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SMG - Q3 2015 Scotts Miracle-Gro Co Earnings Call

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OVERVIEW:

SMG reported 3Q15 Co.-wide sales growth of 9% or 12% excluding impact of foreign currency, adjusted EPS of $2.68. Expects 2015 EPS excluding Bonus S to be at midpoint of $3.40-3.60.

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PRESENTATION

Operator

Good day, and welcome to the Q3 earnings conference call. Today's conference is being recorded.

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

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

Thank you, Noah. Good morning, everyone, and welcome to the Scotts Miracle-Gro third-quarter conference call. With me today here in Marysville are Jim Hagedorn, our Chairman and CEO; Randy Coleman, our Chief Financial Officer; Mike Lukemire, our Chief Operating Officer; and several other members of the management team.

Jim is going to provide an overview of the current state of the business. And he also will provide you an update on where we stand against our long-term strategic plan. Then Randy will walk through the financials and the implications of today's results on in our full-year outlook. After their prepared remarks we will open the call to your questions, but in the interest of time we ask that you keep to one question and to one follow-up. If there are questions that we don't address, I'm glad to handle those off-line with you after the call.

One bit of housekeeping before we begin. We are currently planning to hold an Analyst Day meeting in New York on Thursday, December 10. Obviously we'll discuss this at much greater length during our fourth-quarter call, but I wanted to get it on your radar now and ask you to hold that date.

Moving on to today's business, I want to remind everyone that our comments today will contain forward-looking statements, and as such actual results could differ materially. Due to that risk, Scotts Miracle-Gro encourages investors to review the risk factors outlined in our Form 10-K, which is filed with the Securities and Exchange Commission, or our most recent 10-Q.

With that, let me turn the call over to Jim Hagedorn to get us started.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Thanks, Jim. Morning, everyone. As you can see from the press release, we announced some pretty strong results this morning. Not only that, but yesterday we announced an increase in our quarterly dividend. As you'd expect, I'm feeling good about the state of the business and the way the team is executing in a challenging season. It's actually a really good story. In addition to providing more color on our performance so far this year, there are two other topics I want to cover.

First I want to talk about the unexpected challenges that we had with Bonus S. As you can see from the press release, the cost associated with the issue is significant. Since this is a one-time event, we've made the decision to exclude these costs from our adjusted earnings for reasons we will discuss later. Most of the charges we took in the quarter are for costs we expect to have reimbursed. But aside from the financial implications, I'm really proud of the way we've handled the situation.

When we realized we had a problem, we put the consumer front and center. We worked closely with our insurers and made decisions as if it was our own money at stake. Our guiding principle has been to put the consumer first and to quickly fix or replace affected lawns.

The other topic I want to cover is related to the execution of our strategic plan. There have been a lot of moving pieces over the past several months, and you're likely to see more in the months ahead. But every step we're taking is consistent with the plans we've shared with you guys in the past. We remain committed to pursuing reasonable growth opportunities and consistently improving our cash flow.

And we're committed to deploying that cash smartly. While the focus has shifted over the past year from returning cash to making acquisitions, it is our goal to have a more balanced approach in the near future. And I will elaborate that point in a few minutes.

But let's start this morning with a more near-term discussion and take a look at our performance so far this year. Just looking at the press release or the P&L doesn't really tell the story, so let me elaborate. While it's been a good year, it has not been an easy one. The last time I spoke with you in early May, consumer purchases in the core US business, excluding acquisitions, were up nearly 5% on a year-to-date basis. Entering August, we're up just a bit more than 1%. But as I said, there's a lot below the surface.

Consumer purchases of mulch are up 11%. Miracle-Gro branded soils are up more than 10%. Ortho insect products are up 8%; Roundup is up 4%; TOMCAT is up 26%. Remember, there are no price increases this year, so the growth has been entirely volume-driven. However, grass seed is down 7%; and lawn fertilizer, our largest and highest-margin product, is down 8%. I'm not particularly surprised or troubled by these results.

It would be an understatement to say the lawns business has been challenged over the last two months. Since May, we've seen historic flooding in Texas, the largest lawn fertilizer market in the US. Record rainfall in the Midwest has made it one of the greenest summers I've seen here, and put a damper on fertilizer sales. And the irony, of course, is that none of that rain fell in California, where the effects of the drought became more severe as the summer weather set in.

Our other major fertilizer market, the Northeast, had an extremely compressed season. After a long winter delayed the start of the season in the region, spring weather lasted just a few weeks and then we went straight to summer.

So when you understand the story in our lawns business, it's easy to see what's driving POS challenges we've seen in recent months. But there's a silver lining with all that lousy weather. Our bug and weed business are having a great season, and we see that momentum continuing. I know we still have two months left in the year, but it's not too early to assess the score. Personally, I'm satisfied with our result. I'm extremely pleased with our execution against those things we can control, and I've been here too long to worry about the things that we can't.

Our retailers are engaged. The consumer is engaged. And the overall category, all things considered, is doing what we expected, maybe even a little bit better. Our European business is also having a solid year on both the top and bottom lines, building on the momentum they had going into the season. Randy will elaborate on that shortly.

Scotts LawnService has rebounded extremely well after weather delayed the start of the season. That team deserves credit for their effort. I'm sure those of you in the Northeast remember the piles of snow that were still sitting around in April. SLS has been in overdrive ever since.

The business continues to benefit from an extremely successful sales and marketing effort. In addition to the acquisition of Action Pest, organic customer count has increased 5% from last year, and our retention rates remain at an all-time high. I remain pleased with the continued progress SLS is making. And we remain confident that the business will hit its numbers for the full year and be well positioned as we begin to plan and budget for next year.

Across the board, our performance this season on a Company-wide basis once again demonstrates how far our business has come in the past four or five years. When I mention the impact of weather on the lawn business, I'm not complaining; I'm just stating the facts. It's also a fact that since 2012 we've had some kind of extreme weather event every year. Several years ago, those issues would have sidetracked us and we would have likely missed our numbers. But 2015 will be third straight year in which we will hit or exceed our guidance even in the face of real challenges.

We have better planning, better visibility, and better execution. I don't want to say we're immune to the weather, because we're not. But I will say we've taken a lot of the volatility out of the business, and our results so far this year prove that point.

I am going to switch gears pretty hard here and provide an update on what's happening with our Bonus S product challenges. As a set-up, let me remind you that Bonus S is a weed and feed product specifically formulated for Southern lawns. We reformulated the product this year with a new active ingredient for better weed control. The launch came after several years of testing, including two market tests in Florida last year. In late spring, we began seeing an increase in complaints from Bonus S customers. Those complaints spiked dramatically in early May, and were primarily coming from consumers who had a type of grass called centipede in their lawn.

We're still in the midst of understanding why this problem occurred. In fact, it didn't occur everywhere. Those affected lawns were concentrated in coastal South Carolina, as well as Baton Rouge, Louisiana. Our focus over the summer was less on why this happened and more about that it happened.

Once we understood the seriousness of the issue, we were decisive in the actions we took to protect our consumers. Shortly after taking the product off the shelves in affected markets, we deployed a team to South Carolina in order to expedite consumer claims and to work with our insurers. It may sound like an odd thing to say, but this crisis was a very proud moment for me and for us.

Everyone in this Company rallied and were committed to doing the right thing in the most transparent way possible. There were literally hundreds of people involved in working this issue, and I want to thank each and every one of them.

As most of you know, Randy announced at a conference in May that we expected the Bonus S issue would cost us $5 million to $7 million, with the balance covered by insurance. Now, about eight weeks later, we expect internal costs to be closer to $10 million. As you can see in the press release today, we took a charge in the quarter for $45 million related to this issue. Except for our internal costs, we expect that charge will be reversed over time as we receive reimbursement from our insurers.

The last word on Bonus S is this: we view it as a one-time event. We are confident that Bonus S will be a strong performer for us again in 2016, and believe that our actions in dealing with this issue reinforced for our consumers that Scotts is a brand that they can trust.

Before I turn the call over to Randy, I want to talk about where we are strategically and where we're headed. The good news is there's nothing terribly new here, but I recognize that the pace of acquisitions over the past year and our willingness to increase our leverage has raised some questions.

Three years ago, on our third-quarter call, I told you we'd focus on margins, cash flow, lower leverage, and returning cash to shareholders. And that's what we did. About a year or so later, we said a modest level of acquisitions would once again become part of our growth strategy. Initially we expected a fairly even split between using cash to acquire businesses and return to shareholders.

Well, once we kicked up our M&A activity, the opportunities were far more plentiful than we had expected. The acquisitions we've made are all strong, strategic fits for the business. Some, like Long Island Compost, tuck in very nicely to the existing portfolio. Fafard not only improves our growing media business, but provides us with access to high-quality peat. TOMCAT presents a natural extension into an adjacent category where our skills can drive meaningful growth.

We also purchased two other small companies in the past several months: Contech, which we acquired earlier in the quarter, has great technology we can leverage in our global controls business; and Debco, an Australian business, strengthens our position in that market as well. Finally, General Hydroponics and Vermicrop provide growth potential that does not exist in the rest of our portfolio.

Not only did we complete these deals, but in May we successfully renegotiated our Roundup agency agreement. As a reminder, here is what that deal did for us. It significantly inhibits Monsanto's ability to terminate us. It allows us to take the brand into other categories. It allows us to enter new geographies. It changed the commission structure for the first three years so we can invest in new products and offset the financing costs. It allows us more flexibility regarding the product ingredients, and allows us to make changes if we feel it's necessary. It gives us the ability to transfer the brand in total or in any specific geography. And finally, it gives us greater access to Monsanto's innovation pipeline in the future.

We still have a few opportunities that we're contemplating. It's possible they all may get done, but if the economics don't work we're also willing to walk away from any or all of them. The financial flexibility we worked so hard to create allowed us to take advantage of one of the most opportunistic periods we've seen in this industry in two decades.

Today, we're a more diverse and stronger company. But with the exception of the urban and hydroponic space, I still don't see this industry growing at more than low-single-digits anytime soon. So our priority for uses of cash will quickly shift back to reducing debt.

We will also look at all of our assets and assess their ability to drive shareholder and strategic value. Whether it's a facility, a product line, a brand, or an advertising campaign, if it's not getting us where we need to go, then we're willing to take decisive action.

As we've looked at the M&A pipeline, especially over the past year, it has reinforced my strong view that Scotts Miracle-Gro is a pretty damn good company. I like what we're doing. I like the team we have in place. And I like the plans that I see coming together. We have walked away from more deals that we've completed, because given the choice between investing in those businesses or this one, I would choose us.

Once we work through the current pipeline and begin to reduce debt, our objective is to get back to returning more cash to shareholders. If we are doing that right now, Randy and I are aligned that we would be an active acquirer of our own shares. I don't think that will happen in 2016, but I'm hopeful that we'll be able to get to that later in 2017.

For the time being, returning cash will come through our regular dividend. And yesterday our Board approved increasing our dividend from $1.80 to $1.88 per share on an annualized basis. It speaks to our continued confidence in our strategy and our commitment of returning cash.

As Jim King said a few minutes ago, we're coming to New York in December for an Analyst Day meeting. By that time, I hope to be able to tell you more about what comes next and the execution of our long-term plans and the steps we're taking to align management pay with achieving long-term shareholder value. And I hope to share with you a story that reinforces the continued upside that I see in this business.

So with that, let me turn the call over to Randy, and he will walk you through the numbers.

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Thank you, Jim, and good morning, everyone. There are four topics I want to cover. First, I want to clarify comments I made in May regarding our earnings guidance. Second, I will provide an overview of the results we announced this morning. Third, I will briefly discuss our capital structure. And fourth, I'll share some early thoughts on next year.

As it relates to our guidance for 2015, I went to elaborate on Jim's earlier comments and clarify certain comments that I made back in May to provide complete transparency on our accounting treatment for the Bonus S situation.

When I first spoke publicly about our Bonus S issue at a New York conference, I said that costs not covered by insurance would be $5 million to $7 million, and I said absorbing those uncovered costs would result in adjusted earnings on the low end of our guidance range. But over the past two months, the scope and complexity of the challenge expanded. That fact, as well as our past practices, led us to determine the best way of managing this issue was to exclude it entirely from our guidance.

This decision is not based on making the year appear better than it is, as the GAAP numbers will obviously reflect our reported results. It also is not designed to protect management compensation. We have already reduced our incentive accrual enough versus last year to offset our uncovered costs.

The reasoning was actually pretty simple. As we begin planning for next year, and as many of you begin building your financial models, the best base off of which to grow is determined by excluding all Bonus S costs from our 2015 results. Therefore, our revised goal for adjusted EPS for 2015, excluding Bonus S, is the midpoint of our original range of $3.40 to $3.60 per share.

The break to the fall season for both the core business and Scotts LawnService is the biggest unknown factor on where we actually will finish. Also, our operating cash flow guidance of approximately $275 million remains intact, assuming we collect insurance reimbursements by the end of the fiscal year.

So with that, let's take a deeper look at the numbers we announced today. Company-wide sales were up 9% in the third quarter, or 12% excluding the impact of foreign currency, driven by a 9% improvement in the global consumer segment. On a year-to-date basis, Company-wide sales are up 6%, the same rate of growth as the global consumer segment. Company-wide sales are up 9% through nine months, excluding FX.

Within the global consumer segment, we were really pleased by what we saw in our US business, which was up 5% on a year-to-date basis, excluding acquisitions, despite POS dollar growth of only 1%. Shipments exceeded POS due to product mix; growth outside of our big-box retailers, where we don't collect POS data; and a 10% increase in year-over-year retail inventory levels at the end of the quarter.

Sales in our international business were flat in the quarter, excluding the impact of foreign exchange rates and acquisitions. During the quarter we made a decision to begin an orderly liquidation of our inventory related to Solus, the UK company we acquired out of bankruptcy last year. While this acquisition came with just a $1 million purchase price, plus working capital, we determined investment needed to deliver a satisfactory return simply was not worth making. We have decided to retain a limited line of products that have strategic value, but will be exiting the rest.

Between Solus and our continued efforts to streamline our cost structure in Europe, we booked international restructuring charges of $6.6 million in the quarter. I said a few months ago we should complete our international restructuring efforts by the second half of the year. Right now, I don't see any significant charges related to international in Q4.

Jim mentioned the strong recovery of Scotts LawnService, and I also want to tip my hat to that team. Sales increased 12% in the quarter and 8% year to date. On a calendar year basis, we now expect a record sales year for our service business.

As you saw in the press release, we increased our Company-wide sales guidance for the year to a range of 5% to 6% from our original outlook of 4% to 5%. We expect that final number to be comprised of organic growth of 4% to 5%, and acquired growth of 4%. Those will be offset by a negative 3% impact from FX. So, clearly, we have had a very good year on the top line.

I want to move on to discuss gross margin, however, which has been a bigger challenge for us this year. Given the fact POS for lawn fertilizer is down 8% for the year and mulch is up 11%, we have a material challenge from product mix. Additionally, the acquisitions we made this year collectively were dilutive to gross margin in the first nine months as we integrated these new businesses. Those issues are the primary reason that the adjusted gross margin rate declined 40 basis points to 37.5% in the third quarter, and that the year-to-date rate is down 100 basis points to 36.3%.

Going into the year, we said we expected the margin rate to be flat. On our last conference call, I told you I thought there was a risk to that number, a risk that has now materialized.

Even when you exclude the cost of goods impact related to Bonus S, we now expect the gross margin rate will likely decline 50 to 75 basis points for the full year.

As we look to the fourth quarter, we expect a gross margin rate improvement from favorable mix generated by volume in our high-gross-margin Scotts LawnService and General Hydroponics businesses. We'll also see the benefit of lower distribution costs, primarily driven by year-over-year fuel savings, as well as manufacturing savings.

There's good news further down the P&L, and that is related to SG&A. Excluding Bonus S issues, total SG&A expenses were up just 3% to $194 million in the quarter; and, on a year-to-date basis, were up 3% to $540 million. Obviously, acquisitions account for a significant increase in SG&A. But those new incremental costs have largely been offset by FX, as well as downward adjustments in the accrual for variable compensation and savings from recent restructuring efforts.

On a full-year basis, I'm expecting SG&A to be up just 3%, which is on the low end of our original guidance. But remember, several of the acquisitions we've made this year came after we provided that initial guidance. So given the higher level of expenses that came with those deals, including the deal costs themselves, I think the organization has once again done an outstanding job of controlling SG&A. As we work on early plans for 2016, I see that trend largely continuing.

Adjusted income from operations before taxes was up 12% in the quarter and 4% on a year-to-date basis. Below the operating line, interest expense was up $1.5 million in the quarter to $14.3 million, and essentially flat on a year-to-date basis at $39 million. For the fourth quarter, you should expect interest to increase by $4 million, reflecting capital invested to acquiring new businesses and our revised Roundup agreement.

The year-to-date tax rate was 35%, slightly better than we expected, and should remain the same for the full year. Also, the focus on acquisitions this year means we have repurchased fewer shares than originally planned, so we are now assuming a full-year share count of 62.1 million.

So when you bring it to the bottom line, adjusted EPS in the quarter was $2.68 per share compared with $2.34 last year. And year-to-date, we are at $3.65 per share on an adjusted basis compared with $3.46 a year ago.

Let me shift gears. As Jim said, the past 18 months have proven to be opportunistic ones for us. We've added some acquired growth and we've also successfully amended our Roundup agency agreement with Monsanto. And as Jim said, there are a few more opportunities we continue to explore.

Given those actions and the strong credit environment, we are planning to amend and restate our current senior secured credit facility to give us increased flexibility and take advantage of the low cost of money.

Jim said earlier that we want to begin delevering once we work through the current pipeline of potential deals. I want to be clear that 4 times leverage is not uncomfortable for us in the short term if we were to get to that level. But getting closer to 2.5 times gives us more flexibility and optionality, and we simply prefer to operate that way.

Let me close by discussing a few of the headlines for 2016 that I'm sure are on your minds. Barring a major swing in the next 120 days, commodities will likely be a decent tailwind for us next year. It's too early to be specific, but we expect a neutral to slightly positive impact in nearly every area, except for peat and grass seed, where cost pressures remain.

Additionally, pricing is part of our growth plan for 2016, after largely foregoing price increases in 2015. So pricing, net of cost, coupled with some additional supply chain savings, should get us ahead of where we finished fiscal year 2014. We will get more specific over the next few months.

Another point I want to address related to next year is the financial impact of our revised agreement with Monsanto. In a worst case, we expect the transaction to be neutral to earnings this year -- next year, rather. Depending on a combination of interest expense to fund the transaction, as well as the startup investment costs related to new business opportunities allowed under that agreement, the transaction may actually be slightly accretive next year.

For those who I have not spoken with personally about the Roundup deal, let me add this final thought. This was a very important transaction for our Company. Roundup has become a hugely successful, global lawn and garden brand under our stewardship, and it is a major portion of our profitability. The gaps in the original deal needed to be addressed, and now they have been. Moreover, the ability to take the Roundup brand into new categories of lawn and garden, as well as new geographies, provides a nice opportunity for growth in the years ahead.

Before we open the call for questions, I just want to reinforce Jim's comments. While it was challenging to maintain POS momentum this season, that has been an issue beyond our control. But in terms of planning, focus, and execution, I give the entire operating team extremely high marks.

Our ability to adjust to the realities on the season, in the middle of the season, was evident again this year. I've been here more than 15 years now and I'm confident in saying that the management approach that we use today has taken a lot of volatility out of this business.

We probably won't share a lot of details around 2016 during the Q4 call. We'll save those for our Analyst Day meeting in December. But I can tell you already that I feel good about our early plans for next year and feel confident in our ability to continue to improve our operating model and further enhance shareholder value.

Now I will turn the call back to the operator and we'll take your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Bill Chappell, SunTrust.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

First question, on the quarter: one thing you had talked about was a 10% higher level of retail inventory. Is that just the retailers were more excited about that category? Just trying to understand why the -- still the difference between the POS and the organic growth.

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Sure, Bill. This is Randy. If you recall back at the end of the second quarter, our retail inventories were down 5%. Now at the end of the third quarter, they are up 10%. So it becomes difficult evaluating points in time and the impact of what that means. But obviously being down on inventory going into the third quarter helped our shipments and helped our growth. And the fact that inventories are a little bit high at the end of the third quarter will likely mean that it could have a little bit of a shipment impact in the fourth quarter as we work our way back down towards the end of our fiscal year, and really more so at the end of this season, which is more so November into Thanksgiving time. But those are the beginning and ending goalposts. And that's essentially what's driving shipments (multiple speakers).

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Look, I got to say, I'm not particularly concerned about it, largely because the retailers are super-sensitive to inventory levels and they've been continuing to buy in and set up for their summer business, and for their -- starting to get prepared now for the fall business. So I think that generally it's not an issue, and the retailers are not complaining about it.

I don't know, Mike, if you have a point of view on it.

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP and COO*

No, I think with heavy bugs and weed season, we loaded up to attack those seasons, and so -- on top of normal inventory.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Got it; so, not a concern. Switching to the outlook over the next two, three months: can you maybe give me an update on plans on locking in some of -- are you going to hedge more or less, the same, on some of the commodities for next year?

And then, Jim, on the acquisition front, should I read this to -- look, we got three or four more in the hopper, and then we're done. And then it's back to -- 2016 is maybe cash for non-M&A-related type stuff, or are you going to still look at other deals?

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Look, so I'll jump in, just because I can't help myself, and then I'll hand it back to you, Randy. The answer to that is yes. I think that we're in the terminal phases. I think we expect that we'll make some more acquisitions in the hydro space. I don't view that as huge dollars, by the way. So I view it as relatively small dollars. But the Hawthorne team is I think ready to come up for air. But we basically said -- or at least what I always said -- is that my appetite was probably higher, to be a little more active in that space. I think that it's -- the integration work, it's gone well; but it's been hard work for that team, so I want to congratulate them on keeping the business under control and getting it done.

I think we here have basically said, we're probably looking like six months out before we start fishing again in that space. We've said that peat is an important asset. I think in the comments that Randy made about peat pricing, I think it's been a rather difficult harvest again. And so, looking to have long-term contracts or own in the peat assets ourselves for what I have challenged the team for is about half of our peat needs, which is after urea, our most important commodity. Except it is just not as ubiquitous a commodity as -- where we are a relatively small player in ag nutrients, we're a large player in peat, and it's an important part of our business.

And you've look at our growth rates, so I think we will continue to work there. Then there's another couple deals that we're looking at that I would put in the more moderate size. And we're also looking at -- I think the assets that we think are actually totally core to us, and what's not.

And so, overall, I would think that I'd like to be through that in less than a year, that whole group. But at that point my view is -- and I reminded the group as we prepped for this call -- that we are closing the book at that point and we're moving back into a shareholder-friendly mode. And we think that's the right thing. I think the Company's a better company for what we've done.

And I think if we look at our long-term approach to shareholder value, I think -- I'm not sure we would have been a better company if we just said we're just going to -- we're not going to open the book at all. I think the Monsanto deal was important and these other, smaller deals were also important. So I think we got some work to finish. And then I think we need to commit to shareholder-friendly. And that's my expectation.

Now, I have a Board meeting Thursday and Friday of this week where this is -- of the two big meetings, we just -- you might not care, but we've changed how we do Board meetings, where we do telephonically all -- a lot of the committee stuff. And when we show up to where we're having a Board meeting -- this will be in Vermont -- we strictly talk about business issues on a two-day meeting.

So it will be end of 2015, 2016, first real budget discussion with the Board, and then we're going to talk talent and we're going to talk our business strategy. And that's all we do on Friday. And so, I don't really want to get too far ahead of my Board, but what I'm telling you right now is kind of my view. I think the management team is aligned with me on this.

It's kind of a long way to answer the question. But I got to -- make sure my Board is aligned as well. I expect probably they will be; but again, they are my boss. So we'll present to them, but I think the answer, Bill, is yes; get the stuff done, close the book, get back to a very strong focus on shareholder-friendly.

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

And Bill, regarding your question on commodities, on urea we're about flat to a year ago, as far as percentage hedged; let's call it about 50%. And on fuel, we're ahead of last year, so we're about 50% hedged on 2016 requirements. And a year ago, we were about 30%, and we'll continue to be opportunistic as we look at oil prices and fuel prices going forward.

And then just to clarify on your first question about regional inventories, just to put that into better context, it's worth about 1 point of our year-to-date sales growth. So it's not a dramatic driver by any means, but give you a sense of what it does mean.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Great. Thanks for the color on all those issues.

Operator

Jason Gere, KeyBanc Capital Markets.

Jason Gere - *KeyBanc Capital Markets - Analyst*

I guess two questions. One, I was wondering if you can dive a little bit more into Ortho and Roundup and what you've seen on the competitive landscape. Obviously you've pointed to some really good growth that you have seen. And I know after last year, you guys are going to be I think a little bit more competitive out there this year, so it seems like that's working. So it's one, I was wondering if you could just talk a little bit about what you're seeing out there, how the category is growing; share, et cetera. And then I just have another question afterwards.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

I'll take the Ortho conversation, and maybe ask Mike to reinforce a little bit with it. I think we looked at Ortho and said, it's -- unlike a lot of our categories, it was a much more competitive and crowded category. And I think you had Spec on the opening price point, really with nobody going after them, and significantly more competition on the value or the value-added side. With us, Central, Bayer, SCJ, who's with us -- I don't know who I'm missing, but it seems like someone. And I think in that context, I think we -- or at least I'll say I, but I think Mike and I were in very much agreement -- we just were not -- we were just kind of in the middle there somewhere.

You had -- I'm going to say Bayer -- on the own the scientific professional side with, like, the German spectacles. You had Spec on the opening price point, and we're just kind of in the middle. And I think our labels were not as clear as they needed to be. And I think our pricing was, to be honest, I think a little lazy, meaning I think not priced for what we were trying to accomplish.

Mike has embraced that super-hard. His marketing team embraced it super-hard; so significant improvements to the labels, significantly more competitive ad spend. So this is going right after Spec. And taking price down, not to Spec's level, but much closer to -- so we're not sort of priced at a point where we're just stuck in the middle.

That has worked super-well for us. Not only has it been a good season -- because where it's wet and hot, you are going to have weed and bug pressure. So it's been a good season for us, and competitively we've had excellent share gains. So I think we feel very good about the choices we made, but I think it started with saying, we did not really like where we were.

And I think one of the things that's great about this Company is, once we make a decision to say, aww, that ain't working, we sort of went after it and didn't dwell on it much, and just attacked it pretty hard.

I don't know, Mike. You're the one that deals with it more day-to-day.

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP and COO*

No, I think we took our cost savings and our [claims] and we were a lot more aggressive. And we've taken significant unit share back without affecting the gross margin rate. And we're really pleased with that.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Yes, I think that's an important point to remember. As we looked at the costs we were putting in the product, thinking we were adding all kinds of value and stuff; and said, look, if the consumers don't really get it, let's take those things out, reduce the price. A lot of the work we did here was not margin dilutive to us. And so this -- it was basically saying, if consumers don't see it and want to pay for it, it's not up to us; it's up to the consumer. And so I think that the changes we made to the product, which is primarily packaging, I think also has allowed us to compete harder.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay, great. The next question -- and kudos to you guys for the SG&A cost-containment, how you guys have been able to really limit that growth. And I was just wondering if we could think about the next couple of years out. Any type of bigger projects on the horizon that you guys can think of? Structural changes that really can continue managing the SG&A as a constant, especially as gross margin has been so volatile over the last couple of years, and in order to drive some of that operating margin improvement.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Look, I'm going to start by disagreeing with you a little bit, if that is okay. We spent a lot of time talking about gross margin. Mulch has been a significant driver in our gross margin, and our internal challenge for 40% gross margin. And I think our view is, if not for mulch, we would be there.

Now, I'm not complaining about mulch; mulch has turned into a giant and rapidly growing category, and we're playing really hard there. And I think our partners that have played with us have taken advantage in the consumer -- it's awesome, I think, value for the consumer. But it does create mix issues for us.

And the season this year, with lawns where you're down -- I don't know what it was, 7% or 8% -- definitely contributed further to it. But I don't actually think that our margins have been that choppy. I think mulch has really been driving a wedge into our aspiration of where we want to get to on gross margin.

And I think we're spending a lot of time talking about that, but it is clearly of business that we don't have really a choice to participate, and I don't think our retailers do, either. We do have some new products coming down the pipeline that really makes that even a more premium product. And we're going to try that, which I think is -- I'm very encouraged by.

The SG&A side, I'm going to leave that to Randy; but my answers to that would be yes. I don't think we're through with streamlining this Company. I think the idea of -- that the core business itself is low-single-digits, I think the -- is say we should then define a management team around that. I think that we in the last year have reduced our senior team by about half.

But the really interesting thing is -- because I've had this conversation with a lot of people, with my family as well -- is the business is so much easier to run now. And I mean maybe a lot of you guys would be saying, we told you that. But so much easier to run.

So I really like my partners. Mike is a really a pleasure to work with. Don't let it go to your head, dude. So I think that there continues to be opportunities, probably not as big as where we've been. But I think that we recognize, in a world where we want to move back into shareholder-friendly, that our costs matter and our cash flows matter, and that we have got to keep a very strong focus on that.

And that that the lessons coming out of where we've been -- because, Mike, how long you been in the job?

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP and COO*

Nine months.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Sold in less than a year, I think the lessons are we can make decisions so much faster when we have a smaller, more engaged team.

So, Randy.

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Yes, and Jason, some examples of just looking across our business and finding areas that we can harvest costs from and then reinvest, largely into media and marketing, is the plan for next year. But there's some media spending that we think we can be a lot more effective once we pull that out and put it in different kinds of vehicles going forward.

I mentioned Solus, so we're largely exiting that business. And it wasn't working for us on the gross margins, and we'll be able to eliminate a lot of SG&A that we added this year as well from doing that.

And then even looking across our international business, we think we're going to have a much smarter approach to operating in China going forward, and we can also save some money there. So those are some specifics around what we're doing, or what we're thinking about, at least, as we start planning for 2016. And we very much are focused on staying on top of SG&A and expect more of the same.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay, great. And while I have your team, clarify just a comment you made earlier just on interest expense. I think you said it was going to be $4 million higher. Is that sequentially from the third quarter or is that year-over-year $4 million higher? Thanks, guys.

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Yes, the fourth quarter interest expense should be about $4 million just as we fund the payment being made to Monsanto in mid-August of $300 million, as well as the buildup from some of the other acquisitions we've done this year. So it would be $4 million year-over-year in the fourth quarter.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Year-over-year. Okay, great. Thank you.

Operator

Joe Altobello, Raymond James.

Joe Altobello - *Raymond James & Associates, Inc. - Analyst*

Just wanted to start off with you, Randy, in terms of the gross margin; obviously [caught] down a little bit this morning. Could we dive into the different puts and takes there? How much of that is coming from mix? How much of that is coming from acquisitions and other items?

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Well, if you think about mix entirely, including acquisitions, it's really the driver primarily of why we're down year-over-year. So, it's about half. What Jim pointed out: lawns is down, mulch is up. And the other half is from the acquisitions we've done that the year-to-date impact from, integrating the deals. Some of them are a little bit lower on gross margin rate, while the equivalent on the operating margin rate.

And with some deals, the first turns of inventory were not recognizing margin on just due to the accounting conventions. So it takes a while for us to put that behind us. 2016, we feel good about the acquisitions. Everything appears to be on track at this point, and we feel like we're in a good place.

Joe Altobello - *Raymond James & Associates, Inc. - Analyst*

Okay, so it's half acquired mix and half and organic mix, I guess is another way to look at it.

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Right.

Joe Altobello - *Raymond James & Associates, Inc. - Analyst*

Okay. In terms of pricing for next year, you guys have mentioned obviously you haven't taken much pricing this year on a net basis. What are we thinking for next year in terms of maybe the impact from pricing on top line?

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

It's pretty early in August to be talking too much about pricing for next year, and we're still refining our plans. But we will be taking pricing primarily in our US business. Like we said, we'll also have the benefit from commodity costs swinging our way. And a lot of the mark-to-market impacts that we had in 2015 we'll have put behind us.

And we also have a long track record of taking cost out of our business just through supply chain projects. So those are the three benefits that we see next year. We do think we'll end up not only higher than where we're going to land in 2015, but even higher than 2014, and get back on the track we want to.

Joe Altobello - *Raymond James & Associates, Inc. - Analyst*

Okay, that's helpful. And just one last modeling question. I think you mentioned the tax rate for the fourth quarter and the year of about 35%. I think that's about 1 point below what you had been looking for. Is that a good run rate number to use for next year?

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

At this point, we're thinking it will be a little bit higher, probably in 35.5% to 36% again, the initial plan assumption. But we're happy with 35% this year. And it's largely due to just looking at reserves for -- whether it's state tax audits or foreign tax credits, and going through our analysis. Once we get really good visibility by the end of the third quarter, we are able to refine that, so that 35% should stick for the full year.

Joe Altobello - *Raymond James & Associates, Inc. - Analyst*

Okay, great. Thank you.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Maybe the federal government will do something to make US corporate tax rates more competitive to the world.

Operator

Jon Andersen, William Blair.

Jon Andersen - *William Blair & Company - Analyst*

I wanted to come back to the top line for a minute. So, year-to-date you've shipped ahead of consumption or point-of-sale. And you have, even if you adjust for the inventory build that you talked about. So, can you talk about some of the dynamics there? I know you mentioned strength outside the big boxes. Maybe you can talk a little bit more about what you're seeing on a channel by channel basis. And what's really driving, again, that shipment growth ahead of consumption, even after adjusting for the inventory build?

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Sure. It ties back a bit to what Mike and Jim were talking about around Ortho, for example, where our shipment growth has outpaced the dollar growth. When you look at just dollar POS, it can be -- it's a little bit misleading at this point in the year. I expect that to remain the same for the whole year, so just -- we've shipped in more than what you'd think based on what's going out of the retailers.

And then when we talk about POS, it's really only tracking against the big boxes, so we have had nice shipment growth outside. Really no big one win, but just across the board the team has done a really nice job across many channels, and that's contributed about 1 point of growth.

And then also, LawnService has caught up after a slow start, which is the same weather issues we faced in our consumer business. But really the LawnService business is hitting its stride. And I mentioned earlier in my scripted comments, we expect on a calendar year basis that this probably will be a record year for Scotts LawnService. So those are the big drivers for why we're doing a little bit better than what 1% dollar POS would indicate.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Now, listen, I think that for us here, considering California especially, second half of the spring, where these water reductions went into effect. And the first half of the spring out there was pretty good, but that changed about the same time that it just started to rain in the Eastern part of the United States.

But when you look at that and say, as someone who has a farm in the Northeast, we sort of to get -- hay, we need three or four days of good, dry, warm weather to dry hay off before we bale. And I think, whether it's from Ohio here all the way up into New England, that was tough to come by this spring.

And Texas clearly was really, really wet. Florida has been pretty hot. When you look at all that stuff, and you look at our results, compared to how challenging the weather has been really across the board, it's a pretty good result; and better than, I think, a pretty good result.

And so, it's one of those things where it just would have been nice if lawns wasn't down. It would've been nice if it was wetter in California. It would be nice if it was less wet in Texas and Louisiana. But I think that shows you the strength of the business. And I'm still hoping for a normal weather year. But if we can do this well in pretty crummy weather, I think what it says is -- I just look forward to the year we have where the weather is more normal.

But there's strength in the market. I think that's the bottom line.

Jon Andersen - *William Blair & Company - Analyst*

Okay, that's helpful. Two additional quick ones. One is just on the Roundup agreement. I assume that's something that you have probably been working to, or would have liked to accomplish, even earlier than you have.

Why do you think Monsanto came to the table, and you were able to make it happen now? And then with respect to General Hydroponics and Vermicrop, what are your expectations for the growth rate and maybe accretion from those businesses? I know you mentioned earlier, Jim, that Hydroponics is going to be an above-average grower, but a little bit more color around your expectations there would be helpful.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Well, since my oldest son runs Hawthorne for us, much better than the regular business. Anyway, what do I think? I think growth rates in Hydro should be double-digit numbers per year, and I think there's plenty of runway for that. So I think they would like to have a number that's well in excess of our numbers, but not quite that high.

But I think Mike and I are pretty much in agreement that it's not so much a budgeting drill; it is that I think our expectation is that this is a significantly above-average growth rate. And we expect to be growing at least as well as the market. And that puts some challenge to the Hydro folks, but I think they can do this.

What was the other part of the question?

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Roundup.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Listen, the answer is yes. We have been trying to get a deal like this done for a long time. I think whether it was the original Monsanto deal that I did with Arnold Donald back in the day, I think it was a time of need for Monsanto. It was after the American Home deal had fallen apart, and Monsanto wanted to do the deal. I would say, call Hugh Grant and ask him, but I think the deal that we had wanted to happen for quite a long time was in part based Monsanto's desire to get a deal done. And I don't think we've ever gotten a deal done, to be honest, with Monsanto -- and I have a lot of respect for those guys -- when they didn't want to do it.

So I think they wanted to do it. I think it probably has to do with their corporate strategy, but they wanted to do the deal and we got it done. And I think that we got a deal that was -- sort of fit our requirements. I view this mostly as risk reduction and significantly greater freedom to operate for us.

And I think if you look at it in those contexts, I think it was a really nice deal for us, especially when you look at it from the risk point of view of how much value that represents I think to our enterprise. And so I think they wanted to do the deal. Yes, we wanted to; we hadn't getting it done. Monsanto wanted to do the deal; the deal got done.

Does that make sense?

Jon Andersen - *William Blair & Company - Analyst*

Yes. Thank you.

Operator

Olivia Tong, Bank of America Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch - Analyst*

First question, just on the gross margin for fiscal 2016, because it sounds like you said raw material deflation coming through. Looks like you're planning to take pricing, probably expect a rebound in mix. So as you think about 2016, it sounds like gross margin is looking to be relatively good on a year-over-year basis. So maybe can you give a little bit more color on what may be the potential opposite side of that?

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Olivia, I agree. Remember, we're still in the process of putting together plans, so it's difficult to provide very many more specifics. But from a high level, I think you have the story right. Top line, we'll still think more than likely, 0 to 1% or 2%. And prepare for more, but plan for that. And again, someday we'll have a perfect weather year, and we should blow that number away. But that hasn't happened in quite a while. And we won't, again, plan on that for next year. SG&A, we expect to keep on top of that, probably grow similar to our sales growth, maybe a little bit higher, depending on some of the investments we make.

I think one of the challenges we'll have next year is with all the acquisitions that we've done we will have a significant increase in interest expense next year. So that will be a headwind to EPS, and our share count will probably increase a little bit as well.

So I would expect our operating income growth to exceed our EPS growth next year. But again, I think basically for the reasons we've talked about earlier -- solid business from an organic point of view, and then the acquisitions that we've done, we think are on track, and that should help operating growth next year as well.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

I do think that, Olivia, the thing we talked about earlier, which is mulch; I've been very outspoken with our retail partners that I think the market has become reliant on Black Friday promotional events with mulch that are destructive to margin. I have to say that having been out in the marketplace this year, I think it's a very powerful tool to attract consumers into a store. It adds -- for $20, you bottom out your suspension, and your garden looks awesome when you put some fresh mulch down. And I think retailers are glommed onto it.

I have a very much diminished my criticism of it; not because the reason to criticize it is not there, but the importance of the vehicle on the early season, get customers into the store. And so, I don't know. It's a longer-term challenge for us, but we continue to see pretty significant double-digit growth in mulch. And I think that is sort of negative.

We talked about peat pricing and peat availability. We, I think, had to bring Baltic peat in this year just because availability of North American peat was limited, which gets back to the reason we need to be more in control of our situation in regard to our basic raw commodities and seed prices, probably.

But I do think this mulch issue probably is not one that goes away. We just have to figure out how we can allow this to occur, try to move consumers up the food chain to a higher quality mulch, if we can. But I think we're going to have to live with it for a while.

I don't know, Mike, if you agree with that.

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP and COO*

Yes, I agree with that.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. With that in mind, is 40% in total gross margin still the right aspiration over time?

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Certainly. If we're not targeting that, then we won't get there. I think we will make good improvement next year. I think when you look at it on a trend line, this year is an aberration. We made big strides both in 2013 in 2014; took a pause, more or less, this year; and we'll be right back on the track in 2016.

So we have not changed our outlook on that at all. It's just perhaps taken us a little bit longer to get there than we'd thought a few years ago.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

In part because this is a competitive marketplace out there, and we've got to be able to compete at the same time.

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

And Olivia, one other thing to note. If we were to remove mulch from our P&L, we would already be at that level. So, it was growing really fast. The margins are mid-teens. And it's having a dilutive impact, but it's adding dollars. And it's really important to how we go into business. But on a pro forma basis, for example, you'd argue we're already there.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

We're not arguing that, but it's one line.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. I guess two follow-up questions, just first on Roundup. Perhaps can you preview some of the potential things you may plan to do with the expanded Roundup agreement in place, particularly markets that you might want to expand into; and, on the flip side, markets that you may potentially exit?

And then just on Bonus S, I want to understand the issue a little bit more. How did it happen? Was there not enough R&D or consumer testing beforehand? How is the region doing now? What changes have you put in place to ensure that this doesn't repeat? And is there any risk in ability to recover on some of the insurance reimbursements? Thanks a bunch.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Well, the answer on the recovery part is yes, except for the $10 million. I think, Olivia, that the issue -- because your questions -- let's just talk to the Bonus S part; I think very reasonable questions.

I think if you look at our experience with the DuPont active that we were really high on; thank goodness we didn't launch it as early as the Pro people did on the golf course side, where I think there was billions in losses on DuPont's side from damage to trees. That said, it was a really good active. It's just nobody figured out that it killed mature pine trees.

And that, I think, really made it an unusable product. I think if you look at the active ingredient in the new Bonus S, I think that a lot of what -- remember, because the old active is this atrazine. A good product; not as effective as we'd like to see, not because it doesn't work. But because as EPA manages risk cup, which is an individual's lifelong exposure to active ingredients, it's a major prime -- corn herbicide. So as they manage risk cup they have tended to reduce the amount that can be used in what they would call specialty products, which would be like ours.

In our warm season grasses, it's an excellent active. At the rate EPA allows it to be put down, it's less interesting. The new active in Bonus S, this [mizo] -- what we call it -- is a highly effective product. And not only that, a lot of these new actives are applied at a much lower rate or, call it loading, on the particle. So you have a very good, highly targeted active ingredient that goes down in a sort of pounds per acre; not in pounds, but in ounces per acre. So the environmental impact is significantly lower. But these are, for the targeted weeds, highly active products.

And, therefore, it presents a whole level of risk on application rates and tolerances by various grasses to potentially over-application. But the problem is that -- much more sensitivity. And what's clear is that on centipede in particular, under certain conditions, which we don't totally understand this point, it's a very effective herbicide against some of these grasses, when it's not intended to be. So I think we're trying to figure it out. You can't say that this went as planned. That's not the case.

But I think that I spent a lot of time during the peak of this. Mike and I were down in Charleston, which was the center of the universe for this, once a week. These were Scotts customers. I had -- legitimately, I was not yelled at by a single customer, and I visited a lot of homes. I had consumers -- I'm not joking here -- crying that a company would actually stand up for its products, get out there; the CEO was there apologizing for what happened and making it right.

So, I don't think we've damaged ourselves. If anything, I think we've enhanced our reputation, because I just don't think there's that many companies that would have done this. And I want to be thankful with our insurers that so far our relationship has been good, and their commitment to the coverage has been high so far.

So I think we're happy of that and feel comfortable we're going to be reimbursed for all except this $10 million, which are more our internal costs of bringing product back, repackaging, et cetera.

On Monsanto, I think that the -- what this offers for us is -- I personally think Asia and Latin America are markets that are attractive to us that we now have freedom to operate in. And so I think that this is the world's best -- and I think environmentally, very good herbicide. And so to have consumer product in Latin America, every place is a weed market. And Asia is an opportunity for us.

I'm not announcing anything here, but I think that we have looked strategically at our European business and were unable to really move forward, in large part because Monsanto -- our Monsanto business is very much integrated into our consumer business. And in the past we couldn't monetize the European business without Monsanto's approval, which they were not willing to give us.

And again, I'm not saying we're moving on any of this, but our ability to do so now; we have the ability to monetize regionally the brand, as well. And so I think that this -- I think this kind of answers the question. I think that Asia and Latin America are pretty attractive, and I think we have a lot more flexibility to look at our European business to say, in or out.

Anybody home?

Operator

William Reuter, Bank of America.

William Reuter - *BofA Merrill Lynch - Analyst*

When you were talking about a handful of smaller acquisitions, it sounds like that potentially could be completed, and then you mentioned moderate sized acquisitions, can you talk a little bit about what size you might be talking about? And then you mentioned 4 times with regard to leverage. Is that the way we should be thinking about you guys going forward, that it's likely one of these moderate sized acquisitions does get completed?

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

I'm not trying to be a secretive dude. What I'm trying to do is keep our cards clean because we're in discussions with people. But I would say if we didn't get one of these moderate sized deals done, we would not see that kind of leverage. I think that's a kind of simple way to say it. I think that you would not see this on some sort of peat adjacencies or some hydro deals. You would not see that kind of leverage increasing.

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

To get to 4 times we would have to see at least a couple of the moderate sized, and then some of the smaller all happen within the next 12 months, call it. So, range of likelihood on that, I don't want to try to estimate, but that's what would have to happen.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

But I would say of the two deals that I'm playing in, I would say one seems to have some legs; the other seems to be falling apart. That's probably just the way it is. But I think there's a point where we're not willing to stretch for something that doesn't make sense for us strategically. I think the comments that I made in regard to -- I really like this Company. And I think long-term, Randy and myself and really the entire management team actually feel this is a pretty good Company to invest in.

And so, all things being equal, we'll go shareholder-friendly. And I think that we don't need to reach for a deal that makes it hard for us to make our returns, that we have to make excuses with you guys down the road because we overpaid.

So it's not like we are feeling obliged to do deals. I think that we very much view this balance as what's the best thing for our shareholders in the long-term. And overpaying I don't think ever is; and, therefore, if we can't get deals done on a basis that we want to do them on, you know what? We'll start buying ourselves back. And we're okay with that. And I think that as we've talked to our shareholders, they are pretty agnostic: dividend need some money, or buy some shares back, I don't really care.

And I think we're good with that. We're not feeling like we're pressured into deals. I don't think we feel like we must go spend money and get to 4 times. I think we're basically saying if this is a pretty opportunistic time, and if things are fairly priced we will do that and then say it's over, and now we're going back to shareholder-friendly.

And I think we have been able to operate from fairly high leverage down to very modest leverage pretty quickly in this Company. And I think we've created a lot of value for a lot of people that way. So we're happy to go there if we can't get deals done.

And I think hydro is -- and we talked about this with you guys. I think becoming more basic in peat, and this hydro opportunity is just a growth opportunity. I think that it's a pretty stunning to those of you who have been out to the West Coast and looked what's going on there, and it's high margin. I think we like that. And I feel actually blessed that I got management team and a Board that's willing to continue to put money to work there.

So, if we just those things done, it ain't so bad. I think that's where we're at, and we're trying to -- in the middle of discussions with some of these folks -- trying to say, look, we don't need to do these deals. I don't know if that -- in part, I'm talking to people we're talking to, so it's a little bit of a message.

William Reuter - *BofA Merrill Lynch - Analyst*

Okay. And then my second question with regard to the POS, it was down. You highlighted all of the regional challenges with weather. Can you talk about how the POS was maybe in some regions -- and I'm not even sure exactly which ones those would be -- that may have been less impacted by weather?

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Well, all I can tell you is California and Texas are big, mondo, giant states, and the rain in Texas definitely impacted our lawn sales. And the second half of the business for lawns -- remember, not a huge lawn market on the West Coast in California, but pretty eye-watering down numbers, post-Brown. And I was there with him when he announced these targets.

Now, we've got some really interesting new actives for use in California that are highly used and tested in the Pro side that we're bringing to the consumer market. But I would say Texas and California drove a lot of sad numbers.

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

So, our best-performing regions this year were the Midwest, followed by the South. And the South was more so Florida, and the Southeast rather than Texas. We count that as part of the West. And the biggest challenge we had was still the Northeast. Even though we came back a lot, we still didn't get all the way back as we'd hoped. And again, you saw a lot of that in the lawn fertilizer POS.

William Reuter - *BofA Merrill Lynch - Analyst*

Great. Thank you very much.

Operator

Josh Borstein, Longbow Research.

Evan Barry - *Longbow Research - Analyst*

This is actually Evan Barry here on for Josh this morning. I just wanted to see if you guys could maybe talk about a little bit more on -- obviously with all the record rainfall we saw in the Midwest, maybe just a bit about any product differentiation you guys saw as a result of the rainfall. And maybe what categories of the business improved as a result of all the rain that we saw.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Dude, bug and weed! Bug and weed are doing really nicely. And I think lawn's much more challenged. If you look at our business, the lawn business across the entire United States is very compressed. Even Southern lawns, like in Texas and a lot of the Southern states, go into dormancy and they all come out like in April. So about the time you got lawn season hitting in the Northeast, it's also hitting in those Southern markets where the lawns are coming out of dormancy.

So if the weather just is really wet in that market, you are going to see challenges. So I think that lawns impacted the most on the negative side; weed and bug impacted the most on the positive side.

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

I think it's interesting, too, when you look at lawn care, it's not just lawn fertilizer. So grass seed was down almost as much as lawn fertilizer. So it really just indicates consumers either couldn't get out in the yard because of the weather, or it got so green, so fast, they didn't feel the need to; or they just moved onto summer. I'd be more concerned if I saw a bigger gap between fertilizer and grass seed.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Now, we're aggressively going after this. One of our Board members who is working with management, very responsible for our marketing efforts, did say all these growth areas that we've had -- all had new and much more competitive advertising. The lawns business will be getting a new campaign starting next year. And I think that -- I told him, don't let it go to your head, because the grass seed and the fert sales are about the same negative. Which I think those back to what Randy said, which are just indicative of the category -- of the turf category. But that said, we are going to be aggressively working on driving that business for next year.

Evan Barry - *Longbow Research - Analyst*

Okay, great. Thanks, guys.

Operator

Eric Bosshard, Cleveland Research Company.

Eric Bosshard - *Cleveland Research - Analyst*

A couple things. First of all, to go back on the POS versus sell-in or shipments comment, it sounded like for the year the shipments will be -- or, excuse me, the POS will be maybe up 1%. And Randy, it sounded like your thought was next year, 0 to 2%. I'm trying to square that with the shipments, the sell-in. Do you feel like you're in a period of time where the retailers will carry much more inventory than they have in the past? Or are the shipments more apt to line up with what the sell-in is?

Randy Coleman - *The Scotts Miracle-Gro Company - EVP and CFO*

Eric, when we think about POS for next year, we've said for the last couple of years we think 0 to 2% is a good planning assumption. So I think that remains the same. I think what you're seeing here at the end of the third quarter is just an aberration, again, from point in time on retail inventories. We don't expect anything different.

When we look forward again to the end of September, end of October and November, we'd expected to be up low- to mid-single-digits. So nothing remarkable by any means. But going forward into 2016, we do expect to maintain momentum with some of the strategies we've employed this year, as well as outside of the big box we expect some continuing momentum. So, 0 to 2% is probably good planning assumption at this point and we don't know anything more at this point.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Look, I do think it's worth saying that part of what's happening is we're taking shelf space. So this idea that we're done, I think is as far as we can't get any more shelf space, I think is not true. A lot of this credit goes to Mike in his sales team and the marketing folks for really getting after the business.

It's one of the nice things that occurred, in my view, in a post-Barry world, is very much alignment on an aggressive attack against the shelf space. Not only us getting our fair share of the shelf, but saying, who says nobody's going to compete with Spec? Why are we saying that? It's too busy on the high end. Why can't we move a little their way?

I think if you look at a lot of our businesses, you are seeing much more aggression. You look at the Ortho advertising. It was pretty severe. And we aren't -- I think there is a little bit of a take-no-prisoners attitude here when it comes to competition, and I'm talking legally, where the value goes to the consumer. And I think this is totally fair and what we should be doing. But part of what's occurring, when you look at sell-in, is we're occupying more shelf space.

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP and COO*

And we're also up 20% in promotional activity in the fall, so part of the inventory is we expect to sell more and finish the year. So, I wouldn't get too excited about retail inventory at this point in time.

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

But this is not like we're seeing complaints from the retailers. The retailers are buying into their inventory decision. It's not like they're on a hold to buy. They are buying into it. So there is I think not only no concern here, but we're not hearing concern at the retailer level either.

Eric Bosshard - *Cleveland Research - Analyst*

But eventually sell-in will match sell-through; so if POS is up 1% to 2%, your sell-in should be up 1% to 2% through the season. That's the right way to think about it, still?

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

I think that's true. I also think that one of the things is we have these top-to-top meetings with our big retailers, and I'm also very happy with how that's going. Running out of inventory in season is pretty -- is not really excusable. And so I do think that there is a point, while everybody wants to operate as low of inventory as possible, people also need to make sales. And if you lose 1% because we're out of product, that makes no sense either.

And so, there's been a lot of discussions in how we manage inventory. And I think those are good, but it probably does not mean you're going to see significant lower levels of inventory at retail.

I think that we got to a point in past years where there were -- the season is so violent, and that's part of what we've seen again this year, is that you get three or four weeks of mondo violence, and that kind of makes a season or not. And if you don't have the inventory -- and I think part of what's happening is people are making sure that they are in stock in order to make the sales.

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP and COO*

Yes. We also have to remember that part of our increased shipments is outside of the big box where we have POS. So, when you're looking at that, I wouldn't calibrate that we would lose all 5% of the top line.

Eric Bosshard - *Cleveland Research - Analyst*

Okay. Secondly on -- and that's helpful -- secondly on ferts, which is I understand this has been a year where we've had volatile weather; but in terms of ferts, it seems like it's been a couple years where that is your highest margin business, and it struggled. And it sounds like you've got some incremental things next year, and I understand some of the challenges you've had with actives.

But as you look out the next couple of years, is the last couple years indicative of the reality of ferts? How do you think about the future slope of the curve for that business?

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

My view is I don't really know. I think that's the fair thing to say. I do think we were seeing unit volume growth over time. And that was something that if we go back three, five years ago, I think we'd be looking and saying it's kind of a declining unit category. We took pricing, margin was enhanced, profitability of the line was better, but units were down.

And one of the things we said, we got to turn that around. And I think we maybe have not gotten a lot of growth, but we're not seeing big declines. I think this year is very much a weather thing. But I do think that if you look over the last 10 years, unit volume on lawns has been challenged.

And this is something we've got to work on. I don't think we're going to (expletive) in the wind too hard on this, because it's a really nice business for us. But, that said, I don't think it's in our interest. We have -- this was part of the reason for the active change in the South was this was an active that was highly efficacious. Now, it blew up in our face a little bit, and I think we did the right thing for the consumer.

But when you have a product where the probability of kill for a certain weed is, call it 50%, and it's a premium product, I don't view that as that great. This new active gave us a probability of kill on that weed of, like, 100%. This is dollar weed, the most important weed in Florida.

Our Turf Builder Plus 2 product: this would be our Northeast fertilizer plus herbicide combo -- is going to be changed next year. Not a new active, a new formulation on the granule that gives us 40% more effective weed control. But I think that if you'd look in the inverse of that and say, you're getting a premium price for a product that's okay but where we can make it better, I think that gives us reason to feel better than we can get some growth.

I think these surfactant packages we're talking about that give us much better penetration of water in the soils to help you be able to get -- I think it's 25% less water to have an equivalent lawn. I think it's good in the discussions I had with Governor Brown, I think very much excited that that's possible, and I think will help our business.

But I think there's a lot of things we have to do to get back and say growth in the lawns business is important. I think as we talk about the marketing, relevancy matters. It's got to be something people care about, they want to do, they understand the benefits of spending the money behind it.

But I think these are all the challenges. I would say, and you're right, that I think if you look over, call it in the medium-term on this business, unit volume growth is -- from the beginning of it until now, has declined. I think in the most recent years we've either leveled it off or marginally had it climbing.

I think we're talking about it now because of a certain weather situation, but I don't think it changes your question that says do we think it's growth challenged. And I think so far the answer -- I think, if we're going to be fair about it -- is yes.

But I think we're doing a lot to change it, and that in part drove us to improved actives that we know can solve consumer problems. It just results in another problem, which is they absolutely have to be used correctly if you're going to be using much more active ingredients.

I don't know, Eric, if that helps.

Eric Bosshard - *Cleveland Research - Analyst*

Yes, yes, that helps. And then the last thing, I didn't totally understand that it sounds like there is a window of a year to make more acquisitions in the hydro space or in these other spaces, and then you return to a focus on the shareholder or shareholder-friendly. Why is there this sort of window, and maybe I didn't understand the statement properly. Could you explain what you think (multiple speakers)?

Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

I think you understood it. In large part, because I say so; and I don't want to sound totally arbitrary on it. I do think it's important for our shareholders, who I think have been relatively patient -- and I'll speak my family as part of that -- of saying, look, it's an opportunity to acquire that we haven't seen this sort of opportunistic period for quite a while. And we had the capacity to do deals that we think are value-added strategically to the Company.

I do think it's important for everybody -- all of our shareholders -- we have a good deal of long-term shareholder friends who have been in the stock and I think have enjoyed it, that we've made commitments to on this idea of shareholder-friendly. I think they get it that it's a time of opportunity. But I think their view is: you guys have returned the most value when you have been focused on shareholder-friendly. And I think we agree with that.

So, I also think it's important for the management team to say let's get some deals done, and then we close the book and we move on and go back to where we were. Because we like that, and we like the equity of it, when it's priced -- when we're very much focused on building enterprise value.

So I think it's a little bit that I just decided. Now again, I got to walk my Board through it and get them to say, we agree with Jim's point of view. I'm expecting they'll probably do that. But I think it's important for everybody to have their head around what we're doing; and at what point do we say, we're moving forward and this is part of our strategy.

So, I don't know. It's a little arbitrary, but I think important for all of us here who run the business to understand what the windows are.

Eric Bosshard - *Cleveland Research - Analyst*

Okay. That's helpful. Thank you.

Operator

And that does conclude the question-and-answer session.

I'd now like to turn the call back over to Jim King for any additional or closing remarks.

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

Thank you, Noah. In case we didn't get to everybody's question today, feel free to call me directly, later in the day or week. You can reach me at 937-578-5622.

Currently we are planning our fourth-quarter, year-end announcement for the first week of November. We will be more specific on that in the weeks ahead, as well. And, otherwise, thanks for joining us and have a great day.

Operator

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