.S. consumer business begins to accelerate in our much larger second and third quarters.

I told you on the last call that I expected the modest uptick in commodity prices would probably cost us about \$0.05 a share this year. Since then, commodities have continued to strengthen, especially fuel cost, creating a few more sensitive headwinds for the year. We're nearly 80% locked at this point on all of our costs, so we have pretty good visibility here for the rest of the year. Our full year guidance for gross margin rate remains unchanged. We expect it to decline 50 to 100 basis points.



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SG&A is up 4% so far this year due primarily to acquisitions. Keep in mind that the actual change is only \$4 million, again, showing the impact that the small quarter can have on our percentages in Q1. We originally guided for full year SG&A to be at 0 to 2% for the full year. We're now looking at the low end of the range, so call it flat year-over-year. Remember that the big numbers in SG&A are linked to our U.S. consumer business, but we have disciplined controls in place, and as Jim said, Hawthorne is also using contingency planning to help make up for the expected sales shortfall.

Moving down the P&L. It's worth pointing out the change on the equity income line. We reported GAAP equity income of \$600,000 in the quarter, compared with a loss of \$13.2 million a year ago. Prior year non-GAAP equity income was a loss of \$3.6 million. Remember that our investment in TruGreen will not be included in equity income this year, as we're now in a negative investment position with the JV. Last year's results are not removed, however, so you'll see large year-over-year swings each quarter, especially in the second and third quarters.

As you may know, Mike Lukemire and I are on the TruGreen board. I want to stress that the cost savings we expected from the JV have been fully realized. The business is slightly behind where we had hoped, but I would attribute that to integration challenges. We remain confident TruGreen is making progress in gaining momentum, and will earn EBITDA approaching \$200 million in fiscal 2018.

I also want to make sure you understand that our negative investment position at TruGreen is simply due to the fact that we've taken roughly \$290 million of cash as a business since the JV was established. This is essentially the equivalent of the value we placed on Scotts' lawn service going into the deal. The future value that accrues to us based on our 30% ownership is not affected by the accounting rules that dictate whether the income shows up on our P&L.

Moving back to the P&L. Interest expense increased to \$17.8 million in the quarter from \$15.3 million. Our leverage ratio at the end of the quarter, on a rolling 4 quarter basis, stood at 3.1x. I continue to expect that ratio to approach 3.5x later this year, as we get our borrowing capacity to fund both share repurchase activities and acquisition.

On the bottom line, the loss from continuing operations in the quarter, on a GAAP basis, was \$20 million or \$0.35 per share compared with a loss of \$58.1 million or \$0.97 per share last year. The difference is largely due to the fact that we recognized a net deferred tax benefit of \$46 million on a result of a noncash revaluation and reduction of deferred tax liabilities due to the recent tax law changes. Adding to this is the favorable accounting impact of TruGreen, which I discussed earlier.

On an adjusted basis, excluding impairment, restructuring and other onetime items, we reported a loss of \$62.2 million or \$1.08 per share, compared with \$52.6 million or \$0.88 per share a year ago. To reconcile last year's Q1 to this year, the largest items are nonoperating in nature. In a loss quarter, impact of lower tax rates and lower share count is actually negative, which was worth about \$0.15 in aggregate -- the true operating change in the quarter is confined to Hawthorne, which Jim already discussed at length.

As you saw in the press release, and as Jim discussed, we raised our full year adjusted EPS guidance to a range of \$4.60 to \$4.80 as a result of the tax law changes. At a high level, here's the story.

As you know, the federal statutory rate declined from 35% to 21% effective this year. Because of our September 30 fiscal year end, we will start from a blended statutory rate of 24.5%. We believe our overall effective rate on a non-GAAP adjusted basis will likely wind up at 26% to 27% for fiscal 2018 once we include state taxes and a few other minor items. Beyond 2018, we believe our overall non-GAAP effective rate will still be 26% to 27% and here's why. First, the majority of our products are manufactured in the United States. Domestic manufacturing expense was deductible under the old rules, but to help fund the decline in the statutory rate Congress eliminated that deduction. Congress also limited the deduction related to performance-based executive compensation awards. We have described in detail the significant changes we made last year to our long-term executive pay plans. We were able to deduct most of those costs in the past because the plan was applied to both cash flow performance and total shareholder return. Unfortunately, the majority of those expenses will also no longer be deductible in the future. We expect that the impact of these 2 provisions alone will more than offset the further reduction and our applicable federal rate from a 24.5% blended rate in fiscal 2018 to 21% in fiscal 2019 and beyond.

Like most companies, we continue to digest the changes and apply them to our internal models. So if we need to fine-tune later in the year, we'll keep you apprised.



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As for the impact on our capital allocation strategy, I don't see a change here. We don't have significant CapEx needs right now, and I don't see big investments in our business that we weren't already planning to make. With that said, every bit helps. The tax changes likely will improve our free cash flow by roughly \$30 million to \$40 million. As I said a moment ago, we still expect our leverage ratio to reach 3.5x, so the extra cash just allows us to move a bit faster than we would have previously.

One other change in our model. We originally guided a share count of 58 million to 59 million shares. As we refined our modeling since we spoke last, we now believe we'll be in the low end of that range, with potential to get slightly better, depending on the timing of future repurchase activities.

Let me close by saying that I encourage all of you not to read too much into our Q1 results. The peak of our year is fast approaching, and I have confidence in the plans we put in place and the ability of Mike and his team to navigate the ups and downs of the seasonal lawn and garden business. I also share Jim's optimism about the continued long-term prospects for Hawthorne.

As I've shared with many of you in person, my optimism is not just about the opportunity for top line growth at Hawthorne, but also our ability to begin driving efficiencies from the acquisitions we made and have made and make significant improvement to our margin structure. With that, I'll conclude now and turn the call to the operator, so we can take your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from Jason Gere with KeyBanc Capital Markets.

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

I guess I'll start, actually, just my one question will be on gross margin on -- and just, overall, the -- looking at the outlook. I get it that you guys are sticking with the 50 to 100 basis point decline, and I know some of the trade program expense reversals play in there. But it sounds like you're getting less leverage on Hawthorne just with some of the issues going on there, and then there's some higher commodity cost. So I guess, really, the question comes back to the pricing that you're able to take this year. I know multi-year reversing some back. So can you maybe talk about the ability to take more pricing this year in an environment, where I think you led off, saying that the consumer -- it's a little bit tougher of a consumer environment. That's been kind of the theme that we've been hearing through HPC so far.

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

Sure. Hi, Jason. This is Randy. Regarding pricing, the way the sequence works is it's essentially negotiated with retailers over the -- in the beginning of spring, over the summer, into the fall. And once it's negotiated in the marketplace, it sticks. So we don't have any concern from that end. And as far as just the overall gross margin rate, confirming our original guidance of 50 to 100 basis points, when you think about the volume decline we were culling down at the company, it's 100% focused on Hawthorne. We really don't have a lot of fixed cost in our manufacturing base for Hawthorne, so it's a much more variable manufacturing operation than what we see in our U.S. consumer business. So we don't have big absorption issues that you'd see similar to our U.S. business. So that's largely why we're able to confirm 50 to 100 basis points.

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

Is there anything and...



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

But listen, but Jason, I'd also say that the probability we're taking the pricing for '19 is 100%. So...

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

Yes.

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

And that those negotiations will begin just in a few months.

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

Okay. And I was just going to ask, just like the timing. Because I know what we heard during the peak of the season was just a little bit more push by some of your retailers on private label. So that's why I was just talking about the ability, how much the pricing goes through, the inelasticity to volume if you're seeing other retailers looking at -- doing a bit more private label outside of the big one that we heard -- in the mass channel last year. So I was just wondering, maybe as you're looking towards the resets for this year, how that kind of plays into shelf space and what you're gaining with new products. But the pricing element, just like -- are you seeing more private label coming in, in that context?

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

Jason, this is Mike Lukemire. We're seeing about the same private label. And you got to remember, we do \$300 million of private label ourselves, our own label. And so the spacing at the home centers is actually better this year for us, not less, and then mass was -- is about the same of what we saw the previous years. So we're looking at that to level out, the home center to be up. And so our confidence is actually -- and the indication through the end of January, we're actually up in our shipments by about 4% over a year ago in the load. So of course, February is the biggest month. So I don't see any real risk there.

Operator

Our next question will come from William Reuter with Bank of America, Merrill Lynch.

William Michael Reuter - *BofA Merrill Lynch, Research Division - MD*

Just following up on the last comments that you've just made there about mass, you commented that you expected mass is about the same in terms of your spacing there. However, in your prepared remarks, it sounds like you expected that to continue to decline, and that that's going to be offset by growth in the home centers. So maybe if you can just talk a little bit more about what those mass customers are doing, and whether they're reallocating square footage to private label or taking away from the category, a little more help.

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

Mike, do you want to take it?



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

Yes. So when we look at the store sets and the combinations, we pick up combinations in certain areas, like lawns and gardens, and maybe lose some in controls. So as that reconfigures, it averages out to be about normal. And so what you saw in the first quarter is a continuance of what happened last year. So you're getting the end effects of last year, which is a little bit of a negative, and then it begins to stabilize for the rest of the year. So it's a combination of last year and this year is really how you bridge that.

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

And look, so Jim here. My view is that all you have to do is read anybody who's selling sort of consumer goods -- and the story of mass is told by everybody. The good news for us is it's a relatively small portion of our sales at this point compared to sort of home centers and hardware, and so I don't think we're seeing it as bad. But I think we're also -- it's kind of it is what it is, which is decisions they made. But I think we believe it's fairly stable at this point, and then it's just going to be a matter of where the consumers shop, and their share of the lawn and garden sort of marketplace. And I think that's part of the story as well. So I think sort of time will tell, but I think everybody is pretty chilled here that things are what they are. And we're pretty happy we're not selling detergents and other things, where mass represents such a larger share of the business relative to us.

William Michael Reuter - *BofA Merrill Lynch, Research Division - MD*

Okay. And then just to make sure, you didn't speak at all about a change in your expectation for leverage in terms of your targeted 3.5x. Should I assume that, that's still where you guys stand with that expectation?

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

Sure. Yes, this is Randy. We actually did say that our plan for this year is to continue to get to 3.5x. We've actually said that in over the last year or so. We've received evidence from the TruGreen business, and we sold our international business and pulled back a lot of cash. So good news, bad news -- that's why we've been able to keep our leverage lower, but we actually like to be a little bit higher, and continue to pursue both share repurchases and acquisitions. So that's our plan.

Operator

We'll move now to Bill Chappell with SunTrust.

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

Can you just give me a little more color on the Hawthorne? And just trying to understand, I guess with regards to the trends, is it on the commercial side? Is it on the consumer side? And then also, you've talked to just about California -- that would imply that -- I mean, was the rest of the business, the rest of the country affected or -- and maybe how much is California of that total business.

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

Okay. You've got a lot in there. So if I don't get everything, just remind me.

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

It's a more tolerable situation, I guess, is all I'm looking for.



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

Yes, I totally understand. California is about 55% of the domestic market, okay? So that tells you the size of it. I would say that it's all parts of the market. California, but -- so if you look and say, let's say -- so the rest of the country, I think is fine. It's not as easy to tell as you'd think, in part because we sell through effectively, call it, 3 distributors, and so -- and they're national. So that I think what we believe we've talked to, in our knowledge of the market, is that it's primarily a California situation. If you look and say, "Where do I think the market is going?" And I think you look at Canada, and I think you look at the reg changes that are occurring in California, and I think -- and we've said this before, that this is an industry that will professionalize and get larger. And I think we're seeing that certainly in Canada, and to our benefit, by the way, much larger sort of capital spend. And so I would say that what's occurred is that as California went adult use, they really are looking to have much more of a, although I view Colorado as kind of state-of-the-art, as far as how they're managing within the state. California was a much looser environment, where these caregivers that -- it's a weird environment, where this medical market was how it was growing. So as they've sort of said, okay, we're going to regulate it, and it's going to look more like Colorado -- the counties also have the ability to set in. And we think the bias is going to be more toward mid and large grows, and grows that are sort of for individual use and that who kind of get squeezed is the sort of the smaller local sort of caregiver grows. And I think we're pretty tight on this. So our view, my view, is that this is a big issue in California. That's what's happening. It's part of them growing up and making a much more sort of professional environment. My understanding, and this is as of yesterday, and so our numbers are, I think, as good as anybody, maybe better, is that of the existing grows in California, less than 10% of them are now licensed in the state. That's just how long it's taking. And the majority of the counties are trying to get their own regulations in order, which they have to do to make these permits happen, these permits to grow for retail, and that -- like 9 out of 10 counties haven't done anything yet to get those rules promulgated. And there's long backlogs in places like Humboldt and other like large Northern California countries. So I -- we're talking to Chris' Head of Sales, who's a long-time Scotts guy, who said, "Only California could screw up a great market." I think our view is this is a -- while it's a little bit of pain in the ass, it's what needs to happen, as the country moves toward normalization of this product, and long term, we think it's good and it's important for us. I think we also mentioned that, certainly, things we're looking at, the prices are not going up. I'm talking good businesses. But I would say, the information you're getting now is probably as good as you're going to get from us. It's as good as you're going to get anywhere. I think this is one of the things that why you guys may be more concerned sort of than we are here is, I think, we see what's happening. I think we're a little surprised by the magnitude of it, how long it's taken and how many people are nervous and not pursuing grow permits, and there's moratoriums on most countries. You can check all this stuff, and you will not find that we're -- I'm giving you any like hoodoo here. So I think we continue to believe this is the right place for us to be. And our M&A is looking cheaper than it was, and we're pretty excited by that. I think this is a pretty impactful event for the industry. And therefore, I think this is one where size and sort of capital structure are very much to our advantage now and in the long term. So I think we're pretty confident. I do think that your side of the business, the sort of analyst community, is not as tied to the market as you guys would be, sort of in lawn and garden. And I -- listen, this is one of my recommendations coming out of this, is that we think about getting together with you guys and taking you out to the markets so you can see what we're talking about. Just because I think that for a lot of the people who follow our company, there are more consumer people than they are hydroponic. And I think it would make sense for us to give you a guided tour, so that you, like us, will look at this, and say, "(expletive) happens," one. And two, I think you would share our view that if you're a consolidator in this space, the world just got better for us, as long as you believe in the market, and we do. And that you believe that this is a California specific thing that works itself out in the short term, and therefore, we are still confident. It's a long answer, but I think it will shortcut a lot of people who want to ask questions later on. I don't know, Bill, if that helped you.

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

No, that helps. I guess -- I just -- for clarification, it sounds like that if the average consumer is still walking in and starting January 1, growing their own in California, it's more of the more commercial customer is postponing kind of entering the market, is what you're saying, due to the uncertainty about regulations. Is that the right way to think about it?

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

Not really. I think it's a -- I've learned a lot in the last week, I can tell you, about how that market grows. It's -- it is a version of home grows almost that supplies a lot of that market -- this caregiver thing. These would be, I just call it small to medium grows. I think the benefit will probably unfortunately go to larger grows, just because I think that it's going to be the people who can afford to make these applications to get lawyers to



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see it through to follow the sort of paper trails that have to happen. And if I could get an appointment tomorrow with Governor Brown, I'd say, "Dude, you've got to fix this because you're going to run a lot of small people out of town, and it's going to turn into, I think, a little more like Canada, which I don't think was their original intent." But -- so I think that the future is probably better for the large -- mid to large grow. I think the pain and suffering right now is on the smaller grows, not just -- I'm not -- when I say smaller, I'm not talking about somebody growing for themselves. I'm just talking about something where you'd see it and it's in a house or it's in a small building. I think that's what's being impacted the most. But the bottom line is even on someone looking to buy product today, my understanding is there's only 90 dispensaries in the entire state that have qualified so far for this like adult-use ability to sell-through that space. And so I think the market is being kind of choked on all places right now, both at retail and people's willingness to either legitimize current or existing grows and standing by because of these moratoriums in the county level to say, "When can we get an application and do we want to do it within the state?" So it's a pretty interesting time. It's -- but it's -- I think what has to happen is the state grows up and becomes a more legitimate sort of adult-use state.

Operator

We'll move to our next caller, Joe Altobello with Raymond James.

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

So just a follow-up on Bill's line of questioning on Hawthorne, and Jim, your comments about where the market is going, and it sounds like it's favorable toward the larger growers versus the home grower and the smaller grower. Could you sort of break out how your business is in terms of your exposure to those larger growers versus the home grower? And if that's the case, because I do think you are underexposed to that larger grower, maybe I'm wrong. But if that's the case, why do you think that things would get better in the second half if this is sort of a secular trend in the industry?

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

Well, because I know one thing. There is long backlogs, like Humboldt, I just -- because they gave me the numbers of -- after talking to the County, how many applications are waiting to be processed, which is huge, okay? So I think there's a lot of people applying to be able to cultivate. And so I think that, that trend is not scary for us. I think if you look at Canada and sort of the work that's happened with the big growing LPs in Canada, with let's say, Canopy, the biggest one up there, we have a fabulous relationship with them. I think this is where I think we've really learned where we can add value with the sort of size of the product line that we carry, the professional expertise that we can bring to helping them actually be more productive and profitable. So this is not like I think. This is I know, which is that Canada has really moved forward from a sort of scale and professionalism point of view. It's not a gigantic market relative to California or the United States, but we have very much benefited from big relationships on across our entire -- where our sales force, our tech people, our ability to innovate, be creative with programs, has come together. So I think this is one where we view scale as good. And by the way, we're developing products to sort of deal with areas where we think they're going to want to save money. But remember, we've talked for a long time with you guys about how at least 1 layer of distribution has to come out of -- when something leaves our plans and gets to the ultimate consumer that there's just too many places it's traveling and people who are taking value out of that chain. And that part of what we're doing, as we mature our distribution system, is to deal with more direct sales. And that's another way to deal with the sort of the demands of the larger, more professional customer, and it's not something we're surprised or disheartened by. It's something we know -- we're just executing our plans, okay?

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

So it does accelerate that process from a 2-step tool to a one step sort of distribution model?

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

Yes.



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Operator

We'll move now to Chris Carey with Bank of America Merrill Lynch.

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

So actually, related to that last comment you just made. So clearly, it sounds like M&A is a -- more part of the picture in the very near term, given the slowdown in California. But you mentioned last quarter, \$100 million per year was what you could envisage doing. Do you see the potentials on this higher now? Can you give us a sense of the size of the deals that may be out there and what sorts of assets you'd be interested in?

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

Yes. I'll start, and then hand it to Randy. Was it \$100 million? I thought it was like -- I thought -- I think what people have told me they're looking for, that we put in sort of the noise range, was like \$50 million a year just to sort of...

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

\$50 million to \$100 million.

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

So that's kind of in my head, where -- this has been one of those things where I don't want to take any grief from you guys. I know it will be flying my way, if I could expose myself, was -- I keep saying we're going to close the book on M&A and move toward shareholder-friendly activities, and that's still the case. So I think we're very much in the terminal phase of our acquisition plans. So to me, the question is when the book is closed, what's the number? And I think what people have convinced me is that like \$50 million is just kind of a number that you should view as close to 0, Jim, and not freak out that the book has been reopened without your authority, and that the business has enough money to sort of make changes, pick up adjacencies, et cetera. In regard to right now, I think that we're closing in on feeling that we have consolidated the Hydro space pretty well. I think there's still some interesting opportunities on the live good front, and we continue to see good growth in -- at the consumer level in that space. So there are discussions in live goods. And in Hydro, I think we're almost done, but it's a pretty rich environment right now -- and prices are down, for sure. So given the importance of it to our strategy, and the fact that prices are definitely not going up in the space, that -- we're not, I haven't said that, but whatever is occurring with us, we have definitely had our antennas up for hard for the last couple of weeks, and saying, "This is an industry-wide phenomenon." California, where we said 55% -- California is equal to -- every state in the union combined is equal to California, okay? So this weakness is affecting everybody, and it's making sort of the opportunity numbers look pretty interesting to us. So anyway, I don't know what you want to add.

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

No. I'll just clarify. We have said \$50 million to \$100 million is bolt-ons or adjacent opportunities. And as long as it's a good strategic fit, and the price is right, we'll do deals. We'll just look at our pipeline -- for those kind of deals, probably not as robust as it's been in the past, but again, this is creating a good buying opportunity right now, and there's a lot of interesting things going on right now. It's a dynamic industry, and we're well capitalized and thinking about how we take advantage of that.

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

I have a follow-up. And then just on margins in Hawthorne, obviously, we -- how do you think about expectations for that business to get to mid teens this year as you had previously said and the 20% long-term?



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

Sure. So we expected the operating margins for Hawthorne to approach mid-teens. There's probably a little bit of pressure on that, but we're working through contingency plans that were already laid out when we started the year. We do that both for our consumer business and Hawthorne, so we have room to navigate. So we're looking at open headcount, discretionary spending plans, investments that right now may not make much sense. When sales are down, you don't need to be as promotional, for example, so we're working through all of that. I'd still expect our operating margins to approach mid-teens, and to try to quantify where we expect the business to land for the year. I'd still say mid-300s, probably a little pressure on that to be low- to mid-300s on the top line for net sales, and still expect EBITDA to be in the \$50 million range, give or take a couple of million bucks. So that's what we're looking at right now for fiscal 2018.

Operator

We'll move next to Jon Andersen with William Blair.

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

Just sticking with Hawthorne for a minute, do you still see the potential for -- I mean, is the target longer-term for the business to approach the profitability of your core U.S. lawn and garden business? And if can you talk a little bit about what are some of that not near-term kind of discretionary spending decisions you can make in that business, but some of the longer-term profit improvement and efficiency opportunities that you're starting to work on or you anticipate realizing over a longer period of time?

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

I'll take the first part, and I'll leave Randy with the math. I -- having sort of -- I see and talk to Chris, what I think is maturing well and definitely under sort of fire at the moment, the work we're doing now, both in our sort of acquisition planning which includes sort of the business process of running post-acquisition and the pressure they're under from California right now, is actually a really good catalyst to make the changes faster than I think they might have done if they weren't under pressure right now. So if -- from my point of view, I see the team as actually eyes wide open, functional. I've been in this company plenty of times where things have not been awesome -- and sometimes, it seems like people run around in circles and bite each other in the ass, and it's kind of like any family under pressure, it gets a little dysfunctional. But I'm not seeing that. I'm seeing actually very functional work happening. But they're accelerating the kinds of things that you're referring to that would really be -- consolidation of their sales, consolidation of their selling programs, consolidation of their tech support, consolidation of their manufacturing and supply chain, and these are good things that happen, so.

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

I'd say, just broadly speaking, to date, what we've essentially done is collect businesses that we really like, that we're growing really fast, with high margins. We've integrated them well. We've put in SAP as a platform. So we can start to do what we did 20, 25 years ago with our U.S. consumer business, where products can ride together to retailers, and make it much more easy to do business with. So we're going to be moving the integration and optimization, which was the plan anyway. But given the circumstances in California, we're going to move a little bit faster now. And then with distribution, in particular, we've talked about there's really 3 options. One, we can just negotiate better fees than what we paid today, which arguably, over the industry norm. We could build our own network and go direct ourselves, which is probably the best ROI in the long run, but would take time. And then the final option is to invest in and/or buy 100% of one of the distributors. So if we go down that route, it could be well in excess of the \$50 million to \$100 million that we're talking about. That's really earmarked more for buying new brands or different businesses similar to what we've done to date. So that's the one potential outlier that we should keep in mind. But again, nothing is imminent at this point, and we're going through a lot of deep thinking right now.



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

Yes, and just kind of one more area -- well, this is just to broadly the group. We went into this year, as we always do, sort of under-promising. And so I'm looking right now at sort of the board in my office that we have been using for the last few weeks to sort of track motion in the forecast, and what we look at the full year P&L to look like, and we had not modified our numbers down. So that between sort of contingencies that Chris and his team have, things that they can accelerate and get into, plus contingencies we have, we're sticking with, and eyes wide opened, sticking with our numbers and not digging also into the Trump tax cuts. So we're actually like more chilled than you would think based on where we are at the moment.

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

I'd say, we typically go through the same kind of process usually April-May time period when we kind of see the business is shaking out, but this is something we're used to doing. We do this every year. We just don't always do it in the middle of January, but we're feeling good about the revised guidance that we provided.

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

Okay. One quick follow-up, just on the core business or the business in aggregate. It's a seasonally small quarter for you, but are you seeing -- to what extent are you seeing logistical cost increases, transportation distribution, and how were you thinking about that impact? Is that -- is there inflation that you're experiencing, to what extent? And how are you kind of embedding that in your margin guidance for the year?

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

Sure. We anticipate a bit of that in our original margin guidance. So I quantify right now \$2 million to \$3 million, largely fuel. Jim said we're definitely taking price next year. We know we're going to have commodity headwinds, so we started out the year thinking it would be a few million bucks. It's going to be a few million bucks more than that for '18, and I'd expect the trend to continue to go up next year. So we have it under control for the current year. We have offsets within the supply chain that we can manage through it, but obviously, surprising. It's an important lever to this business and something that we're going to have to do next year.

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

Mike, anything you want to add?

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

No, I think that's -- you covered it, 80 -- we're 80% covered, and we have offsets and retailers are facing that same problem on stuff they're picking up. So they've got that problem as well on stuff they come and pick up from us. So everybody's facing that, but I think we get that covered for this season.

Operator

Our next question will come from Eric Bosshard with Cleveland Research Company.

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

A question for you. The California situation, I'm trying to understand if this is a pause while they process these new regulators or if this is a structural change. And the reason I ask, I'm a little surprised to hear that acquisition prices are declining as a result of this. I'm a little bit surprised to see you



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either rightsizing or optimizing your business if this is just a -- hold your breath for 6 months, and then it returns to normal. And so I guess the core of my question is does the world look different after this, and that's what people are responding to and different worse or different worse for some people? That's what I'm trying to get some context to.

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

Well, dude, I know you dig into our business, so you would be one of the top guys in the list, and say, "Let's go out and visit and talk to people" and -- because I think this will be a really good -- dude, you're one of the best diggers we have, okay? And so I think that we need to help you become familiar with the space. I think different is different, not different is good or bad, and I think it's a pretty important structural change that's occurring. And I don't think for the worse, because I start by saying you're the state the size of California that goes adult-use. That's good, okay? Then just start with the simple part. That's good, okay? Now they want to regulate, and you have an environment where -- of so much of the growing was done in a fairly unregulated fashion, and now everybody's going to be licensed and everybody has got to have paperwork, and the counties have the ability to sort of make their own rules, and you've got -- and the fees are pretty heavy. The regulatory burden is pretty heavy. I think you're going to -- I think you're going to see a structurally a different grower. I don't think it's good, by the way. But when I say good, it's just because I like small businesses, and I think it's -- you go out and visit California, it's a really interesting place in this market, and it's -- I think I've told you guys this. It always seemed to me that it's really inspiring. You go out there, and you see just like people who's -- like all kinds of weirdo people who are like running really cool little businesses, and I think it's going to be hard for them because I think a lot of them just have never faced the challenge of operating in businesses that are much more regulated like the state of Colorado, for instance, or Nevada, and so I think it's going to fundamentally change it. But I think underlying is the state is a really great environment for that market, and I don't see that changing. But I do think that different is different and the cultivators who come out of that are going to be probably more professional and proficient at doing paperwork and dealing with the sort of regulatory burden, and I think that's going to phase out quite a few of those people. And honestly, I'm sad about that just because they've been great customers. I look at where the market is in Colorado, because I put Colorado as a very, I wouldn't say very mature, but I'd say a mature state in regard to cannabis sales, and it's a great business environment for us. It's just very small relative to sort of the size of California. So where the market goes for us, I think, is more like just a gigantic version of Colorado, and that's good for us, not bad for us. It's just I think there's -- in the Air Force, we would say change is the result of a significant emotional event, and without that emotional event, you don't have change. I think this is a pretty significant emotional event for the California cultivation market. And I think it would be great to take you in to visit, and others who are interested, to actually see it yourself and talk to a bunch of these people and try to get a feel for what's happening. It's not all fubar-ed and scary. I think it's just probably bigger than we thought, and I think the effect of the local county regulations and the fact that -- I was shown a map yesterday of counties that aren't even accepting applications right now, and that's the vast majority of cultivation permits in the state of California are in counties that have not gotten the rules together yet. And it should be soon, I mean, within the next couple of months. But I think that's what's occurring, and that's affecting people's build-outs, and that affects people's willingness to buy lights and other sort of fixed products, benches and trays and all the things that we sell. So I don't know if that answered your question, sir.

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

Yes, it does. I understand the change. I guess the follow-on is that your portfolio in position that -- was to deal with the small local guy now becoming for the bigger professional cultivator. Do you have to do anything materially different with the portfolio to service a different customer and/or does that invite different competition to consider as the end market customer is changing?

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

Look, I'm not going to sort of try to sort of editorialize on competition. I don't think there's anybody better positioned than we are by far, okay? I think there's people struggling out there, okay? And that ain't us. So I think we're looking to sort of round out the portfolio. I think the biggest challenges for us is, I'm not sure if Randy or Mike are talking about it, but we all agree on this. And if Chris was on the phone with us, he would say, "I agree," which is because we've seen it in Canada, which is when you're dealing with these big LPs, these are companies worth what Scotts is worth, okay? It's bringing the entire portfolio together with technical support, the ability to help them design, to install program sales that are all the way from lights into nutrients. And right now, we have been very successfully kind of not pushing the full integration too far. I think that's a deal with the future marketplace, and maybe the future is upon us. I think they're going to actually be what we had always planned to be, which



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is one -- it's dude, it's Scotts North America. It's one face to the marketplace. That's -- and in that environment, maybe with a little bit here and there, with either partnerships with other companies and a few more product categories that we're interested in, which is not gigantic money, I think we have everything we need to be the powerhouse of this industry and to really support the large growers, and we're seeing it -- it is our advantage in Canada when we put this consolidated effort forward, just like we did in retail in the United States.

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

Think of Hawthorne as the complete solution for this category. So all the things we put together, all the technical capability. So now you're dealing with the grower or a small grower and you are actually being able to provide them all the help that have great success, and basically, what we've put together is that capability with the technical services, and so we're ready to go either way. So -- and to your point about 6 months, but this kind of slowed. We have a list of things we wanted to integrate. We're just accelerating them. So it actually -- it should help us when it breaks loose. And then if there's pent up demand, it actually could go the other direction to fairly quickly as far as, do we have enough in supply. We'll be much better situated to handle that. So on the operations side, I am very optimistic when we come out of it. The question is when do we come out of it and how much can we get ready when it comes out?

Operator

Our next question will come from David Stratton with Great Lakes Review.

David Michael Stratton - *Great Lakes Review - Research Analyst*

When we look at your interest expense, this rising rate environment that we're seeing right now, can you break out how much your exposure is to a fixed versus floating and your overall interest expense at this point? And what you see or are possibly doing to prevent any downside in the future if rates were to continue to increase with the recent pace?

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

Sure, David, this is Randy again. We're about 60% fixed at this point for the current year. We've put on some new fixed rate swaps in the last quarter. And there are points in the past we've been a little bit higher than that, but part of our reluctance to go much higher at this point is we have access to oversee Wolf's facility that it's actually beneficial to us from an interest rate perspective, and we can tap that particular facility and borrow at cheaper rates, especially during the peak of the season. So we really like where we're at right now. And when you go out beyond 2018, we're still on that 50% or so locked position for the next couple of years. So I think we're appropriate, and like where we're at.

David Michael Stratton - *Great Lakes Review - Research Analyst*

Got you. And can you tell what your weighted average rate is right now?

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

It's in the mid-4s at this point. It's crept up, as you expect, over the last few months, but getting closer to 5. It's been probably just 20 bps or so higher than what we saw on average over the last year, but we're still early in the year. We expect it to be 4.5 to 5 by the end of the year. And that's the weighted average, including bonds and everything else, our whole debt facility.



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Operator

Thank you, everyone. That will conclude our question-and-answer session for today's call. At this time, I would like to turn the conference back to Jim King for any additional or closing remarks.

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

Thanks, Yolanda, obviously, a lot of questions today. So if people have follow-ups, again, you can call me directly today and tomorrow, (937) 578-5622. Thanks for joining, everybody, and we will talk to you again soon.

Operator

That will conclude today's conference. Thank you, all, once again for your participation and you may now disconnect.

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