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SMG - Q2 2012 The Scotts Miracle-Gro Company Earnings Conference Call

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OVERVIEW:

SMG announced 2Q12 net sales of $1.17b and GAAP net income of $127.2m or $2.05 per share. Management reaffirmed FY12 EPS guidance of $2.65-2.85 on net sales growth of 6-8%.

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PRESENTATION

Operator

Good morning and welcome to the second quarter 2012 earnings conference 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. Jim King, you may begin your conference.

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

Thanks Amber. Good morning everyone and welcome to the ScottsMiracle-Gro second quarter conference call. With me to this morning are Jim Hagedorn, our Chairman and CEO, and Dave Evans, our Chief Financial Officer.

Jim will start with an overview of the current state of the business, both in the context of our Q2 results as well as our overall progress. Dave will then walk through the financials and update you on our full-year outlook. After their prepared remarks, we'll open the call for your questions.

Also with us this morning for the Q&A session is Barry Sanders, Jim Lyski and several other members of the management team. In the interest of time, we ask that you limit your time to one question and to one follow-up. If there are questions that we can't address during the call, we're glad to handle those with you off-line afterwards.

With that, I'm going 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 discussed. Due to that risk, ScottsMiracle-Gro encourages investors to review the risk factors outlined on our Form 10-K, which is filed with the Securities and Exchange Commission, or our most recent 10-Q which we filed today.

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

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

Thanks, Jim. Good morning everyone. We are obviously pleased with the results were announced today for the second quarter and remain encouraged by the strong consumer purchases of our products across the US. While we still have at least another four to six critical weeks in front of us, we are optimistic about what we are seeing and are convinced the steps we've taken this year are working.

But I'm pleased with more than the financial results. I'm pleased with the activity that is driving the result, and will drive it in the future quarters as well.

When we announced three years ago that we were making significant change to our business model, we said the change would take several years to implement. Are we at the finish line yet? No, but we've made a lot of progress so far this year.

As many of you know, we made a leadership change a little more than a year ago when Jim Lyski joined us as Chief Marketing Officer. And since then, we've made other changes in the marketing group as well. Today we are benefiting from sharper consumer insights which are impacting everything from our product design to our packaging, to our pricing philosophy to our advertising message.

Since last year we have also reconstituted our strategic planning efforts and put them under the leadership of Dave Evans. Today we have more clarity on the opportunities in front of us, and we're actively working on projects that include everything from the redesign of our pricing and trade programs, to productivity improvements, to exploring options for growth in our regions or in adjacent categories that leverage our core strengths.

The team has also begun to focus on ensuring that our strategy is well understood at all levels of the organization, from associates on the client floor all the way to the Board of Directors, and that their efforts are aligned with our five-year goal of driving to $4 billion in revenue and $600 million in operating profit.

I'm also pleased with the interaction of the entire leadership team. Since being named president 18 months ago, Barry Sanders has overhauled the way we work, interact with each other and make decisions. Like any significant cultural change, this change has not been easy. But he has stayed true to our goal, and the change we envisioned is clearly taking hold.

Today we're working more collaboratively, making better decisions, and have better alignment than at any time I can remember. While it's difficult to quantify the impact of these efforts, take my word for it. The impact has been substantial.

But the efforts we have undertaken have not just been focused on the organization and cultural change. We have also been focused on changing the way we execute, and the result of those changes is evident in our early-season success this year.

We made a step change in our media investment, launched two new advertising campaigns, and introduced our largest innovation in the lawn fertilizer category in decades. Those factors and others had us poised to take advantage of the favorable weather in March, and we took full of advantage of it, getting it off to a terrific start.

We had positive POS growth in nearly every product category during the quarter. Preliminary market share data indicates that we are outperforming both the private-label and our branded competitors. Just as importantly, it tells us we're making progress in regionalization.

Our market share in the Southwest is now on par with the corporate average. The team in Houston has been making significant strides over the past three seasons. We also continue to see progress in the Southeast, where our share gains this year are well above the corporate average.

The other piece of good news is that we're also seeing growth in every major retail channel. This includes the mass merchant channel, which struggled last year. In fact, at this point, I would tell you this channel is easily exceeding our early-season expectations. We're seeing stronger support, higher inventory levels and an overall recommitment to the lawn and garden space.

Let me dive a little deeper into what we are seeing with the consumer at this point in the season. Before I do, I want to point out that unlike the remarks you'll hear from Dave, my comments around consumer purchases are based on data entering May, so it's pretty much real time.

In aggregate, consumer purchases in the US entering May are up 8%. As you saw in the press release, POS was up 20% in the quarter, but we gave some of our early seasons back in April due mostly to colder weather and the fact that some consumer activity simply occurred earlier than normal. So we entered May pretty much where we expected to be.

Let's look at POS by category, starting with lawn fertilizer, where consumer purchases of our branded products are up 6%. Our goal in turning entering the season was to drive an increase in unit volume after seeing units decline for the last several years.

Entering May, consumers had purchased about 1 million more bags of fertilizer than they had the same time last year. Obviously the season isn't over, and May is an important month for the business. But so far, we like what we are seeing.

We're also -- we also like what we're seeing in our durables business, where consumer purchases of spreaders are up 14%, a number in part driven by the introduction of the Snap fertilizer system. While early good season weather helped, we're convinced the combination of innovation and improved advertising has been key here.

A lot of that increase has been related to Snap, and the Snap results are strong. Remember, in all but a few markets, consumers had never heard of this product before March, and the product is a substantial change from what consumers are accustomed to. Entering May, Snap represented nearly one-quarter of all new spreader sales.

What's even more encouraging is the average consumer is purchasing more than 2.7 bags of lawn food when they buy a Snap. That's higher than we anticipated, and in the test markets from 2011 the number of bags being purchased is even higher.

It's too early to declare success with Snap or the overall fertilizer business this year. But we believe the combination of a great product, a great ad campaign and a great in-store product placement is creating a lot of consumer excitement this year, and we believe setting us up for continued momentum next year as well.

I want to move on to Ortho, another place where innovation has had a major impact. POS is up nearly 30%, with double-digit increases in all but five states.

Our new battery-powered application wand is driving a high level of consumer excitement, so much that we have had a hard time keeping up with demand at times. This is especially true with our Ortho Home Defense product, which is seeing a POS increase of more than 30% from last year. And consumer purchases of Weed-B-Gon, our selective weed control product, are up over 40%.

A new TV spot featuring the wand has been well-received, and retailer support has been strong at the break of the season.

The other side of our weed business, [nonselect] controls, is also off to a great start with POS of Roundup products up 25% entering May. We're also seeing strong performance with the SCJ brands we're supporting in the DIY channel. Year to date they're up 40%, and we expect strong increases for the bounce of the year as well.

Our mulch business has been going strong, with a POS growth of 26%. This is a product category that has nearly doubled in size over the last five years, and should represent about $200 million in revenue this year. And while we're extremely pleased with what we have done here, it's a business that has much lower margins.

But for those of you who attended our analyst Day event in February, this is where our discussion about the supply chain is extremely relevant. We're in the midst of implementing significant changes, as we see mulch having continued topline momentum in the years ahead. For competitive reasons I won't be specific here this morning, other than to say we expect to see significant improvements to our cost structure in time for the 2013 season.

Consumer purchases in the remainder of our gardening business, primarily plant food and soils, are each up about 4% entering May. However, in most major markets in the US, gardening season is usually a May and June activity regardless of early warm weather, so the peak of the advertising and promotional support is just now hitting the market.

The only major category in which POS is down so far has been grass seed, which is down about 15%. We see this as a carryover from last year's weather more than anything else. The nature of the weather most of the US last year did little to damage lawns, so seeding activity this year is light.

Grass seed has always been a category with a choppy year-over-year track record. But as we look ahead, we are very pleased with the positioning of both EZ Seed and Turf Builder grass seed. When you analyze the overall market place, our performance has been strong.

As many of you know, one of our competitors last year decided to run an ad campaign attacking our brand. They are doing so again this year, and we have responded in kind with what we believe is a truthful presentation of the facts, and the consumer seems to be voting with us.

Based on preliminary data, we believe we have gained significant market share across the United States in grass seed. And that includes each of the 10 markets where that competitor has been spending most heavily on advertising. I know most of you listening today are in New York, and that was one of the markets in which our advertising strategy focused on going head to head with them. We are winning.

Speaking of advertising, I want to switch gears and focus on what we have been doing so far this season. As I start, I want to congratulate the entire marketing team for what they have accomplished. They created more than one dozen new spots across three brands, made significant improvements to our digital efforts and have built the best truly integrated program we've had here during my tenure at Scotts.

As many of you know, we entered the year with a planned increase of $40 million in advertising investment, translating roughly into a 50% increase in media placements. Even in a year of double-digit media inflation, our dollars are going farther than we planned to, due to substantial improvements in our media buying efforts so far this season. And that increased visibility has helped drive a 10-point improvement in awareness of the Scotts advertising campaign.

On the digital side, traffic to our website increased nearly 50% through March and visits to our site from mobile devices now comprise 11% of total traffic. Our improved use of search word optimization has led to a ridiculous increase in visits to our website when searching for key lawn and garden search terms.

And in social media, Miracle-Gro brand formed an important relationship with Zynga to get a high profile visibility on its popular Farmville game site. As a result, he Miracle-Gro now has 1.1 million Facebook fans compared to a little more than 5000 two months ago.

There is little doubt in our minds that we can drive further growth by investing more heavily and intelligently in media. We don't expect the kind of increases we made in '12 to repeat again in the near future. But as we laid out and in February, our five-year strategic plan calls us to continue investing in advertising and digital in a rate higher than sales growth.

Let me switch gears quickly and discuss Scotts LawnService, where we continue to see positive trends. Sales in the quarter were up 10% and the seasonal loss in the business was improved from a year ago. Remember, this business makes all its money in the second half of the year, and we feel good right now about what we are seeing.

Customer account is nearly 8% higher than a year ago and our retention rates are better as well. We also continue to benefit from lower associate turnover. Even as the economy has started adding jobs, we've been able to keep more of our people than a year ago, a major benefit in a hands-on service business like lawn care.

As we said during our Analyst Day meeting in February, we continue to be encouraged by the trajectory of SLS, and we see it as having substantial growth potential in several years, or in the next several years. We've begun to explore opportunities for acquisition growth in this business and I am hopeful we will be able to make some investments in this business within the next 12 months.

Before I turn things over to Dave, I want to make two brief points. First, I want to congratulate each of our associates. We got kicked around a little bit last season, and it wasn't fun.

Entering 2012 we streamlined our management ranks to improve efficiency, and that meant some job cuts. Needless to say, morale was not at an all-time high. But the team was quick to put the past behind them and rally.

Yes, good weather has helped us go off to a strong start. But more important than that was the execution we've seen across the organization. I want our shareholders to know that while we are pleased with the start, we're nowhere near the finish line. And we are committed to driving the business, not just to deliver on guidance for this year, but to hit our long-term targets as well.

And second, and speaking of guidance, I want to anticipate one of your questions. Yes, the business got off to a good start. Yes, we are ahead of our internal targets through the first six months.

But no, we're not moving away from many of the guidance we provided in February. Why? More than half of the consumer purchases for the year occur in Q3 and Q4. In fact, more than one-third occurs in May and June alone. And as we have seen recently, predicting the season at this point is a fool's game and we're not playing.

But here is what I will say. At this point in the season, we are doing exactly what we said we would do. We needed to make continued progress with regionalization; we've done that. We said we had to drive unit volume growth in our lawn fertilizer business; we've done that.

We said we needed to make the Ortho brand relevant with consumers and improve our market share in that category. We've done that. We said we needed to drive unit volume growth in the Roundup business after declines last year and new competitors coming at us this year. We've done that. We said we needed to defend our brand against bogus competitive claims and recapture market share in the grass seed category. We've also done that.

Listen, the year isn't over, so I won't declare victory too soon. But I really like where we are now, and I'm confident in our business and I like the plan our team has put in place. They're executing with a high level of precision, which gives us confidence in reaffirming our earnings outlook for the year. And we're also making continued progress and our long-term plan, which I'm confident will drive long-term shareholder value.

With that, I want to turn things over to Dave.

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Thanks, Jim, and good morning everyone. As we stated in our press release this morning, as Jim reiterated, we are pleased with our performance in the quarter and the first half.

If you attended our Analyst Day meeting this past February you will recall that we planned quarterly splits and F '12 roughly in line with the average pace of business over the most recent four years. That plan suggested a very moderate year-over-year decline in sales in the first half with strong growth in the second half.

As you saw this morning in our results, we finished the first half slightly ahead of plan on both sales and operating income, so it was a solid start. But as Jim said, with more than half of the year's consumer purchase activities still in front of us, it is too early to move beyond our original outlook of $2.65 to $2.85 per share. And we know our plan already requires strong growth in the second half.

Where we believe there is potential for refinement of our original guidance for individual components such as gross margin rate or interest expense, I will provide those updates. However, my comments this morning will principally focus on explanations of the quarter and year-to-date results.

I want to make one additional point for clarification before getting into the details. As Jim said, his update on consumer purchase activity reflects results through the end of April. This is consistent with second-quarter calls in past years. POS is a critical metric for us, but it is also a non-GAAP measure, so I want to be clear in saying that my comments will focus on reported results and will align with the fiscal quarter-ends unless otherwise stated.

Diving into the details then, net sales on a Company-wide basis were up 4% in the second to $1.17 billion and up 2% for the first six months. Scotts LawnService had another strong quarter. Revenue was up [10%] to just under $36 million, for reasons Jim has already stated.

The big driver in the quarter, though, was the 3% gain reported in the global consumer segment. In the US, our sales were up 3%, benefiting from the shift of preseason retail inventory load from our first to our second quarter, favorable early weather, increased media and marketing, and new innovation.

As you see, our sales growth in Q2 lagged POS growth at our major retailers, as retailers ended March with lower year-over-year inventories. This inventory reduction was a function of strong consumer activity at the end of March, and not anything more strategic than that.

Outside the US, sales were up 5%, or 8% excluding the impact of FX. As in the US business, sales also shifted from Q1 to Q2, so was an outcome of migrating from distributors to direct retailer shipments in France. Canada also continues to perform strongly.

Sales growth in our global consumer segment included increased pricing, inclusive of reduced trade promotions of 140 basis points in Q2. Pricing benefited sales growth 130 basis points year to date.

Sales for the corporate and other line were up almost 50% to $18 million for Q2. You will recall corporate and other includes sales to ICL under our supply agreement post-divestiture of our Global Pro business last February. Corporate and other also contains sales related to our Pro seed business, which we continued to wind down.

In both cases, sales are essentially no margin. I will come back to this when talking about gross margin rate.

Given season-to-date growth in our leading sales index, consumer POS, and excluding any unforeseen issues, we remain committed to our original full-year guidance of 6% to 8% growth in consolidated net sales. I know some investors believe this number is conservative, and we hope you are right. But with more than half the consumer activity yet to occur, we believe sticking to our guidance at the right call when considering all businesses, all geographies, and all channels.

Moving on to gross margin, on an adjusted basis the gross margin rate in the quarter was 39.5% compared to 41.1% a year ago. As expected, cost increases were the biggest reason for the decline, driving 250 basis points of pressure. These increases were partially offset by an 80-basis-point benefit from pricing.

Adjusted gross margin rates declined from 37.8% to 35.2% for the first six months. As with our second quarter, cost increases and pricing were the biggest drivers, so negative mix from supply agreement sales to ICL drove 50 basis points of the decline. We now have a full four quarters activity embedded in our year-over-year comps for supply agreement sales.

Gross margin rate is the area on the P&L where we have seen more fluctuation than we expected, so let me pause to tell you why, and how we see things for the full year.

We have known all along that material costs would be higher this year and that we chose to forgo pricing to offset commodity inflation. What limited pricing we did take, including reduced trade spend, was a modest benefit in the front half of the year. That may be true to a lesser extent in the second half.

We have incurred some higher-than-expected distribution expenses in recent weeks to meet the early spike in consumer demand, and we have seen disproportionate growth in some lower-margin products like mulch in the month of April. We continue to monitor these items closely, but the net impact of these factors coupled with the higher costs that were already in our plan means that gross margin rate could fall modestly below the low end of the range I provided in February.

At that time, we projected up to a 90 basis point decline in margin rate. Given the significance of volume that occurs in both May and June, and the sensitivity of our margin to mix, it is hard to be more precise right now. While we are not sure the extent to which this risk will materialize in the second half, I didn't want it to come as a surprise later in the year if it does.

Let me move on to SG&A. SG&A in the quarter was $237 million as compared to $216 million a year ago. The increase was almost exclusively due to higher advertising expense. Through the first six months, SG&A is flat at $360 million including a nearly $18 million increase in advertising.

If you will recall, the impact of higher planned advertising expense and the reinstatement of variable pay into our plans, the impact of which will be seen entirely in the second half of the fiscal year, created about a $70 million gross headwind for the year, which was only partially offset by savings from our 2011 restructuring and other savings initiatives. Given our current plan, we still expect SG&A to total about $750 million for the year, if not slightly better.

Moving below operating income, interest expense in the quarter of $17.9 million was roughly $4 million higher than F '11. Interest was $10 million higher for the first six months. The year-to-date increase in interest expense was attributable to higher rates associated with the financing structure completed in F '11 and higher average borrowings.

Our average total debt to EBITDA ratio as calculated for borrowing arrangements was 2.5 times at March 31. We expect interest expense in the second half of the year to be approximately flat to 2011, resulting in a full-year increase of about $10 million, at the low end of the range we provided in February.

While our guidance on interest expense should be at the low end of our guidance, we now believe our tax rate will be slightly higher than last year by 50 to 100 basis points. There are various puts and takes, but right now I will tell you I think the effective tax rate is more likely to be closer to 36.5% for the full year.

Moving on, adjusted net income was $133.2 million or $2.15 per diluted share, compared to $150 million or $2.22 per share a year ago. On a GAAP basis, net income was $127.2 million or $2.05 per share compared with $148.6 million or $2.20 per share last year.

The difference between adjusted and GAAP numbers related to two items. The first is $3.5 million of charges related to product recall and registration matters. Most of this charge relates to additions to our accruals to reflect the potential civil penalties associated with our product registration issues in 2008. You'll recall that we previously agreed to $4.5 million in criminal penalties and accrued for the amount in fiscal 2011, though we are still awaiting approval of that agreement from a federal judge.

The second adjustment of $5.6 million was primarily attributable to a non-cash asset impairment charge resulting from issues with commercialization of Lawn products containing the active ingredient MAT 28. As many of you know, we had high hopes for this active and greedy and in our Lawns business.

Shortly before we took it to market however, significant concerns were discovered as an outcome of the professional version of this product is being marketed by its manufacturer. Recent events and a reassessment of commercialization led to the write off or capitalized cost in the second quarter.

So wrapping up the P&L discussion, while we see some risk in gross margin rate and tax rates, in balance with sales and spending, we remain comfortable right now reiterating our EPS guidance of $2.65 to $2.85.

I want to shift gears a bit and talk about cash flow. Our forecast there remains unchanged as well, with approximately $300 million of operating cash flow forecast for the full year. Recall that includes about $75 million of benefits from items which may not recur, related to expiring tax stimulus provisions, liquidation of Pro seed inventory and variable compensation.

I also want to give you an update on the uses of cash. We told you we plan to use cash essentially in equal thirds for CapEx, acquisitions and shareholder returns. We've also been consistent in our desired leverage range of 2 to 2.5 times.

The unknown in that equation was always acquisitions. We said if we didn't find suitable opportunities, we would then return the cash to shareholders.

Our teams have been working diligently over the past several quarters on several small transactions to leverage our assets or accelerate growth. We completed one small transaction in April to acquire brands, product registrations and inventories which make us more competitive in the rose care, tree and shrub categories. The value of this transaction was less than $10 million.

There is a reasonable probability of closing on more of these targets over the balance of the fiscal year. None are individually significant in size, but they do represent potential opportunities to accelerate entry into new close adjacencies or expand our presence where we're underpenetrated.

Because we see some level of acquisition activity as likely and our current leverage is at 2.5 times, we did not repurchase shares in our second quarter. So a share count of roughly 62 million for the full year now seems a certainty, with the only unknowns being the impact of stock option exercises and share price.

One final area that I want to discuss was the changes you will see in the accounting treatment for our Pro seed business. We began winding this business down about one year ago. It now seems likely that we will seize the ongoing operations by year-end, classifying Pro seed as a discontinued operation.

Obviously we will provide more details when that change actually happens, but it's unlikely to impact our EPS for fiscal year '11 -- I'm sorry, for fiscal year '12.

In closing, I want to reiterate that we are pleased with the consumer engagement in the category, market share improvements and the continued progress we're making against our consumer first strategy. We're also pleased with the high level of support we're getting from our retail partners in all channels.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jon Anderson, William Blair.

Jon Anderson - *William Blair - Analyst*

Good morning. I guess my question is -- you touched on this a little bit in the prepared remarks, the consumer purchases being up 20% in the quarter. But the global consumer sales or the US sales being up 3%, it seems like that is a significant divergence. And I'm just wondering if there is any more kind of color there beyond the inventory comments you made that would help us understand that divergence.

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

Hi, Jon. This is Barry Sanders. Traditionally when we looked at a replenishment on how the stores would stock, I don't think anybody anticipated that the purchases would be up 20% in March. And it turned out that we had a fantastic start to the season, and so I would say for the most part we were playing almost a JIT, getting product back in stock and making sure that inventory levels were appropriate.

So, where we would have come out of March with higher inventory getting ready for April, as Jim said, a lot of those purchases really shifted into March. And so it was a matter of timing -- (multiple speakers) I'm sorry, shifted into April.

Jon Anderson - *William Blair - Analyst*

Okay, thank you. And then I guess --

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

I would say it is more of a timing issue, Jon.

Jon Anderson - *William Blair - Analyst*

Okay. And I guess one other question on the mass channel, which was a more difficult channel for you last year; it sounds like that has -- the performance in that channel has improved. Can you talk a little bit about what you have done there specifically to address that, and the source of the better performance in the current year? Thanks.

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

Jim here. I will sort of start with this, and then Barry if you want to kind of complete, you can do that. Start with -- I think our team managing the big customer in that space has done a really superb job of re-engaging with the retailer, and that has been great. And I think the relationship between the two companies is significantly enhanced, and the level of trust, all of the things that take -- which is the beginning of anything is everybody wants to work together and everybody wants to succeed in the lawn and garden category.

Last year, we ran some work that we had done in Florida where we did some print work, some integrated radio work with the customer and what we saw -- and this was in the fall. What we saw is really incredible performance like we haven't really seen in many years with that retailer.

I went down and visited personally with the CEO before the year-end and basically offered up an opportunity to see if we could do that a couple more times on a national basis. And what we have seen is similar kind of result, which is that the results we saw in Florida in the test, we've seen on a national basis. Those promotions continue.

So, what do I think? I think everyone is committed to the space. The degree of cooperation between the two of us is way better. And the inventory position and promotional and integrated sort of marketing plan to the consumer I think is way better.

It's a kind of a long answer to a question, but it was something that really concerned us last year, and you know, and this is -- my part of this is kind of the CEO to CEO part, which was important. But most of the work has been done by Barry and his team. And I don't know, Barry, what you would add.

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

Just summing it up, Jim, I would say significant improvement in the relationship on both sides has led to a much better business plan. And the teams believe in it, and they're doing a fantastic job of executing. So I think the results are reflective of those primary three things.

Jon Anderson - *William Blair - Analyst*

Thank you.

Operator

Bill Chappell, SunTrust.

Bill Chappell

Can you talk a little bit more just about the commodity costs, especially as we go into next year, watching urea outside of the kind of range of what you expected and probably what we would've expected on categories that -- I think you have said you probably can't raise prices again on lawn fertilizer and other things going into next year. So, how are you looking at that? I know it doesn't affect this year, but how do you look at it going into next year?

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

So let me just -- before Dave goes on there, just in regard to pricing, which is -- we are in discussions with people now. You can assume we are taking pricing next year. Okay?

Bill Chappell

Okay.

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

All right. So, Dave?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

So Bill, you're correct. So, commodities, we had gone out and a hedged to fairly significant extent. I believe right now we're about 88% locked for the fiscal year. So we did see -- you are probably referencing urea. We saw a spike in urea. And I think we've had a high correlation to favorable spring weather and aggressive planting by farmers using that particular product for the growth.

When we look at the forward markets, we don't see the current market as being indicative of the forward markets, for when we're going to be back in the market purchasing urea for next fiscal year. So, at this stage we're not seeing urea as a material concern for next year.

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

And I'd just add -- and we're committing to that forward market.

Bill Chappell

All right, that helps. And just as a clarification, I thought historically the biggest months of the year were kind of April and May, and it seems like you're saying it is more May and June. Has the season kind of been pushed out versus historical, or is it extended? Or how should I interpret that?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Your numbers are right, Bill, but I would say June is equally as important month. It's not as big as April and May, but it's still important to us.

Bill Chappell

Okay, thanks so much.

Operator

Olivia Tong, BofA Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Thanks a bunch. I just want to talk a little bit about returns on advertising in the healthier category, because you sort of had the perfect intersection, I feel like, this quarter. You had clearly one of the warmest starts to the season in many years. You increased advertising pretty significantly and you also had a competitor that had some supply issues.

So, can you just give us some more thoughts on the return on your advertising, and also just the incremental improvement that you are talking about in the health of your categories up to this date, and then sort of thinking about as you go longer-term?

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

Olivia, I can't help but to sort of want to reach through this phone and grab you. (laughter) You are making it sound like we had nothing to do with it; it was just a competitor who couldn't deliver and good weather and that's it.

Listen, I know you know that's not true, and all you've got to do is look at the grass seed category, for example, is an area where effectively the weather has not been good, largely due to the fact it was a cool, wet year last year and grass wasn't stressed. But we have taken significant share.

In addition, on the regional basis, as you go back and remember that as part of regionalization we're looking to pick up, call it, roughly 10 share points -- the difference between our legacy markets and those Southern markets. We have made a major, like, down payment in motion on that delta, and in the Southwest to say we're at our corporate average is huge news.

So, now, that being said, this is a question we're asking ourselves a lot, which is, okay, so what is the payoff? And how do we look at this in the future? And I know Jim has been working on this. So, Jim?

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

Yes, I would say what we're trying to do is quantify the effect of advertising to net sales and share gains. And so, right now, we don't have enough data points in to conclusively say the percentage gain. So we've gone to the next level removed from that and looking at campaign awareness, which is up over 10 points for Scotts' campaign.

The Miracle-Gro campaign is just kicking off, so I don't have those numbers on that one yet. And also we have seen an increase in purchase intent from those aware of the campaign.

Additionally, we are able to measure all the effects of digital because it is a much quicker response time. And we're seeing digital gains of significance, where we have seen website traffic up nearly 50%, mobile traffic up over 100% and key search terms -- many of those search terms up over 100% this year.

So, I would say by the next call we'll have a much better articulation of the specific effect that the advertising is having on our sales and share.

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

Look, I don't want to diminish kind of the cosmosity of what Jim just said, but remember what we came out of last year saying -- we're not taking pricing, and we're going to jack our advertising pricing up, and that we've got to show we can grow these categories and that we can take the lion's share of that growth. And we have done that.

And then follow-up with basically the math; the marketing does owe us to make sure that we're spending the money wisely. But I'm going to say we like what we're seeing so far and we believe that advertising works.

Now, we're going to have to prove it to everyone, including ourselves. But that being said, we feel pretty good about it, Olivia.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. I'm a little afraid to ask a follow-up question. (laughter)

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

Come on, that was kind of an insult. (laughter)

Olivia Tong - *BofA Merrill Lynch - Analyst*

That being said, can you talk about advertising playing sort of a longer-term just -- is this a new normal as far as a percentage of sales or in terms of dollars, and sort of going to next year?

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

All right. So this is the stuff that a CEO gets to do is challenge the team. So the answer is this is not a one timer. It is -- we do expect to see advertising as a percent of sales increase.

And roughly, where I would like to see us -- and we have got a ways to go and a lot of work to do to say if it justifies itself -- but my view is that, at what point -- this may be a little bit of a question to ourselves. At what point would you say we can't sort of spend the money effectively. In my head, that is somewhere around $200 million and we're sitting today at what, Jim?

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

Total about $160 million.

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

So, I don't think we're far off. But remember, that's on a -- call it a -- it's probably somewhat more than a 10-week campaign. But that sort of gets us at least at my fantasy rate.

So, you are sort of approaching like $1 billion annualized rate of advertising, which would put us at a level that is at the very extreme of what other marketing companies are doing that have year-round kind of product lines. So, Jim what would you add?

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

I would just say that so far we've seen positive results on the spend. We expect the spend to go up. We think we have a natural targeted spend for each of our brands, and that when you add those all up, we start approaching numbers closer to what Jim just articulated.

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

But again, this is us doing a lot more work figuring out how we spent the money this year, how it worked. And so this is not a commitment to spend it or a threat to spend it. It is really saying, I think as we look at targets, that is where we would like to see the Company eventually.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Thanks a bunch.

Operator

Jeff Zekauskas, JPMorgan.

Jeff Zekauskas - *JPMorgan - Analyst*

Hi, good morning. I was hoping that you would clarify your strategy in urea a little bit more. You said you were very committed to the forward market. So does that mean that after the planting season is over in corn, what you plan to do is take a significant long position in urea? Or do you plan to wait for later in the year to take your long positions?

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

I'm going to say both, but I think we're already committed to the futures market on urea and starting to make commitments that we would take delivery for our sort of lawn fertilizer campaign that would result in products that are sold in '13. So we're already beginning to commit to the market, and we're pretty relaxed about the prices we are seeing in the futures market. Anything different?

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

No. Well said.

Jeff Zekauskas - *JPMorgan - Analyst*

And then secondly, you said that in the quarter the SG&A compensation costs for management really would hit in the following quarter, and that there wasn't much difference in the March quarter. Why wasn't a piece of that allocated to the March quarter?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Jeff, this is Dave. The reason being that historically we will establish a target rate that we're going to accrue at. And we will accrue at that target rate, call it at 100% of target, through the first half of the year. Then in the second half of the year we'll begin, so in our fiscal third quarter to adjust up or down based on our forecast results.

So, what I'm saying is year-over-year, generally through the first half, we're consistently accruing at 100%. Last year in the second half of the year we're unwinding those accruals. At this point that is not the intent for the second half of this year, [see we had] a fairly wide divergence in the second two quarters.

Jeff Zekauskas - *JPMorgan - Analyst*

Okay, thank you very much.

Operator

Joe Altobello, Oppenheimer.

Joe Altobello - *Oppenheimer - Analyst*

Hey, thanks. Good morning. First, I want to start off on the advertising line. I think I heard Jim say earlier that you guys are looking at about $160 million of spending this year on ad spending, and I think last year you did $141 million. So is that the right number I'm looking at? Or is the increase year-over-year only about $20 million, not $40 million?

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

I would say that the increase was $40 million net on media, and when you look at global media we're close to about the $160 million and some change.

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Joe, I apologize. Sometimes we can get tripped up as there is a difference between what we call working media versus the total media. So when you look at our 10-Qs or 10-Ks, what we define as media includes agency fees, a whole variety of production cost, talent, things of that nature. So if you look year-over-year at the media advertising line we disclosed last year, was about $140 million inclusive of all of that, globally.

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

Fees and everything.

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

This year, what we said in February and we're continuing to say is we're expecting about a $40 million increase to take the total to $180 million. That is a little different than -- the dialogue Jim was just having was about working media and our US consumer business. So I just wanted you to be clear on the differences.

Joe Altobello - *Oppenheimer - Analyst*

Okay, I got it. That's very helpful. Thank you. In terms of POS, it sounds like you guys are expecting POS and sales growth to sort of converge in the second half. Is that fair to say?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Yes, Joe, that's a fair comment. So we expect them to converge. And as you know, looking at our first half, our sales -- we need second half to be strong to get back to our full-year guidance, just as we need the POS to be strong. But by the end of the year, they should begin to converge.

Joe Altobello - *Oppenheimer - Analyst*

Okay, so that goes to my next question. What was April POS? You kind of alluded to the fact that April weather was a bit colder than normal, so if you could just give us what that number was, that would be great.

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

A lot of people are trying to pull something out (multiple speakers)

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

I don't have a year-to-date basis. So, it was -- I don't think we have that precise information in front of us, but it was closer to flat to modestly down low single digits.

Joe Altobello - *Oppenheimer - Analyst*

Okay, got it. Just one last one if I could; in terms of the promotion spending, you kind of alluded to that as a potential area of weakness in the back half for gross margin. Is that all mass? Is that all mass-related, or are there other promotional activities that are increasing other channels?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

No, I wouldn't isolate it to the single channel, Joe. I think what you should read from that is partially -- it's a function of where we see accelerating growth, we accelerate some of the support to partner with our retailers to get that growth. So as a rate, we can see it slightly tick up. But it is in relation to getting increased volume as well. But it cuts across all -- I wouldn't say it's specific to the individual channel.

Joe Altobello - *Oppenheimer - Analyst*

So it is more sales-related than anything that the retailer is coming to you on?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

It is driving growth.

Joe Altobello - *Oppenheimer - Analyst*

Okay, great. Thank you.

Operator

Reza Vahabzadeh, Barclays Capital.

Reza Vahabzadeh - *Barclays Capital - Analyst*

Actually my questions have been asked and answered. Thank you.

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

You're welcome. That was easy.

Operator

Josh Borstein, Longbow Research.

Josh Borstein - *Longbow Research - Analyst*

Thanks for taking my questions. You talked a little bit about some execution risk from one of your competitors. Could you give a little more color on what extent that you benefited from that?

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

I didn't bring that up, Olivia did. Look, the beginning of the season was freaking explosive. Okay? And I don't think anybody was prepared for the early start to the season, which was really superb.

And this is a Company where we really view our ability to sort of execute on time and in full as a very important kind of core skill set. Our folks were tasked out hard and we got through it. Our sort of delivery metrics did suffer a little bit and it drove our margins down, as we basically had to sort of ship inefficiently to sort of get product into the stores.

So I would just say other competitors who saw similar kind of weather, even if they weren't growing at our rate, I could see if they didn't have the sort of skills in the supply chain, that they could suffer. That would be very easy to see, because we were just barely hanging on. And so, that is how I'd answer the question.

Josh Borstein - *Longbow Research - Analyst*

Okay, thanks. And just lastly, POS up 20% in the quarter. Can you give us a little more breakout on what you saw in independent garden centers versus the home center versus the mass channel?

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

I'll start and Barry probably has better data than I do. I go to some garden centers where I live, and everybody was having a really great beginning of the season. So I don't think that the business was exclusively happening with big box. I think that good weather floats all boats and people were doing really well. So, Barry, anything you would add differently?

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

I would say there's a lot of different retailers in there. Specific to the independent garden centers, I think we're going just as equally well for them as it was for the mass retailers. So, just as Jim said, all boats are rising with that weather.

Josh Borstein - *Longbow Research - Analyst*

Great, thank you.

Operator

Sam Darkatsh, Raymond James.

Josh Wilson - *Raymond James - Analyst*

Good morning this is Josh Wilson filling in for Sam. I wanted to really make sure I understand the comments on the divergence between sales and POS. You said it was a timing issue, so we should expect some sort of restocking benefit in the coming quarter as opposed to this being part of an inventory rationalization by your customers?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Josh, this is Dave. So, in my I prepared comments I tried to address this. I think if you connect the dots of what you're hearing this morning, what Jim just said was we had some significant -- I'll call it violence in demand pattern from consumers in the back half of March.

That explosive growth in the last -- call it two weeks of March, these are big weeks. They drove our POS up and created this divergence. As now come our supply chain was replenishing that inventory and we will see the benefit of some of that replenishment in the month of April, so our third fiscal quarter.

As Jim said, we incurred some incremental cost to fulfill that, but over time we would expect the POS growth and sales growth curves to converge again. So it is early in the season; through March you get some really spiky information. And when it happens at the very end of a fiscal quarter, you get this big divergence.

We don't see that as any indication -- so the retailers ended March with less inventory. We don't see that as anything strategic they're doing. It was simply a function that consumers bought a lot of product at the end of March and cleaned out the shelves. We replenished in April, and that all is all there is to that story.

Josh Wilson - *Raymond James - Analyst*

And so the April POS you said was flat to down, and if I remember correctly, April last year was down over 20% with the bad weather, so that doesn't affect their thoughts on how to stock for the balance of the season?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

No. I think, if anything, the way they're looking at it is, as David said, a lot of this to get good inventory and position from April for what they expect to be a good March and June as Jim has -- I'm sorry, a good May and June, as Jim has talked about.

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

I've been on the phone this week with basically all of the senior management of ours, and there is no lack of commitment to the space for the month of May and beyond, including the fall. So, no; no worries there.

Josh Wilson - *Raymond James - Analyst*

Thank you for the color.

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

You bet.

Operator

Eric Bosshard, Cleveland Research.

Eric Bosshard - *Cleveland Research - Analyst*

On April, the down a couple percent versus the down 20% last year, can you just give a little bit of sense and do you have more history with the business about how we should think about that as April being an easy comparison, and the numbers down against an easy comparison? How do you -- what do you extrapolate from that, or what do you make of that?

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

Eric, this is Barry. When we looked at the markets, particularly the Midwest and Northeast, they were on fire in March. We talked about some pull-ahead, and quite frankly, when you look at average weather it wasn't as bad as it was, quite frankly, on the weekends. So, I think April was not a good weather month.

When we look at our business on the West Coast we saw the same thing. The Southern markets were okay. Based on our read, it was entirely based on the weather in April.

Eric Bosshard - *Cleveland Research - Analyst*

And the fact that the weather was horrible a year ago, that doesn't sort of matter or factor into that?

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

No. If it's -- it was cooler and raining, people weren't out in their gardens. So we don't look at it that it was anything other than -- while March was a great month in pull ahead, April kind of (multiple speakers)

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

You know, look, I've got to say this is the question you know was coming. But we are ever better with data and, you know, to me in the sort of stretch and pull of what makes a script and how we present ourselves during this call, a lot of people want to be cosmic about it. It's not cosmic.

There were a couple of weekends there it was just cold as [expletive]. You could see it. And when it was a good day or one city had great weather, you saw great results. So we can see all this. There's nothing more cosmic than that.

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

Yes, and I think if you look at the mix of the business, and I think we've discussed some of the data, the lawns business, the weeds business, the bug business was going very well in Q2. And what's happened when we look at the quarter and that the mix of our products is, people have not started their gardening yet.

So as we look at the industry, I think live goods are bit delayed. And when we look at our garden fertilizers and our soils business, we're really waiting for that to kick off. And we think that is going to move from April into May.

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

And plus, remember, the data I gave to you guys was not the first-half data. That was all the way up to our most current data which, was through the end of April. So that included April.

Eric Bosshard - *Cleveland Research - Analyst*

The second question is the guidance for the coming into the year was this up 6% to 8%. And I don't know within that guidance that you would have thought POS in your second quarter would've been up 20%. I don't know that you would've thought you would have gained -- you would've hoped to, but I don't know that you would have projected the magnitude of the market share gains that you have realized.

And so, help me square probably the better-than-expected POS in this quarter, the better-than-expected market share progress, with a year that you're still guiding 6% to 8%. I understand you don't know what the weather will bring, as we learned last year. But how do you sort of connect those dots?

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

So, I would start by saying, as we said in our script a few times, it is early. We've only got -- less than half the consumer demand has occurred. We're being -- perhaps you may think we're being cautious, but I would tell you we still need very strong second-half performance. We need strong POS. We need strong shipments.

We're early in the season, and frankly, it doesn't appear to us to be upside in trying to call a year early, when we also see that we may also have some other modest pressure in March and other areas. We're being cautious, but it's early.

Eric Bosshard - *Cleveland Research - Analyst*

Okay, thank you.

Operator

Alice Longley, Buckingham Research.

Alice Longley - *Buckingham Research - Analyst*

Hi, good morning; a couple things. Zeroing in on shipments in the third quarter, you under shipped, it looks like, by about 17 points in the March quarter. And last year, in the June quarter, your comp is really easy because last year your sell-throughs were down 6 and your shipments were down 16.

So, if you put those two pieces together from different periods, it looks like if your POS were to be flat in the June quarter, your shipments should be up at least 20% for US consumer. Is that a fair compilation of numbers?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

So, first of all I would tell you that when we plan the year, we really consciously try not to plan monthly and quarterly splits off of 2011. It was a fairly extreme weather year, and building a plan off of that would be challenging, which was why, when we planned our year, we really looked at a trailing four-year average and said over a period of four years, weather reverts to its mean. POS -- we look at an average POS growth and a shipments growth.

Here's what I can tell you with some certainty with respect to the guidance we have provided. We need second-half growth in net sales to be about 10% to 14%. So that is our sales in Q3 and Q4 combined.

To get there, we need POS growth from our retailers for the last five months of the year at our largest three retailers to be up, in call it very low double digits. So, we're not trying to call the splits between June and July here, but you would be right in assuming we need sales growth in the back half of the year up 10% to 14% to get back to our 6% to 8%.

Alice Longley - *Buckingham Research - Analyst*

Okay, and that means you need POS, just repeat what you said, at the three largest retailers to be up low double digits in the last five months of the year?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

That's correct.

Alice Longley - *Buckingham Research - Analyst*

Okay, thank you very much for that. And then (multiple speakers)

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

I would add to that. So, for some context, what we do know -- again, because we are planning, when we look at the averages over multiple years, we know that 2010 was down to 2009, and 2011 was down to 2010. Okay? When we look at the average weather seasons over a longer history, that growth number that I just quoted you fits more into perspective in that with a long-term lens.

Alice Longley - *Buckingham Research - Analyst*

Got it. And then just one other question; it reverts back to the pricing issue. It looks like when weather is good, for instance using mulch as an example, you were concerned about mulch dragging down your mix. And yet, purchasing was up 26%, it looks like, year-to-date.

It looks like the person who is buying mulch probably doesn't care that much about pricing, because your mulch is more expensive by far than the cheap stuff. So, why is there -- have you done testing? Would that consumer even notice if you had a 5% price increase?

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

Well, listen, as long as you back off and say that -- I spend a lot of time in stores selling mulch this year. You really get a feel for what people like and what they don't like.

If you look at sort of the commodity, a lot of which we make, compared to the branded product, which is ours, is it hard to move somebody up, call it, like on a lot of promotions this year, call it like $0.60, $0.70 to the attributes of the premium product? Not really. Now, that is with no advertising, okay.

Do we feel that the sweet spot that we sort of honed in on this year as we have kind of played around with retailers on price? The answer is yes. So, I think that what we know is that we need to at least double our margin on this business and we have a plan to do that, and without taking huge prices to the consumer. But it requires a bunch of things to happen, largely in the supply chain.

I think what the retailers and the marketing groups have discovered is that we can sell premium products and where it is priced right, we're seeing a flow off the shelf -- and this is important -- of roughly 50/50, which is consistent with generally what we see in opening price point in branded products, whether we make them or anybody else makes them, so that you see kind of a 50/50 mix in units, about 60/40 in dollars.

Alice, you have been following us a long time. You know that that is kind of what we expect to see when you have kind of an opening price point and a national brand.

And so, we know when we price properly, which I'm going to sort of say call it $4 on the premium side, that we're thinking right now is kind of our sweet spot. But I think we've got a ton more work to do to get sort of our minds right about this.

We have a plan on the supply chain to more than double our margin. We are seeing sort of price points and tools on the marketing side to get us to a 50/50 mix, and this is not an exception, but this is what we're seeing on promotion. So we're really comfortable.

And, we think that mulch is just an important part of the business going forward. So we've got to be able to make decent money on it and advertise. And we're pretty comfortable with that.

Alice Longley - *Buckingham Research - Analyst*

Okay and then one final question. How has May been so far, POS?

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

I think last week was like our second biggest week in history.

Alice Longley - *Buckingham Research - Analyst*

So May is great so far, versus a year ago?

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

No, I would say in absolute terms we saw a lot of kit last year -- or last weekend.

Alice Longley - *Buckingham Research - Analyst*

The best May ever?

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

What I said is, as a week, it was the second biggest week we've ever had in the history of the Company.

Alice Longley - *Buckingham Research - Analyst*

Thank you.

Operator

Carla Casella, JPMorgan.

Carla Casella - *JPMorgan - Analyst*

You may have already commented on this, but you made some cautionary comments in the press release about the back half gross margin, and you pointed to a couple of potential risks -- cost and promotion, trade environment. Can you just say which of those you think are most at-risk? Is it more on the cost risk, or is it more the promotional environment would get more heated?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Carla there is a lot of --

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

What are you looking at me for? (laughter)

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

I'm not sure any individual one I would weight more than another one. I think they are all modestly -- there's a little modest risk in each one, but none stands out above the others.

So we have talked about the cost. When we talk about cost in this context, it's both -- it's delivered cost. So what I do know is, in the month of April, we had violent demand in the last four weeks of March and we had some cost to distribute that product over what we planned in April.

We're seeing some modest pressure on our commodities. But as we said, we had already hedged the vast majority of those, but not 100% of them. Promotions -- you can go down the list, and each one I would say there is a modest but proportionately relatively equal risk in each of those line items.

THOMSON REUTERS

Carla Casella - *JPMorgan - Analyst*

Okay, great. And just on that same note, you mentioned about the timing of April on the shipments. It sounds like for POS versus sell-in in April, the POS will drop down. But the sell-in should increase over the POS, and then by year-end you're hoping the two normalize. Is that correct?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

That's correct. So in the month of April we saw a convergence of those two numbers. I'm not saying they were equal, but the two numbers converged as the retailer inventories got back into appropriate levels.

Carla Casella - *JPMorgan - Analyst*

Okay, thanks.

Operator

Connie Maneaty, Bank of Montreal.

Connie Maneaty - *Bank of Montreal - Analyst*

I just have a couple of questions on trade promotion and pricing. First is just a maintenance question. Did you say that trade promotion was down 140 basis points in the second quarter, but pricing was up 130 year to date?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

No. Connie what I said was, in aggregate -- so when we talk about pricing, we're including net delivered pricing to our customers, so it's not just a list price. It includes program costs or anything else. It's all in. So, all-in, including trade promotions, pricing was a net benefit year-over-year of 130 and 140 basis points.

Connie Maneaty - *Bank of Montreal - Analyst*

So 140 in Q2 and 130 year-to-date?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Connie, it's (technical difficulty) go back to my notes and see which one was the quarter and which one was (multiple speakers)

Connie Maneaty - *Bank of Montreal - Analyst*

I can follow up with Jim on that. But just in general, at the start of the presentation, you were talking, Jim, about a redesign of your pricing and trade promotion programs. Can you guys refresh us on what your long-term thinking for these two variables is?

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

Make them effective. I think the trade programs -- and I don't think there is a huge disagreement between us and the retailers, if we sat down and said what do we think drives business. And do we think our promotional activities, which have been increasing over time, if you go back and look, call it, three or four years, have they been driving sales at the rate of increase in the cost of the programs? And the answer is no.

So I think we have really defined thoughts on what we think drives the business and what would be helpful, at least to us and maybe the category in general. So those are things we're willing to pay for. And things that don't drive growth, we're not really willing to pay for.

So there has been just an absolute ton of work. Those programs are being presented sort of as we speak. So we are in the process of describing to retailers and explaining how it works and how to manage sort of to the programs.

Because it's like any incentive. People want to figure out how to manage them and they will. It is part of our job not to be afraid of it, but view the change as important for actually driving growth, which we all need. The other part of the question was --?

Dave Evans - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Pricing.

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

Pricing, listen, we did not not price last year for any other reason than it just didn't feel right to me. And I will take the total credit, blame, however you want to look at it.

We knew costs were up. Our retail partners know that our costs were up, and it's easily reflected in the financials, so they can see it. I think we are a lot smarter than we were a year ago, and I think we believe there are significant opportunities to price.

If you look at what is selling this year, a lot of our most premium products are what is selling this year. So it's not that there is no opportunity.

Jim talked about the health of our brands. We are actively measuring sort of brand health and those numbers, based on the increased advertising and product, but the whole package is good.

Branded business is not losing share, it's gaining share. So, I think if you put the whole thing together, I think we believe that kind of low single digit pricing is something that is extremely reasonable, based on what I just said.

So, we're pretty much headed down that track. And it's up to Barry and his team to sort of make that happen. But that's the direction that has come down from Dave and myself. And I think the marketing group and the sales group feels comfortable with it.

Connie Maneaty - *Bank of Montreal - Analyst*

Okay, thank you.

Operator

Jim Barrett, CL King Associates.

Jim Barrett - *CL King Associates - Analyst*

Given your own POS growth year-to-date, and given the fact you're taking market share, what is your estimate of what the category is growing year-to-date?

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

I'd put that to Barry but I --

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

It's lower than what I -- since we're gaining share, it's lower than (multiple speakers)

Jim Barrett - *CL King Associates - Analyst*

Right.

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

It's in that 3% to 4% range, Jim.

Jim Barrett - *CL King Associates - Analyst*

Okay. And then, Barry, on a related point, why -- you are at the corporate average in terms of market share in the Southwest. Why has that outperformed the other targeted regional markets in terms of performance, and any light on that?

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

Jim, you have to look specifically at each region. I would say in the Southwest our product portfolio was much closer aligned to what the needs of the market is. It was a faster fix just on execution and the marketing efforts.

If you look in the Southeast and you look in the West, there are some specific gaps we have in our product portfolio. And as Dave alluded to earlier, we're looking at either greenfield developing those ourselves through our own innovation efforts, or where we need to plug product portfolio holes to make it more aligned, and then we can execute on a better standpoint.

So I would say, you look down in Florida and California, we're not as relevant as we are as to what Jim would call our legacy markets. And so we've got to fix that going forward. But we know what those plans are and we are in the process of executing that right now.

Jim Barrett - *CL King Associates - Analyst*

Okay, well, thank you both very much.

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

You're welcome.

Operator

I will now turn the call back over to Jim King for any closing remarks.

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

Thanks, Amber. Thanks everybody for joining us this morning. Just one housekeeping note.

We will be at various conferences throughout the spring, including a conference in mid-June, I think the second week of June where we historically have given an update on where the season has trended since this call. We plan on doing that again this year, so our next public update on the state of the business will be in the second week of June.

Other than that, if you have any other follow-up questions, feel free to give me a call directly; 937-578-5622. Thanks for joining us today and have a good day. Thanks.

Operator

Thank you for participating. You may disconnect at this time.