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SMG - Q2 2013 The Scotts Miracle-Gro Company Earnings Conference Call

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OVERVIEW:

SMG reported 2Q13 sales of \$1.02b and adjusted income from continuing operations of \$100.1m or \$1.60 per share. Expects full-year 2013 sales growth to be 1-3% and adjusted EPS to be \$2.50-2.75.



CORPORATE PARTICIPANTS

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Barry Sanders *The Scotts Miracle-Gro Company - President and COO*

Larry Hilsheimer *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

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Jim Lyski *The Scotts Miracle-Gro Company - EVP and Chief Marketing Officer*

CONFERENCE CALL PARTICIPANTS

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PRESENTATION

Operator

Good afternoon. My name is Ryan and I will be your conference operator today. At this time, I would like to welcome everyone to the 2013 quarterly earnings call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions)

Thank you. I would now like to turn the call over to Mr. Jim King.

Jim King - *The Scotts Miracle-Gro Company - SVP of IR and Corporate Affairs*

Thanks, Ryan. Good afternoon, everyone, and welcome to the Scotts Miracle-Gro second-quarter conference call. With me today here in Marysville are Jim Hagedorn, our Chairman and CEO; Barry Sanders, our President and Chief Operating Officer; as well as Larry Hilsheimer, our new CFO.

Jim and Barry will provide an overview of the current state of the business, both in the context of our Q2 results as well as our overall progress. And then Larry will walk through the financials and our outlook for the balance of the year. After their prepared remarks, we will open the call to your questions. Also with us today for the Q&A session are Jim Lyski, our Chief Marketing Officer; Randy Coleman, our Head of Global Operating Finance; and several other members of the management team.



In the interest of time and given the time of day, we ask that you limit your questions to one and to one follow-up. If there are questions that we don't address, we are glad to handle those with you offline. In fact, we will be staying late this evening and trying to handle as many of the follow-up questions as we can before you leave.

With that, I want to move on to today's call and remind everyone that our comments will contain forward-looking statements. As such, actual results may differ materially from what we discuss. 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, which also was filed earlier today.

With that, let me turn the call over to Jim Hagedorn to discuss our performance. Jim?

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

Thanks, Jim. And good afternoon, everyone. As most of you know, we seldom have late-day conference calls and earnings releases, but we needed to adjust our schedule this quarter to accommodate both our upcoming Board meeting as well as participation in the National Hardware Show. So I appreciate your understanding. And given the hour, we will try to keep things as brief as possible.

I'm going to share my time equally this afternoon with Barry. I want to spend some time discussing the implications of today's release on our full-year outlook, and then Barry will explain in more detail what we are actually seeing in the marketplace right now.

Clearly, the second-quarter results were short of what we expected and what Wall Street expected, but I'm also saying that today's relative results should not be overanalyzed. As you will hear from Barry, momentum is on our side. After an extremely slow start to the season due to weather, we had a strong April in all categories and geographies. The first weekend in May was equally encouraging. Consumer engagement has been outstanding whenever the weather has been good, and that has been true going all the way back to February.

Typically, Florida and Texas are good bellwethers for us to read the season. But this year it was California, where POS was up 43% in the second quarter. In fact, the entire West Coast was strong. But the common denominator was good weather. And when we saw what was happening, we were cautiously optimistic that it would play out the same across the rest of the country. And so far, that's exactly what's happening.

So I won't steal too much of Barry's thunder other than to say that POS in the United States is up 19% so far in the third quarter. And that data includes this past weekend, which was up 23%. In terms of dollars, we had nearly \$130 million worth of consumer purchases at our largest customers last week alone, making it the fourth-largest week in the Company's history.

I have not been shy about my conservative view of the United States consumer. But right now, consumers seem to be encouraged by record stock prices and a resurgence in home prices. Gasoline is stable, and even the dialogue in Washington is a bit more civil. This time a year ago, every one of those factors was weighing negatively on the consumer, and they disengaged. Before you ask, let me say that my view of the consumer hasn't changed. They're still on edge. I'd like to see consumer sentiment remain strong even in the face of some bad news here and there before I change my long-term view; but my near-term view is good.

In this environment, as long as the weather holds, the consumer is engaged. Entering April, POS in the United States was down more than 25% on a year-to-date basis. After this past weekend, that deficit is now in single digits -- a number that we believe is manageable, given our modest sales assumptions for the year, the comps we have for the rest of May and June, as well as the long-term weather forecast in the United States over that same period of time. So as you saw in the press release, we are confidently reaffirming our guidance. Larry will share some of the details in a moment that will help you better understand the timing of some critical line items, especially gross margin rate, so you can make sense of your financial models.

And so if I had to summarize our mindset in a single word, I'd say confident. We still have some work to do to make up lost ground, but the team understands what they need to do and they are executing the business extremely well right now. Of course, Barry is the one leading that effort right now. So let me give the floor to him, so he can share some more detail on the trends we've been seeing as of late. Barry?



Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Thanks, Jim, and hello, everyone. I'll start where Jim left off. I, too, feel comfortable with the guidance that we have given you and with the current trends we're seeing in the business. All of the conservative planning in the world could not have predicted such awful weather in March. We still have major markets like Denver and Minneapolis where the season still has not broken. Aside from those markets, I'm really encouraged by the level of consumer participation we have been seeing in the business. I agree with what Jim said -- March was so bad from a weather perspective that it's almost impossible to gauge the state of the business from our second-quarter results.

But the minute the season broke, we saw an incredible level of consumer participation. We now have had five consecutive weeks in which consumer purchases of our products and our largest retailers in the US easily exceeded 100 million. Our lawn fertilizer business has been rebounding well, with POS up 54% since April 1. POS in our mulch business was up 30% -- 34% during the same period. Growing media, which struggled in 2012 for the first time in years, is up 7% in the past five weeks. And our controls business have also been performing well.

POS of Roundup has increased 1% since April, and Ortho is up 2%. Remember that Ortho and Roundup both had strong results last spring. Other than mulch, which is up 9% for the year, POS in every product line is still slightly negative on a year-to-date basis. But remember, the traditional peak of our gardening season in key Northeast and Midwest markets is just hitting now.

Another reason for confidence is that our retail partners have been supportive. I have been on the road for most of this spring, and have had high-level meetings with each of our major retailers and several independents. As Jim said, I'm leaving tonight for the Hardware Show, and I'll visit with more customers at that event. They, like us, knew that March was nothing more than a delay. And a positive twist of fate is the fact that some of the promotional events, which were scheduled months ago, just happened to be perfectly timed for the break of the season.

I'm confident we'll see a continued high level of retailer support and consumer engagement. All of our retail partners have significant plans for May, and they are looking to take advantage -- full advantage -- of two key weekends -- the upcoming Mother's Day weekend, which historically is one of the most important weekends of the season; and a three-day Memorial weekend, which is also critical.

From a market share perspective, it's still early to draw any real conclusions. We believe we lost a bit of share in mulch. That's not too surprising, as high-end brands like ours tend to be more severely impacted when retail foot traffic is low. But as high-end brands tend to benefit more when the marketplace is strong, we believe we call back any weakness we saw in March. Remember, given the choices we made entering the year, the goal is to hold market share in line with last year.

While we remain confident in the North American component of our global consumer business, we still see challenges in Europe. Weather was a big drag on the start of the season there as well. We have begun to see things turn around, but it's unlikely that the team there will be able to hit their full-year targets. Over the past several quarters, we have talked about the steps we've taken to improve profitability of that business, so let me give you -- provide you a quick update.

Over the next several quarters, we believe we will see restructuring charges in Europe in the range of \$10 million to \$12 million, in line with what we originally expected. Most of those charges will occur in the second half of this year, but some will likely spill into 2014. From a competitive perspective, our European business is doing fine. But consumer discretionary spending remains under pressure, which is evident within the lawn and garden sector. I don't see the consumer environment improving any time soon in our European markets, so it is critical that we rightsize this business for that reality.

Let me briefly touch upon our last business, Scotts LawnService, where the trend line remains encouraging. Once again, the decline in sales you see for the quarter was weather-related and manifested itself in two ways. With existing customers, some lawn care treatments had to be delayed because there was still snow on the ground in much of March. And that same fact made our selling campaigns less successful than history would have predicted.

Our year-over-year customer account remains at record levels, as does our customer retention rates. Whether SLS hits its full-year sales target or not is probably 50/50. However, we are still driving leverage through the P&L, and so even a modest miss on the top line should not impact our



ability to drive higher level of profitability yet again in this business. And we continue to see SLS as critical to driving long-term growth and shareholder value.

Speaking of driving shareholder value, most of you will recall that what we've said the key to driving shareholder returns over the next two years will be improvements in both margin and cash flow. As it relates to margin, we're making great progress here, even though the second-quarter results today don't show it. Again, Larry will explain the details. But the combination of our pricing strategy, our commodity management efforts, and our cost-out initiatives have all begun to kick in for the second half of the year. And so we remain confident in the guidance that we provided, that gross margin right can increase by up to 125 basis points for the year.

As it relates to cash flow, we are actually trending slightly ahead of our plans. So, across the board, I remain confident. You always want to start the year off strong, but we also know we can't fight the weather. Now that the season has started, we are executing just as I would have expected. Our new marketing campaigns are resonating with consumers. Our sales force is interacting daily with our retail partners to keep them fully engaged. Our supply chain is working around the clock to keep retailer inventory at their appropriate levels, and our cost-out initiatives are driving the kind of margin improvement we expected.

We haven't fully climbed our way back after a slow start, but we are making important strides every week. And as I said at the outset, I share Jim's confidence that the targets we provided in December are sound and achievable.

So, with that, let me give the floor back to you, Jim.

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

Well said, Barry. I want to compliment Barry and his entire operating team for their execution. You know, it's frustrating when you have to sit back and wait for the season to come to you, but sometimes that happens in this business. When it does, we've got to be able to respond with even more energy and precision than normal. And his team has been doing that so far this season.

So, before we get into the numbers, I want to spend a few minutes talking about my new partner, Larry Hilsheimer, who we hired a month ago to replace Dave Evans.

Why Larry? And why pick an outsider? As a former Vice Chairman of Deloitte, a tax lawyer, and as both a formal Chief Financial Officer and an Operator at Nationwide, Larry brings a lot of credentials to the organization. He's got plenty of gray hair and someone whose past experiences are already helping us make us a smarter company. From a talent perspective, we didn't need to go anywhere. We've got one of the best financial teams you'll see in any company our size. Our last two CFOs were homegrown. And while I thought highly of both of them, especially Dave, I thought it was important to bring in some new outside perspective.

Larry is highly engaged in the Central Ohio civic and business community. It's hard to show up at an event around Columbus where Larry and his wife aren't in attendance. With that level of engagement comes a different type of perspective, and it's a big part of what he brings to Scotts -- some fresh thinking that is shaped by his own diverse experiences and influences. He's got a fantastic work ethic and a personal style I believe will work well here. I've been impressed with his first month on the job, both in preparing for this call and our Board meeting later in the week. He's been highly engaged -- a sign, I'm sure, of good things to come.

Most of all, I believe he will be a great finance partner for me. He and I are of like minds about the need to remain focused on improving market structure in the business, in a way that's focused on driving cash flow that can be utilized to enhance total shareholder return.

So with that, I'm glad to introduce and turn the call over to Larry Hilsheimer.



Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Thank you, Jim, and good afternoon, everyone. Let me start by sharing my excitement in joining Scotts Miracle-Gro. I've known Scotts and Jim Hagedorn for a long time, having had previous affiliations with Scotts from my days at Deloitte extending back to the 1980's. Nothing I've experienced in my first 36 days on the job has dampened my enthusiasm.

What I've known for a long time is that this is a company with great brands, and a management team focused on delivering value and enhancing its brands. What I have come to better appreciate during the interview process and my initial month here, however, is that this is also a company that possesses the opportunity to drive significant shareholder return. I look forward to helping accomplish that and to serving as the type of partner that Jim just described.

I know that Jim King's team has been scheduling meetings for the two of us to meet with many of you over the next several weeks. I'm truly looking forward to those visits. We plan to visit more of you in the months to come. As it relates to today, I will discuss both our second-quarter results and our full-year outlook. I believe I'm prepared to respond to your questions, but I may call on some of my finance partners to respond if the question requires deeper insight than I currently have. And let me just say that Dave Evans built a solid finance team here, and my orientation has been greatly accelerated by their help.

So, let's get started. I'll come back to this point in more detail later, but I want to start out by reiterating Jim's comments about our full-year outlook. Despite the slow start to the year, we remain confident in our guidance. We recognize that many of your models probably need reconfigured after the results we announced today. We will help you do that, to the extent that we can. I'll get into that later in my remarks.

First, though, let's talk about the quarter. Sales during the period were \$1.02 billion compared to \$1.17 billion a year ago. Most of the decline was in the global consumer segment, and we believe it was nearly all attributed to weather. The initial sell-in to our retail partners was mostly in line with what we expected. And in areas of the country where weather was good, POS was strong, especially in the West; so, replenishment in those areas was strong as well. But based on the POS data that Jim shared with you, retailers in most parts of the US and Europe had little need to replenish their inventories in the last few weeks of March, compared to last year, when the start to the season was extremely strong.

Breaking down the consumer segment, sales within the US were down 12%, while sales elsewhere declined 15% in the quarter, excluding the impact of foreign exchange rates. As Barry already said, the weather in Europe was even more challenging than in the US.

As Barry also said, sales at Scotts LawnService were also lower due to weather-related issues. For the quarter, LawnService sales were down 8% compared to a year ago; but year-to-date, sales are still up 6%. Like the rest of the business, SLS saw a pickup over the past several weeks, and we still see growth in this business for the full year. The balance of sales for the quarter were on the Corporate and Other line, and were down \$2.8 million to \$12.1 million, which was in line with internal expectations.

You will recall that Corporate and Other consists of sales under the supply agreement with ICL. One area which deserves specific focus is the gross margin rate. For the quarter, the adjusted rate declined 230 basis points to 37.2%. Most of you probably remember that we previously had projected the gross margin rate would decline in the first half and then improve sharply in the second half. While the decline in Q2 was greater than we expected, and this was attributable primarily to lower sales volume for the quarter in the global consumer segment, which resulted in reduced leverage of fixed manufacturing and warehousing costs. We saw modest and expected headwinds from increased product costs during the quarter, but those were offset by pricing.

SG&A in the quarter was \$207 million, a decline of \$29.9 million compared to the same quarter a year ago. The year-over-year savings were primarily due both to planned lower spend and delayed spending in both sales and marketing, as well as reaping the benefits of other productivity initiatives. These decreases were partially offset by higher incentive costs. During the quarter, we had modest severance costs related to our Europe restructuring efforts, which were adjusted out of earnings. As Barry said, the larger restructuring costs will hit the P&L in the second half of the year.

Moving on, the rest of the P&L was in line with internal expectations. Interest expense for the quarter was flat at \$17.9 million. The tax rate for adjusted earnings for the quarter was 35.6%, in line with our expected rate for the full year. And we ended the quarter with a diluted share count



of 62.4 million shares. Taking it all to the bottom line, adjusted income from continuing operations was \$100.1 million or \$1.60 per share during the second quarter. That compares with \$132.3 million for the same quarter last year or \$2.13 a share.

Before I discuss our full-year outlook, I want to touch on the balance sheet. The year-over-year increase in inventory we saw in the second quarter is primarily attributable to lower sales volume, partially offset by better inventory management. As sales accelerated in April and into May, we are seeing our inventory levels decline, in line with our internal expectations. We continue to expect lower inventory of \$30 million to \$40 million in 2013, and remain committed to reducing inventory by as much as \$75 million by year-end 2014.

We finished the quarter with a 12-month average debt to EBITDA leverage ratio of 3.2 times. Our leverage ratio should begin to fall quickly, and we expect it to be around 2.5 times, perhaps even lower by the time we report Q3 results. As most of you know, we have repeatedly stated that once we get leverage back in that range, we will prudently be returning more cash to shareholders.

I know that some of you have asked our IR team whether that stance would be adjusted now that I've joined the team. That's a very easy one. No. I agree with this total shareholder return strategy completely. In this environment, and given the earnings and cash flow potential of this Company, I am comfortable using as much as two-thirds of available cash for shareholder-friendly actions. Whether that's through share repurchase, special dividends, and adjustment of our recurring dividend, or a combination of the three, has yet to be determined. However, we have begun a robust process to discuss our options, and we'll have more to share with you by the end of the year.

Okay, with that, let me close by coming full circle and discussing our full-year outlook. Starting with the top line, given the shift in the season, the momentum we've seen over the past five weeks, and the near-term weather forecast, we continue to believe we can hit our topline outlook of 1% to 3% growth. Clearly, that means that the second half of the year has to be up double-digits. And while that seems like a high hurdle, the important fact to look at is the historical pacing of our business. However, in the event we fall behind on the top line, we remain confident in our bottom line guidance because of expected improvements in gross margin rate, as well as contingency plans and SG&A.

Let's start with gross margin. While we're obviously behind plan for the first half, we expect a dramatic shift in the second half of the year. There are three reasons we expect this to occur. First -- as timing of shipment shifts to the second half of the year, we will see improved leverage of fixed manufacturing and warehousing costs. Second -- the vast majority of the cost-out initiatives that we implemented -- and remember, those are roughly \$15 million to \$20 million for the year -- will be realized in the remainder of the year after we have worked through order inventory. Note that we have a high degree of confidence in our cost outlook for the balance of 2013, as about 90% of our commodity costs for the year are locked.

Third -- the timing and mix of the price increase we took should further enhance the gross margin line in the second half of the year. In terms of the magnitude of these issues, the cost-out initiatives and pricing on a combined basis should be about equal to the benefits we expect from the leverage on our fixed cost.

Here is another point to remember. In the second half of 2012, we incurred unplanned costs related to expedited shipments. So far this year, we have seen far fewer disruptions, and we don't expect similar surprises in the back half of the year, so we have a year-over-year benefit to gross margin here as well. Because your gross margin rate -- our gross margin rate is so sensitive to volume, we have not provided a specific range for the year. Instead, we have said we expect the improvement could be as high as 125 basis points. That remains the case.

As for SG&A, we are still looking for a reduction of 2% to 3% for the year. And this is an area where we likely have some cushion if we fall short in other areas because of contingency plans we had put in place, as well as the impact on variable compensation. Below SG&A, the guidance that David outlined for you back in December remains valid. So, bottom line, we continue to feel good about the [2.50 to 2.75] range.

While I continue to assimilate the specifics of both our near and long-term plans, I have a high degree of confidence in what I've learned so far. While the start to the season has created a bit of a headwind for us, I know that Jim, Barry, and the Operations and Finance teams remain confident in the goals we've outlined for the year, and have reaffirmed this afternoon.

So, with that, let me turn the call back over to the operator and take your questions.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jon Andersen, William Blair.

Jon Andersen - William Blair & Company - Analyst

I guess I wanted to ask about the guidance, to start. You kind of reaffirmed the view that you can hit 1% to 3% for the year, but at the same time, you talked about the slow start in the consumer business in the quarter; Europe perhaps softer than anticipated, and that continuing. And SLS being kind of a 50/50 proposition to hit the full-year target. So again, just looking for a little more color on what gives you confidence here that, given these factors, that that 1% to 3% is something that's achievable.

Jim Hagedorn - The Scotts Miracle-Gro Company - CEO and Chairman of the Board

I think -- with pricing, I think it was 1% to 3%.

Jon Andersen - William Blair & Company - Analyst

Pricing, yes.

Jim Hagedorn - The Scotts Miracle-Gro Company - CEO and Chairman of the Board

So I think that's -- it was zero in units, 1% to 3%. Listen, just before Barry goes in there, I start with -- from Larry's and my point of view on the corporate side, and that is that you sort of just have to go with me on this, that we have an extremely conservative budget. The team is managing this really hard, that the acceleration in our business has been extremely rapid since April 1. And we've made up just an absolute ton of ground. And that, because of the conservativeness that's within our budget, I think that both Larry and I are very confident that the operators have a plan to get there.

And I'm not sure I can -- what more I can say. Barry, if you want to add some color to that?

Barry Sanders - The Scotts Miracle-Gro Company - President and COO

Yes. I would say, Jon, it was a slow start. But I think your planning numbers off of last year -- last year was a very good year. We knew it wouldn't be quite as good. But clearly, the business has shifted probably in a four to five-week range. And what we are seeing in our sales on a weekly basis is now -- is recovery of that.

And so are we absolutely confident that we'll get back? The numbers are trending in the right way, and we would expect to understand much clearer -- if the weather patterns remain as they are right now through the end of May, we should get pretty close back to where we thought we would be. And so I think, when it comes to the end of this month, I think we will actually think about how we will give guidance relative to that in the June time frame.



Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Yes, I would just add and supplement that a little bit. We watch weather maps a lot, and obviously, they're going to be what they're going to be, and that will determine a lot. But right now they look good, and we take heart in that. And like we said, the activity that we have seen in the markets where the weather has been good has been outstanding. And so, it gives us cause for encouragement.

Jon Andersen - *William Blair & Company - Analyst*

Just one point of clarification or follow-up. When you talk about conservatism and budgets, are you referring to conservatism around topline assumptions, volume and pricing, promotion? Or are you referring to conservatism on the SG&A line, perhaps, where your SG&A was down 13% year-over-year here in the second quarter? And then are you looking for just (multiple speakers) --

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

(multiple speakers) Jon, I mean, I don't want to interrupt. I would say, on the topline. I think there's a lot of contingencies and ability to make adjustments in the P&L that probably we were a little more awkward at in previous years, and that we understand the importance of making our numbers. And I think when I say conservative, what I'm saying to you is that I don't have to hit budget to get to guidance. That's really where I'm at.

And so I think that we've spent a lot of time sensitized -- going through sensitivities on volume misses to budget, okay, which is not numbers that we share with you guys. And I think that almost in all cases, we're good in the guidance. And I think that's the basis that we feel, when we say confidently reaffirm -- which I don't think that we've ever done before -- it basically means that it's not hollow, put it that way.

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Yes. In my comments, I mentioned that we have multiple contingency plans. And I also mentioned that part of why we're where we are in SG&A through the second quarter is that we pushed back and delayed spend on advertising to try to match it up to the market. And so we've got actions that we can take, to the extent necessary.

Jon Andersen - *William Blair & Company - Analyst*

Great. I'll pass it on. Thank you for the color.

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Thanks, Jon.

Operator

Olivia Tong, Bank of America.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Just maybe you could remind us what comps look like in April, May and June of last year, to help us bridge the gap on how you get from a 9% down POS through early May to sort of back on track and back to getting sort of a 1% to 3% sales growth for the full year?



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

I mean, Olivia, look. Barry is cranking with numbers. I'm just going to give you kind of a factoid. We picked up 3% in the last week. Okay? So that tells you how rapidly this stuff can move. But, Barry, what are the comps we're up against?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Yes. I'm going to tell you the numbers that I know off the top of my head, Olivia, is that we ended March last year up approximately 30%. I think it was -- we had our conference call in the first week in May. At that point, we were up 8% and we ended the year flat. So we lost 8% through that period. And so the numbers that we're looking at is essentially to be --

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Yes, we were essentially flat April/May last year. And then June, July, August, we saw roughly the same kind of performance, down a little bit. And we had a big pickup in the fall and were really encouraged both September and October, even in November, as we closed out the year.

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

So, you know, Olivia, from when we were prepping for this call, positive year-over-year numbers sort of after the middle of April -- I think we had one or two positive weeks, up until the fall, and then we had sort of an awesome fall. But we've got pretty easy comps we are up against, and that's the bottom line. And if we need to get actual numbers back to you, we will make sure that that happens. Okay?

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it, thanks. And touching on an earlier question, what's -- you obviously reiterated the topline outlook for the full year. What's coming in better than you expected so far in the last four to five weeks? Because you obviously mentioned that European weakness is probably going to hit the full -- is coming in worse than you expected; lawn service is sort of 50/50. So, the expectation, of course, is that there's something that came in a little bit better over the last four to five weeks in the US?

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

I'll tell you the big one -- lawns. I mean, the lawn business is doing really, really well. And that's like -- that's [a fine] margin for us. So we are doing great in mulch. But the lawn fertilizer business is a business that you know we have been watching carefully over the last couple of years. And we are just seeing really good lawn sales, and really clean inventory on some of these very seasonal products like Halts. So I would say that right now, if you were to ask me what's the big headline, we continue to do well in our dirt business and our mulch, in particular. And the lawn fertilizer business is just doing really pretty fabulous.

Jim, would you add anything to that?

Jim King - *The Scotts Miracle-Gro Company - SVP of IR and Corporate Affairs*

No. I'd say that we had 32 straight days of positive POS on ferts and we don't see that stopping any time after the balance of the month. I mean, things look good, sales are good. And it's all north-driven too.



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

Olivia, you should go out to stores. I mean, the Northeast is honking, lady. (technical difficulty)

Olivia Tong - *BofA Merrill Lynch - Analyst*

Will do. And then just lastly, you mentioned a couple of POS numbers earlier in your commentary, Barry. And you said that growing media was underperforming relative to some of the other categories like fertilizer and mulch. So what was driving the lower growth in growing media?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

I'm going to clarify one comment just about mulch. I said we lost share in mulch. It was actually supposed to be March. So we lost a bit of share in mulch. But --

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

In March.

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

But it was actually March, not mulch. But it's a delay in planting. We looked at -- we try to triangulate on live good sales. And Olivia, right now, to us the best intelligence we can get right now is, because of the weather, planting has been delayed by three or four weeks. So when you go back to my script, when I said from Mother's Day through Memorial Day, we expect that a large number of the live good sales will catch up in that period, and that will pull the growing media along with it. And so we saw a delay in fertilizer from March into April and May. And we think that there's a delay in the growing media, really from April, end of April pushing it more towards the end of May.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. Thank you.

Operator

Jason Gere, RBC Capital Markets.

Jason Gere - *RBC Capital Markets - Analyst*

I guess if you could talk maybe about in the March quarter as well as what you have seen in the last five weeks, about the pricing impact. I know this year was the year that you were taking pricing and the competition wasn't, a reversal of last year. So maybe if you could talk from that perspective, maybe put aside the weather impact and maybe looking at the economic impact. And then just tying with that, on the advertising side, is there -- to hit this kind of double-digit, and based on what you have seen so far, are you stepping up more of the advertising if maybe some of the cost control on the SG&A is coming in a little bit better?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

First, to go to pricing, Jason, I don't -- at least what we see at this point, we expected there would be a little market share pressure from the pricing. Our perspective, the numbers that we saw in March were more traffic-related than they were pricing. Because what we've seen in April is that we



are recovering those and we expect that March, we're going to pick those back up even more so. So probably right in line with where we thought we were going to be on market share.

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

(multiple speakers) I'd say, on advertising, we had a large national buy this year that we left in effect. But then all the regional and spot markets, we were able to push back to better match the POS curve. And we have been able to do that specifically for the northern region. We've also been opportunistic to take advantage of certain events that are happening, and certain outbreaks of either pests or weeds in key markets, and matching up our media spend and our creative message to those markets at the right times.

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

But Jason -- Jim Hagedorn here. I think we spent a lot of time as we prepped for the call on this issue. And I query the folks sitting on the operating side pretty hard. I generally don't think we see much happening in regard to sort of low-single digit pricing we took. And so when I push pretty hard, both at the regional level and at the national level, I don't think that anybody could call anything that they thought where we were losing share due to pricing.

Jason Gere - *RBC Capital Markets - Analyst*

Okay, and then just a housekeeping question -- I apologize if you gave this. But do you have the POS by month in the quarter? So what we saw in the second quarter, by each of those months?

Jim King - *The Scotts Miracle-Gro Company - SVP of IR and Corporate Affairs*

I can give them to you offline afterwards, Jason. I don't know if we have all of them right here, right now.

Jason Gere - *RBC Capital Markets - Analyst*

Okay, I appreciate it. Thanks a lot, guys.

Operator

Bill Chappell, SunTrust.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Maybe you could help us, and I'm not sure there's a perfect way to do this -- but looking back on the March quarter, how it came in versus original expectations? Because, obviously, some of it was just a tough comp with the great March we had last year, and then some of it was a bad March this year. I mean, how far off was it from what you've kind of originally anticipated?

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

Oh, dude, it was pretty bad. It was pretty horrendous here. I mean, I know, like these guys can share the numbers with you, but I was in the Northeast on Friday, and -- I think it's actually called the North Territory now. But I know Mike Carbonara was off, at the peak, by like \$150 million at the end



of the first half. That's -- I mean, and that's a big number for Mike to be that short. He's made a lot of that back, which is a good thing. But it felt pretty crappy here, you know?

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

(multiple speakers) Okay.

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

And I'll add just a little color to it. This is not science behind it. We came into the month, we expected it to be down about 10% relative to the strong comps last year. But it was down 10% even more beyond that. So we came in out of February positive and came out of March in a much different spot.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Sure. And then as I look, kind of going forward (multiple speakers) --

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

(multiple speakers) But Bill, before we jump off that, I think that my comments in the script are really important in this, which is that a lot of those negatives, whether it was the stock market, housing, the political dialogue which was super negative -- I mean, everything last year was just pretty scary.

This year, where the weather has been good, business has been really good. So this is not one where I think we are all frightened as long as the basically next 60-day weather forecast is coming out of NOAA, and the vendors that we use, Plantronics, is correct. So that based on both private weather and our government's weather forecast for the short-term, where weather has been good, sales have been really good. And I think that's -- and especially in, like, businesses like our lawn business, it's a high margin business for us.

So I think that we don't have commodity pressure, we don't see the sort of social economic problems that we saw last year, political issues that we saw last year. While they are not great, I don't think they're sort of top-of-mind for people. So I think we are -- like I said, we are pretty confident and we don't have to hit our internal budgets to make the guidance we've provided you guys. And so I think we are pretty darn comfortable that we are okay here and that there's nothing crazy going on other than March sucked. And that's the business we're in. You know? (multiple speakers)

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Sure. (multiple speakers) And I think I understand the switch, kind of March, April, May. I guess the other question would be -- you are talking about double-digit growth for the remainder of the year. Are you expecting an even push into July? Because I don't remember the comps being as easy, as we get to June, July, August, September or -- that last quarter. So I'm just trying to understand, was it really just a big shift from 2Q to 3Q?

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

I would say yes. And I just want to emphasize that I can have slippage on the top line and still get to guidance. And that's important. So I'm not going to be like -- last year, I remember how I felt at the end of March, which is the mark is just way bigger. And it's not been pulled forward. I think that a lot of times when the weather is not good, you don't make all of it up. Well, what I'm telling you is I don't need to make it all up. Okay? And so again, we're pretty confident in the sensitivities to the top line that we've got it covered.



Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay, and then just last one -- looking back two years ago, I think you had a record gross margin, around 41%. Is that the type of numbers we are talking about, just with all this revenue coming in this next quarter of -- and more tame commodity environment?

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

Bill, are you talking about margin for the quarter?

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Yes, for the quarter. I mean, kind of a gross margin for the quarter to get back to that [125] for the year.

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

Well, I mean, Larry, your level of comfort on (multiple speakers) --

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

On March --

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

-- getting back to the margin that we (multiple speakers) --

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Yes, I'm very comfortable to the -- of having a very nice increase in our margin for the year. Like we said, up to 125 basis points, absolute confidence of getting above last year relative to where we are at right now.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay, great. Thank you.

Operator

Alice Longley, Buckingham Research.

Alice Longley - *Buckingham Research Group - Analyst*

So what kind of -- what level of POS increase do you need to have in May and June, in order to get to like up 1% for the year? Are we talking about 8%, 15%, 20%? What POS do we need?



Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Yes, Alice, it's in the mid-double digits -- 13%, 14%, 15%, in that range.

Alice Longley - *Buckingham Research Group - Analyst*

Okay. (multiple speakers) And then if it's like 8%, you'll get to, say, zero for the year, but you still think you can make the bottom line? Is that the idea?

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Correct, absolutely.

Alice Longley - *Buckingham Research Group - Analyst*

Okay. And then on raw material costs, would you say that your commodity costs or the commodity costs you are sensitive to -- oil, natural gas, urea -- how are they trending in such is -- what is your confidence, is what I want to say, for fiscal '14 gross margins based on commodity cost trends?

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

I would say the outlook that we have today is more positive than the outlook we had at the end of the calendar year. So I think that the trends and commodities are positive to what we had assumed in our '14 internal financials.

Alice Longley - *Buckingham Research Group - Analyst*

So can you give us any sense for how much? I mean, you've told us about up to 125 basis points in fiscal '13 for gross margins. Can you give us a gander as to what that might be for fiscal '14, at this point?

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

See, I'm not going to go there. I mean, as we -- again, as we prepped for the call, the way I'm operating with Barry -- and I'm really pleased with the work -- I've got to tell everybody who's on the call, that it's really disappointing to see the amount of really good work that's gone in and then the sort of struggle based on a crappy March. This happens. But it's just -- it's unfortunate that so much good work has gone into it.

But the guidance that I give Barry is effectively for margin rate. I mean, so margin rate and cash flow is really important to the guidance that I'm giving Barry that he's got to solve for. Barry is solving for, I'm going to say, pretty significant margin increases over the short-term, meaning multiple years.

And what I'm telling you -- and that's consistent with what we've told you guys and consistent with the highest margin rates that we've historically shown. And so you can go back and look at what that is. Barry is trending and the business is trending very positively toward the guidance that I have given, and that Larry, I think, affirms is the proper guidance. And that from many ways, whether it's cash flow, return on invested capital, operating cash flow, that these are all positive, placed both on a percentage and an absolute basis as we go forward.

So Barry is on track. And the quality of the financials over the next couple of years will significantly improve. I'm talking quality.



Alice Longley - *Buckingham Research Group - Analyst*

And I think your adjusted gross margins, since you restated your numbers, peaked out for the year at almost 38% in fiscal '10. Do you want to update us as to when you think you'd get back there?

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

Not really, except to say I have expectations that it's at least as good as that.

Alice Longley - *Buckingham Research Group - Analyst*

By, what, fiscal '15?

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

I'm looking to Randy Coleman, who's the Head of Operating Finances, who's got to actually work with Barry on this.

Randy Coleman - *The Scotts Miracle-Gro Company - SVP of Global Operating Finance*

Well, Alice, I think you know over time, we expect to get closer to 40% is what we've said publicly in the past. I think for next year we expect to see an increase similar to what we are planning for '13. So we say up to 125 basis points. I think we are comfortable saying something in that same range again for next year.

Alice Longley - *Buckingham Research Group - Analyst*

Perfect. Thank you very much.

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

You're welcome.

Operator

Joe Altobello, Oppenheimer.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Just one quick question first on retail inventories -- obviously, you had a pretty violent last couple of months coming out of March and now coming out of April. So where do retail inventories stand at this point? And are you comfortable that the strong POS growth that you're hoping for in the next couple of months will translate into strong shipments as well?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Yes. Joe, this is Barry. Our retailer inventory is down low-single digits to last year. And so we are comfortable with the replenishment model that we should be able to get shipments commensurate with what the POS is.



Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay. So it's pretty lean?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Yes.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay. And then secondly, in terms of pricing -- this is more of a philosophical question, I guess. But you guys have taken pricing some years in the past, you haven't taken pricing in others. How should we think about your philosophy when it comes to pricing? Is this going to be an annual event? Is this something you are going to do when commodities are high? Is it behind innovation? Or is it a combination of those three issues?

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

Well, I guess the fair thing to say, it's a combination of all of them. We believe that this business should be at approximately a 40% gross margin. I mean, we could go down and I can take you and tell you this is what I think the operating profit percent out to be; this is what I think our EBIT, call it EBITDA, ought to be as a percent. But within that, what we're solving for when it comes to pricing is gross margin, and the gross margin obviously is a critical item for us. I don't think we want to put a huge amount of pressure on the consumer.

Do I view, in the quest for what I view as the margin this Company should be at, in order to have a healthy P&L and be able to make the investments we want to make, and have the ability to sort of withstand kind of a crap month or whatever? I think we need to be in that 40% range. I expect Barry -- and he's doing it -- to quickly get to that level. Do I believe that pricing is a part of that? Yes, I do. And are we going to aggressively push toward that? Yes.

But within -- I mean, this just happens to be a discussion we had today. It is a lot of factors that go into it. It's the savings that Barry and his team are putting together that go into gross margin. It's the mix of what we are selling goes into our gross margin, and it's pricing. And so all those factors are on the table every year, and I do think that -- and we talked about this, which is the issue of not taking pricing for a couple years, allowing our margins to decline, and then trying to make up for that, it's just -- it's kind of stressful in the relationship with the retailer, in particular.

I think that the issue, as we talked about share this year based on low-single digit pricing, is not that big an issue to the consumer. I know Jim Lyski is concerned that it be controlled, but I don't think that low-single digit pricing is an issue. And I think that the importance of getting to sort of, call it, roughly 40% on gross margin is such a powerful thing for us that we do need to get there quickly. And if pricing has to be part of that, then it is. I don't know if that answers the question, Joe.

Joe Altobello - *Oppenheimer & Co. - Analyst*

No; it does, it does. I was trying to see if we have room for additional pricing over the next few years, but it sounds like you are expecting that this is going to be an annual event.

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

Yes.



Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay.

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

I think in the quest for getting to 40%, we think it's important. And we have lived through periods where margins have declined and we have been less aggressive dealing with it. And it's pretty painful for all kinds of ways. We just don't want to be there.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay. Got it. Thanks, guys.

Operator

Connie Maneaty, BMO Capital Markets.

Connie Maneaty - *BMO Capital Markets - Analyst*

How much last year did the unplanned shipments cost in the second quarter?

Randy Coleman - *The Scotts Miracle-Gro Company - SVP of Global Operating Finance*

Connie, this is Randy Coleman again. We don't have specific numbers, but we are going to say it's something in the range of \$6 million to \$7 million is what landed in the quarter.

Connie Maneaty - *BMO Capital Markets - Analyst*

Okay. And how do you know if the season is going to be shorter this year? I mean, let's just assume this year's season is going to be shorter than normal. How do you know you won't have those kinds of shipments in the second half?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Connie, this is Barry. We, from a retailer relationship standpoint, have the best programs in place that we've had in a long time. The sales team and the supply chain team really what I would say jointly manage what those flows are going to be. And so we have mapped it out. A lot of my visits to the retailers are making sure that they understand the compression of what can happen and the fact that we can't afford to incur those kind of expenses.

And so the way that it's planned out right now, I think we are in good shape, and the shipments look like that we will be able to ship it in and not have any real issues. And what I would say going back to last year, if we looked at the season, we had some really explosive sales results in our mulch business. And we just had phenomenal results this year in mulch; it's one of the categories that are up 9%. I have not had -- we have not had any issues delivering it and have not really had to expedite many shipments at all. So I think, to a certain extent relative to the promotional activity for mulch, I think we are beyond that part that's going to affect the season. And we know now going in that -- what shipments we need to make and I think we are in good shape.



Connie Maneaty - *BMO Capital Markets - Analyst*

Okay, so it sounds like April and the beginning of May were really good for sales. So if -- and you probably closed the books on April, right? So how close to guidance are you or to plan are you, through April? Because we see the results from March, and everything got a whole lot better in April. So how close are you on a year-to-date basis where you thought you'd be on your plan?

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

Randy, why don't you take this?

Randy Coleman - *The Scotts Miracle-Gro Company - SVP of Global Operating Finance*

Sure. So, Connie, like we said, we saw strong POS in April. We were up 18% for the month. And I guess in someone's script, we said this was just the fourth best week we've seen in the last four years, I believe. So very much on track, feel really encouraged. And we're not back to where we need to be, but if we had to call it low-double-digit to mid-double-digit POS for May and June and beyond, and like I said, we've had pretty easy comps going forward, we would be very much right on track. And to reiterate what Jim said, if we fall a little bit short, I think we have appropriate plans in place to cover shortfalls of a fairly decent magnitude, and still feel really good about protecting the bottom line.

Connie Maneaty - *BMO Capital Markets - Analyst*

So just a question also on replenishment. With the season starting as late as it is, if retailers fell out, how quickly can you deliver significant amounts to them without incurring additional costs?

Randy Coleman - *The Scotts Miracle-Gro Company - SVP of Global Operating Finance*

Different retailers we do different ways, Connie. But we have the logistic capability from the time we get to the order to have it back on their shelves that week, and then get our merchandising team in there. So if we get the orders by a Monday or Tuesday, and we can get it packed out, it can be back in stock by that weekend. And so, I mean, that's one of our key advantages that we built that. Now, that may be a different cost structure that we've agreed to from a pricing standpoint with our retailers, but we have the absolute logistic capability to get back in stock.

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

Yes, Connie, Jim here. I've got to tell you, I don't see, actually, that we are going to blow up the supply chain. Just having spent -- New York is totally on fire. And if I was to say -- I was in a huge volume store on Long Island, that we are just putting a lot of labor into, just to keep it clean. And it still was -- a store that's under that kind of pressure just needs a lot of labor. I know Mike is within his kind of flex budget, so he's got his labor hours -- I would say there's more stress right now on the labor of keeping the stores good looking, merchandising the product, counseling is where there's pressure. And I know that Mike Carbonara is within budget and has flex time built into his current budget with us that he's got to cover. But I would say that's more where the pressure is; just keeping the stores looking good under this kind of volume pressure is the issue.

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Yes, Connie, just going back to last year, to put everything in perspective, we had -- the two big issues that we had was -- one was mulch, and the demand far exceeded what we had planned. This year, we planned in advance and put a lot more prepack down on the ground. And so we had more inventory and space, and we worked with retailers on a logistic plan to make sure they had enough. And so I think we are in good shape there.

The other thing, if we go back to last year, our controls business with our new wand -- we saw some just explosive sales in March, where volume was up in hundreds of percent. And so we were expediting a lot of that back in, as well as air freighting in some materials that we had to keep up with some demands on that new unit. Both of those things I don't see as issues at all this year. And so, those kind of charges that we saw for that -- I just don't see that happening. And actually, I would be happy if we had some logistic issues, because that would mean that the volume was going to exceed our expectations. And -- so I think we're in good shape at this point we're at this year.

Connie Maneaty - *BMO Capital Markets - Analyst*

And if I could just ask one last question. What's the margin structure of mulch look like now? Because it was so low-margin last year. What's it look like this year?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Yes, so last year was, we'll call it mid-single digits and we expect to be into double digits into, call it, 15%, and aspirations to get it to as high as 20% in the next couple of years. So really encouraged about the progress we've seen. Supply chain folks have been working like crazy. I think we've deployed capital in ways that makes a lot of sense and vertically integrated, and I think it's definitely a success story for the year.

Connie Maneaty - *BMO Capital Markets - Analyst*

Okay, so then the mid-single last year was an operating margin. Right?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Well, we didn't really have a lot of expenses below margin, so (multiple speakers) --

Connie Maneaty - *BMO Capital Markets - Analyst*

So that was growth and operating?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Right.

Connie Maneaty - *BMO Capital Markets - Analyst*

Okay, thanks.

Operator

David MacGregor, Longbow Research.



David Zore - Longbow Research - Analyst

[David Zore] filling in for David MacGregor. (multiple speakers) I guess if I may, I'd like to shift the discussion away from maybe how the weather impacted results and focus on the lawn services business. I guess, first, if you look at the growth in 2013 or the expected growth and maybe beyond, I mean, how much will come from penetration, that is, just selling a customer more services?

Jim Hagedorn - The Scotts Miracle-Gro Company - CEO and Chairman of the Board

Brian? Brian Kura, who's the General Manager of the business -- do you want to talk?

Brian Kura - The Scotts Miracle-Gro Company - President of Scotts LawnService

Yes. I'd say most of our growth is going to come from new customer growth. We are budgeted about 8%. And right now we are up about 5%, so it's mainly new customer growth.

David Zore - Longbow Research - Analyst

Okay, great. And then if you could just talk briefly about maybe operating leverage in that business and maybe how variable the SG&A line is there?

Barry Sanders - The Scotts Miracle-Gro Company - President and COO

Some of the margin impact that we've talked about in the second quarter year-to-date results actually relates to lawn services. And the labor and trucks that we have are effectively fixed. We had them in there. And as the sales and activity is not occurring, we end up hitting -- taking a margin hit. That stuff will reverse as we go through the rest of the year.

David Zore - Longbow Research - Analyst

Okay, great. Thank you very much.

Jim Hagedorn - The Scotts Miracle-Gro Company - CEO and Chairman of the Board

You're welcome.

Operator

Eric Bosshard, Cleveland Research.

Eric Bosshard - Cleveland Research Company - Analyst

Three questions for you -- first of all, market share. I wasn't perfectly clear on Barry's comments on the market share in either March or mulch or whatever it was. Can you just clarify where you are market share year-to-date or through March, whatever data or insight you have?

Jim Hagedorn - The Scotts Miracle-Gro Company - CEO and Chairman of the Board

James, you want to talk?



Jim Lyski - *The Scotts Miracle-Gro Company - EVP and Chief Marketing Officer*

Yes. Sure. This is Jim Lyski. I'd say overall, surveying the data that we have available to us, I would say slightly down through March, which is not unexpected. We typically lose a little share in poor performing months and we gain share in good performing months. We also gain share when the major retailers have their big promotions. Depot moved their big promotion into April, so we anticipated a relatively weak March and it came up a couple points shy.

I don't have the April data yet calculated on share for that month, but my expectation is we are going to get most of, if not all of that back, given the promotions they've been running this week -- or this month, sorry.

Eric Bosshard - *Cleveland Research Company - Analyst*

Great. And then secondly, you talk about a number of drivers related to margin. You talked about if sales don't get there, you've got some contingencies, which I assume are SG&A, that you can take out the upside on gross margin, it sounds like, on price cost and then the slightly lower ad spend this year. I'm curious, when you think about those initiatives, how you balance that relative to market share? And how you think that plays out, not only for share but as you think into next year as well?

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Let me clarify a couple things first because you sort of mixed things there. So obviously, SG&A is separate from the margin. And with respect to margin, there's a couple elements there is, we've got cost takeouts in our supply chain that are going to come to fruition in the second half of the year. We've got more of the pricing changes that we implemented that will flow through in the second part of the year.

And then we have, first, the item that I mentioned in lawn services' impact on margin, as well as leverage that we have on warehousing cost that when our sales are lower, because that's a fixed cost element, it doesn't translate to margin. All of those things will shift into the second part of the year. With respect to contingencies, and those -- that is in the SG&A area, is some of that plays out just automatically, if we don't end up hitting targets, some of the incentive that is being accrued ratably through the year ends up falling away. The other is some of the other items that we could pull levers on in various contingency items that we've got in a plan.

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

The one thing I'd add to what Larry is saying as well is, the way that our Roundup margin flows through into the P&L, Roundup business shifted from March and pushed out in April as well. So that will, as well, help the margin line.

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

But I want to just get back to the issue that I think maybe you are focused on, which is, we know what drives volume in our business and we know what drives our performance and what it's unique about this company. It's our brands, it's our advertising, and it's our ability to execute in the field. These are not areas of expecting a lot of mining activity to occur to make the year.

And so I don't see us doing further cuts of any significance to our advertising or our ability to execute in the field. And so those are not areas where we are looking to pull a lot of money have to make numbers. And Eric, it's really important that we do not need to get our budget topline number to hit our guidance. And so it's just a little bit of a natural hedge and that we have room in our internal budget compared to what we have discussed publicly with The Street. And I think that's important, it's especially important this year.



Eric Bosshard - *Cleveland Research Company - Analyst*

And those sort of natural hedges, in areas where you can pull in, or areas that are transparent were not apparent to a consumer? And is, they are not areas that you would have otherwise invested for market share or for growth?

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

That's true.

Eric Bosshard - *Cleveland Research Company - Analyst*

Okay, and then the last question -- you commented on hold, and that wasn't totally clear on that. How did halts -- my assumption is always, in a year where the season starts slow, starts late, that of pre-emergent products, halts, would underperform. How have you done with that line this year?

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

Really well. And so it's not -- listen, I think it's unfortunate, to be honest, that when I first got in this business you would see multiple terms of halts at the retail level. I think today people tend to make their debts and want to sell it out. And we established a pretty significant return allowances based on that. This is the year that, while it is late, it has not warmed up real fast. And so there has not been a lot of pressure to pull the product back, and inventories, the best I can tell -- and I have been out of the markets quite a bit this year -- are extremely manageable, meaning I think virtually sold out. So halts has had a good season, if you just define a good season as the inventory that was placed in the field by the retailers and merchants is sold out.

Operator

Jim Barrett, CL King Associates.

Jim Barrett - *CL King & Associates - Analyst*

Jim, with the mitigation of the drought this year that I hear that at least in selected markets -- how much is that -- is that expected to help with the grassy or fertilizer?

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

Yes. We are still concerned about drought, particularly in Texas. But I think we have good, sort of when weather of this type kind of programs, kind of weather-smart programs in the state of Texas that I think Barry has talked about, where we are working directly with the state of Texas on it and very successfully. But I would say the rest of the country, coming out of drought and hot summer with a lot of damaged lawns, I think the grassy business editor of business in general is pretty good.

Jim Barrett - *CL King & Associates - Analyst*

And then, Larry, sort of a generic question for you -- with Europe struggling and certainly the consumer struggling, should the tax rate, if it is more, if the profitability is more US-centric, is the tax rate likely to drift up over time, not so much this year but looking forward?



Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

To the extent that, I guess, to the extent that the European business shrinks, yes, our tax rate would end up getting up a little bit. But it's so small as a portion, it's not something that I would have any concern about.

Jim Barrett - *CL King & Associates - Analyst*

Is it, what, 100 basis points, that order of magnitude?

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

I don't know, I have not measured. I don't think it's that much, though.

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

I can't quantify the exact impact on our effectively, but our relative profit in Europe versus the US is so small that the impact can't be even really worth talking about.

Jim Barrett - *CL King & Associates - Analyst*

Okay. Okay, well, thank you both.

Operator

I would now like to turn it back over to Mr. Jim King.

Jim King - *The Scotts Miracle-Gro Company - SVP of IR and Corporate Affairs*

All right. Thanks, Ryan. I know we didn't get to all of you. There are a couple of folks that tried to get back in the queue. So if we didn't get to those follow-ups, I'll give you a call back directly. And of those of you who want to give me a call back, please do. My direct number is 937-578-5622. I'll be here until 7.30, 8 o'clock tonight, in case you need follow-up.

One minor housekeeping item -- Barry, Larry Hilsheimer and I are going to be attending the William Blair conference in Chicago. That's going to be on Tuesday, June the 11th. And it will be webcast live on our IR website. Other than that, we will talk with you again in early August when we report our Q3 results.

Thanks for joining us today and have a good evening.

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

Thanks, everybody.

Operator

This concludes today's conference call. You may now disconnect.



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