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SMG - Q4 2012 The Scotts Miracle-Gro Company Earnings Conference Call

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OVERVIEW:

Co. reported full-year 2012 consolidated adjusted net sales from continuing operations of $2.83b, and adjusted EPS from continuing operations of $2.01. 4Q12 adjusted net sales from continuing operations were $401m, GAAP adjusted loss from continuing operations was $36.6m or $0.60 per share, and adjusted loss from continuing operations was $36.4m or $0.59 per share.

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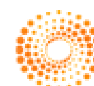

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PRESENTATION

Operator

Good morning and welcome to the fourth-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, IR and Corporate Affairs*

Thanks, Amber. Good morning, everyone, and thanks for joining The Scotts Miracle-Gro year-end conference call. With me here in Marysville this morning are several members of our executive team, including Jim Hagedorn, our Chairman and CEO; Barry Sanders, our President; and Dave Evans, our CFO.

Jim will get started shortly with some brief remarks about the results we reported today, as well as our thoughts entering fiscal 2013. Dave will then walk through the financials. When they are done, we will take your questions, and Barry and others will join us for the Q&A.

As many of you know, we have moved up the timing of our annual Analyst Day to December 14. Given the proximity of that meeting to today's event, we will not be providing any direct guidance related to our 2013 outlook. We would ask you to keep that in mind during the Q&A session and keep your questions confined to the topics related to the results we announced today.

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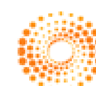

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Speaking of Analyst Day, the event will be held at the Waldorf Astoria in New York. We already have about 80 people registered for the event. So if you haven't already done so, please register by sending us an email at investor@scotts.com, or you can call my assistant, Heather Scott, at 937-578-5968.

We expect the meeting to begin at about 9.00 am. Presentations will conclude prior to lunch, and we'll conduct a Q&A session with management near the end of the lunch session. We're still getting some of the details put together and will communicate more to you in the weeks ahead.

With that, let's move on with the call. I want to remind everyone that our comments this morning will contain forward-looking statements. As such, actual results may differ materially.

Due to that risk, Scotts Miracle-Gro encourages investors to review the risk factors outlined in our Form 10-K, which is filed with the SEC. If you did not receive a copy of today's press release, you can find it on the Investor Relations portion of our website. And as a reminder, this call is being recorded, and an archived version of the call will be available on the website as well.

If we make any comments related to non-GAAP financial measures not covered in the press release, we will provide those on the website.

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

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

Thanks, Jim, and good morning, everyone. I do want to take a quick moment before I get going on the script just to remind everybody how bad things are in New York.

I can tell you at our house we still don't have power. My aunt, who is 90-years-old, lives in the road in a cold house with no power. There's no gasoline to buy there. Everything is like four-hour long lines, if you want to get gas. Most people don't have enough gas to go to the gas station at this point. And then we had six inches of snow last night, and so it's just one thing after another. I just think the next thing is locusts or something.

But I'm not sure how people can help, except it's just been a terrible response, and I don't think most people are seeing it, which is the electric grid is just smashed, at least on the North Shore of Long Island.

Anyway, back to business. The results you saw this morning for the quarter and full year were in line with what we told you to expect at the end of the third quarter, so there's not a lot of news there. But the story that played out over the course of 2012 is an important one for us. One that will inform our plans for 2013 and keep us focused on getting our earnings back to an appropriate level.

I want to share some of the headlines from the year and help you better understand what worked, what didn't work, and how we are adjusting.

I'll start by giving you a quick recap on the year and then discuss progress we've made over the last 90 days to shape our plans for the year we're in.

I'll start by discussing the US and then touch upon our international businesses where sales for the year were down 4%, but flat when excluding foreign exchange. Then I'll discuss LawnService where our sales were up 4% for the year. Since analyst day is just five weeks away, we'll hold back on providing many details around our 2013 plans until then.

As for 2012, consistent with the revised guidance we provided in August, sales in the global consumer segment were flat for the year and up 1% in the quarter. Sales in the US side of the business were up 1% for the year and down 3% in the quarter. Consumer purchases for our products in the US as measured by POS data from our largest retailers were up 2% for the year.

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It was a strange year in the US consumer business. Of that, there is little doubt. We got out of the gate strong with high levels of consumer engagement in March, in fact, record levels. And from there, consumer activity in the US was well below expectations until we got to the end of the year. But consumer purchases of our products related to fall lawn and garden activity, which is typically August through October, were up 7%.

Even though our full-year growth was below what we had planned, we're pleased to see strong market share gains in almost all categories, and that's a point I want to emphasize.

We continue to outperform the category. In fact, that was one of the goals we had entering the year. So what you are seeing is the consumers will walk away from the category before they walk away from our brands. Part of the reason they stick with us is because we have a history of providing them with better solutions, and that was evident again in 2012. Where we had innovation, we saw strong consumer response.

POS in Ortho was up 13%. It was a solid season for controls across the board, and we were aided by strong consumer interest in our new battery-operated sprayer. Retailer support for the brand remains high, and we continue to see the applicator is driving consumer activity.

Another area where innovation was in the spotlight this year was our lawn fertilizer business. The nationwide roll out of Snap was largely in line with the internal goals we had established entering the year. Satisfaction rates remain extremely high, which we believe will translate into a strong level of consumer support going forward. We remain confident in the Snap system, and it will become a significant part of our lawns business over the next three to four years.

Overall, consumer purchases of branded lawn fertilizer were up 1% for the year. While this was a bit less than we hoped for, it was a good story nonetheless. As we said going into the season, we have seen multiple years of unit volume declines in this category. So we see the reversal of that trend as good news heading into 2013.

Quickly looking at the rest of the US businesses from a POS perspective, consumer purchases in our mulch business were up 16%. Throughout the season our retail partners were highly promotional with mulch. Consumers clearly saw the great volume value they were getting with some offers as low as four bags for $10. While this is a good news/bad news story for us, while mulch represented our greatest area of growth, it is also a product that is dilutive to our margin rate. But our supply chain has been working to drive margin improvement in mulch for both 2013 and 2014.

As I mentioned, POS and Ortho was up 13% for the year, and Roundup had another solid season with an increase of POS of 6%.

The battery-operated sprayer will be an important part of the Roundup offering in 2013, so we are optimistic about the continued performance in that business.

Grass seed POS was down 9% for the year. As we said in the past, we expected the business to be soft in 2012 after a strong year in 2011. While we spend heavily on advertising in this category, we felt it was necessary to combat the competitive advertising that targeted our brands with bogus claims. While it's frustrating that some of our competitors feel more compelled to attack us than to drive more consumers into the category, we want shareholders to know that we will always defend our brands. Not only did we do it last year, but we'll do it again this year if we have to.

There was good news in grass seed at the end of the season as well. Not only did we take 350 basis points of market share in units, we saw POS of grass seed increase 20% in the fall, which is not unusual after a hot dry summer. While history would suggest that this activity would carry over into the spring, it's too early to make that call right now.

Our gardening business was the biggest frustration in the US, especially in our soil business where full-year POS was essentially flat for 2011. As we discussed on the last call, this is a business that typically peaks in May. Unfortunately, this was about the same time when the consumer went into hibernation.

As a result, the second half of the lawn care and most of the gardening season, when we saw some of our highest-margin products, was soft. I will come back to this point later because it is important in understanding how we view the business right now.

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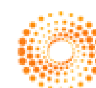

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Wrapping up the US, I'm also pleased with our partnership with SC Johnson. While the economics remain modest right now, we are clearly seeing the benefit of this distributing raid and off in the DIY channel and having them deliver our products in grocery and drug.

Let me shift gears and talk about advertising for a moment. As most of you know, we made a big bet this year with our decision to dramatically increase our advertising investment in United States. We've already said we will reduce (technical difficulty) spending in 2013. Essentially, we are reducing the year-over-year increase from 2011 to 2012 by about half so that the 2011 to 2013 differences will still be significant.

While I am on the subject, I want to say I'm really pleased with the improvement our consumer marketing team has made in 2012.

Those of you who know our story well have heard me say that we have to greatly enhance our efforts here if we are going to win with the consumer. Since our third-quarter call, we've received a full dataset related to the past season, and we like what we see. The strongest results were from our Scotts advertising campaign, which featured Scotty the Scotsman. The campaign tested extremely well in terms of being memorable with consumers and having higher persuasion scores than we had anticipated.

One of the reasons we think the campaign is working is that we've done a good job of integrating it into nearly all of our lawns programs. We view Scotty on TV, radio, print, as well as in-store and online. We were also able to effectively use him to help drive our Major League Baseball sponsorship, which we are planning to do again in 2013.

Going into the season, Jim Lyski also talked to you about our increased investment in digital. We saw good progress there as well. Traffic to our homepage was up 57%. Mobile traffic was up 270%, and search traffic had increased 80%.

So in some regards, 2012 was a good year, an important year in terms of consumer engagement. There's lots of good things to take away from the season and to build on for next year. I want to transition for a moment to our international business.

I told you already that sales outside the US were down 4% for the year. That is true even though we had strong performances in both Canada and Australia. In Europe, however, we had a tough year. Sales in the UK were down 13%, and in France we were down 9%. We believe weather was the overwhelming factor in Europe as rain and cold temperatures were the norm throughout the spring. We saw some strength in the late spring and early summer, but it was just too little and too late to make a difference.

In addition to the weather, we're seeing the same thing everyone else in Europe is seeing right now -- a weak consumer and a stagnant economy. Although our European business had been doing well over the past few years and we expect improvement in 2013 from what we saw the season, we still believe this business will be under stress from the macro economy. Getting our European profitability back in line is a major priority for us.

Let me talk briefly about Scotts LawnService, which grew 4% for the year. We saw a 240 basis point improvement in customer retention levels, and customer satisfaction levels stayed near all-time highs, despite a hot dry summer.

The team also continued to make good progress in improving route density, which is key to driving improved productivity in this business. We still get questions about SLS, so I want to reiterate our view. We see this business as a core and strategic part of Scotts Miracle-Gro. We are committed to it for the long term and see both organic and inorganic growth opportunities in this space.

Let me change gears here. I want to close the loop on our assessment of the past season and tell you what it means for 2013.

I also want to talk a little bit about our agenda for Analyst Day.

On the last call, I told you that we were surprised by how the season unfolded and that at the time we weren't quite sure what to make of it. While I don't think we'll ever have a precise answer, the benefit of time has helped us better understand our business in the context of the broader marketplace.

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First, when you look at weather over the course of the entire season in the US, it definitely posed challenges in some markets during the late spring and summer. In March, the weather was fantastic everywhere, which allowed us to get off to a strong start. But it turned in May, especially in the Northeast and Midwest. There were cool and wet weekends during May in the Northeast, and that certainly didn't help. Here in the Midwest, lawns became pretty stressed and browned out by a Midsummer, and a lot of consumers just stepped away from lawn and garden care in the midst of the drought.

Like most seasons, weather helped us at times and challenged us at times. But was it the big issue? I don't think so.

For sure, some of the softness we saw in April and May was due to the strong start and pull forward of some consumer purchases. Weather was an issue in some markets as well. But I've been in this business long enough to know the challenges this spring were more than weather. We worked to better understand weather was a structural issue with our business or something broader. We're convinced it was a something broader.

Consumer spending in most sectors of the economy was up across the board in the US in February and March. Not only were we up during these months, but we had a record month in March.

Then consumer spending for April, May, and June declined. These happened to be the biggest months of the year for us with well over half of POS occurring during that period. The weakness that we saw persist, particularly in May, not only occurred as overall retail spending fell, but as gas prices increased and the stock market declined.

We had stated in the past that we thought our business was resistant to economic downturns and at times almost appeared to be enhanced by recession. That didn't appear to be the case in 2012 as we found ourselves trending more in line with swings in consumer sentiment.

In fact, if you look at how our business performed during the spring and look at what other CPG companies reported, the results were remarkably and unusually similar.

While this does not impact our long-term confidence in the category, it does impact how we are approaching next year. We have baked in a low single-digit price increase to our plans for next year. In hindsight, we don't think we've gotten much from holding pricing last year. Our retailers have been supportive of the increase, and we don't expect it's big enough for consumers to react negatively.

With that said, we're still assuming zero growth in unit volume and zero improvement in market share. Are both of those measures still important to us? Damn right. And I'm actually cautiously optimistic that we'll see upside from our plans, but we'll not build a business plan or a budget around that assumption.

I'm not going to spend a lot of time revisiting decisions we made in 2012 about pricing and advertising. Given the facts at the time, I was confident in that decision. But with the benefit of hindsight, I think we could've taken a 2% or 3% price increase, and we continue to believe the advertising investment was appropriate based on the historical track record of the category versus the overall economy.

But over the last two seasons, we've seen much more fragility on the part of the consumer. When the weather, the economy, and consumer sentiment are all trending favorably, then we benefit. But when any one of those factors slip, we tend to feel it. So even though we have an excellent program in place for next season, we're taking a conservative stance in regard to our 2013 budget. If we see upside for assumptions, our bias right now is to allow that money to drop straight to the bottom line.

So by focusing on what we can control, we expect to see improvement on both gross margin and SG&A, so we'll give good leverage without much volume increase. Right now the external consensus is slightly above $2.50 per share, and I feel confident in saying we should be able to do at least that well in 2013, assuming we see flat unit volume.

In terms of being more specific, that's all we have to say regarding guidance today. We will, however, provide a range for EPS during our meeting next month in New York.

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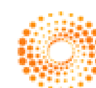

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Speaking of that meeting, let me tell you what else you will hear. Over the course of the summer, we've been working aggressively at examining every opportunity that exists to improve gross margins through pricing, cost-out initiatives, and to more fully leverage our SG&A. And we've seen progress in all areas. We'll describe in more detail some of the cost-out initiatives that we believe will help drive gross margins. We'll also discuss some of the organizational changes we've made as we continue to keep a sharp eye on SG&A.

Our content for the meeting will be mostly focused on 2013. We will focus on steps we're taking to drive profitability and the momentum that will give us -- that will allow us to make even more progress in 2014. We'll talk a bit about our aggressive goals for cash flow and our desire to resume shareholder-friendly initiatives as we delever in the second half of 2013.

While we'll provide a reminder of some of our longer-term initiatives, we won't elaborate much. We recognize the need to restore our profitability and our credibility in the near term, and that's where we will spend the majority of our time at this meeting.

With that, let me turn things over to Dave to share the financials.

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

Thanks, Jim, and good morning, everyone. I'll provide some color on our fourth-quarter and full-year results, but before discussing our results from continuing operations, I wanted to highlight that, as previously anticipated, we did complete the wind down of substantially all operational activities of our professional seed business in Q4. And as an outcome, pro seed is now classified as a discontinued operation.

We will update prior year's quarterly and annual financial results from continuing operations to reflect this change when we file our Form 10-K later this month.

With that housekeeping, I'll now focus the balance of my comments on adjusted results of continuing operations.

And I think starting with a bit of context helps. Fourth-quarter sales have historically represented about 14% of our full fiscal year sales, and given our relatively fixed cost structure, the fourth quarter has historically been a loss order. This reflects the seasonality of our business.

From a macro level perspective, Q4 of 2012 was no different. Sales represented 14% of the full year, and we reported an adjusted net loss of $0.59 per share.

While the fourth quarter was in line with our guidance, it was nonetheless a larger loss than 2011 when we reported a loss of $0.41 per share. Given that, my comments for the quarter will be focused on factors contributing to that increased loss and begin to provide some visibility on actions we are taking to drive significant improvement in earnings in 2013.

The fourth-quarter headlines for 2012 are very similar to our third quarter with the year-over-year increase in loss attributable to declines in gross margin rates, along with modest growth in SG&A. With that, let me start at the top.

Net sales for the fourth quarter were flat to prior year at $401 million. Consolidated net sales for the full year were 1% to $2.83 billion. Changes in FX rates had a nominal impact on consolidated net sales for both the quarter and the full year.

For the fourth quarter, sales for our Global Consumer segment were up 1%, excluding FX up 2%. Sales for the full year were flat, excluding FX, up 1%.

Breaking this down geographically, at constant FX, for the full year, sales within the US increased 1%, while international sales were flat. The 1% increase within the US was consistent with POS growth at our largest US retailers, which had ended the year up 2%. The difference of 1% between our sales and POS reflects the drawdown of inventory at our largest retailers at our fiscal year end. This drawdown had a larger proportionate impact on our fourth quarter, explained the divergence of POS growth in Q4 of 3%, and our total US consumer sales in Q4, which declined 3%.

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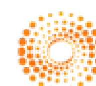

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For the year, we saw double-digit growth in our sales of mulch and controls products within the US. These increases were substantially offset by declines in wild bird food, grass seed, and plant food products.

Jim already touched briefly on international and Scotts LawnService, so I won't spend additional time on these businesses. As Jim has already articulated, we have constructed a balance plan in 2013 that assumes flat unit growth, plus low single digit price increases. We believe this is an appropriate approach considering the current uncertain environment.

Moving on, gross margin rate contracted 200 basis points of the quarter, ending the year 280 basis points below fiscal 2011 at 34%. Causal factors for the full-year decline are relatively unchanged from those I articulated last quarter with the most significant relating back to increased year-over-year product costs.

At the onset of the year, we expected this product cost headwind to be partially offset by modest pricing, favorable mix, and distribution cost benefits. As we stated the last quarter, we didn't realize the full benefits of these expected tailwinds.

While our gross margin rate continued to contract in Q4, the rate of decline slowed, in part due to a moderation of commodity cost increases. While we don't expect a full recovery of gross margin rate in 2013 to 2011 levels, we do expect significant improvement based on discrete actions we've taken.

Namely, we'll see some benefit from price increases, and we'll also realize initial benefits from the product cost-out and productivity initiatives we launched a year ago. You may recall Dave Swihart spoke of this initiative last February at our Analyst Day.

We still expect modest headwinds from increased commodity costs, though these are more a function of legacy costs from 2012 than any increase in expected acquisition costs in 2013. Through the end of October, we've now locked about 46% of our commodity costs for 2013. This is up from a year ago.

SG&A in the quarter was $148.6 million. The year-over-year increase of $12 million was attributable to increased advertising, plus some charges we took for restructuring activity and additions to reserves for doubtful accounts.

For the full year, SG&A was $705.7 million. The year-over-year increase of $19 million was driven by a roughly $30 million increase in advertising.

I mentioned restructuring charges, and I want to comment of those. We incurred about $3 million of charges in our fourth quarter to make changes we believe appropriate to reduce our cost structure, strengthen our organization, and outsource certain non-core capabilities. These actions reflect some of the steps we're taking to adjust our cost structure to improve our near-term profitability, while still balancing the need to invest and grow capabilities essential to our long-term growth. We'll spend more time on these initiatives in December to give you greater confidence in our plan.

Moving on, the rest of the P&L is pretty much in line with expectations. Interest expense in the quarter was $12 million compared to $13.7 million a year ago. As expected last February, interest expense for the year was about $62 million or $11 million higher than fiscal 2011 primarily a result of higher average year-over-your debt. The full-year tax rate for adjusted earnings was 36.6%, and we ended the year with share count of slightly more than 62.1 million.

Taking it all to the bottom line, adjusted loss for the quarter was $36.4 million or $0.59 per share compared with a loss of $25.7 million or $0.41 a share a year ago.

On a GAAP basis, loss from continuing operations was $36.6 million or $0.60 a share compared to a loss of $62 million or $1.00 per share last year. The difference between adjusted and GAAP numbers for the quarter related to some nominal legal costs incurred on the closure of the EPA matter.

As you know, during the quarter we finalized both civil and criminal agreements with the US Department of Justice and the EPA related to certain products distributed and sold through 2009. As an outcome, we do not expect to incur additional costs related to these matters in future periods.

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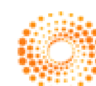

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Adjusted earnings for the full year were $2.01 per share, consistent with our guidance in August.

Finally, I want to touch briefly on some credit metrics on the balance sheet. Our year-to-date EBITDA leverage ratio was 2.9 times. We expect this ratio to stay around 3.0 until we report the third quarter of next year, at which time we should see the ratio rapidly moderate back to our targeted range of 2.0 to 2.5 times.

There's a handful of year-over-year changes in the balance sheet, the most notable of which is inventory, which increased $28 million. When considering the liquidation of proceed inventory, inventories increased $57 million. This increase was an outcome of several factors, including lower-than-expected sales.

Regardless, we have established plans to aggressively reduce the level of inventory we exit next season with and will describe initiatives to achieve this in December.

In anticipation to your questions, I am not providing any specific guidance for 2013 on today's call. We'll provide a clearer outlook for the year at our Analyst Day meeting on December 14.

With that, let me turn the call back to the operator to take your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Sam Darkatsh, Raymond James.

Sam Darkatsh - *Raymond James & Associates - Analyst*

One in for Sam. A few housekeeping questions for me on 2013. I know you don't want to provide too much on the consumer, some of the margin area, but could you give us a sense of where you think interest expense and tax will shake out for the year as we get to that [250-plus]?

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

Look, I think interest expense we're not -- unlike the change from 2011 to 2012 where we saw some pretty significant changes, from 2012 to 2013, I'd say my expectations would be for reasonably flat year over year in interest expense. I can provide more color on how we get there in December.

Sam Darkatsh - *Raymond James & Associates - Analyst*

Okay. And then it sounds like --

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

I'm sorry, the tax rate. I think if you look at our history, you'll see that we've generally been 36%, 37%. I wouldn't expect anything different from our history as you look forward to 2013.

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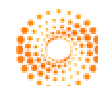

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Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

I would throw out there that in terms of all candidates, thank god, are talking about making corporate tax base more competitive globally. And so let's all be hopeful that corporate rates come down as a result of fiscal cliff and whatever permutations are part of that.

Sam Darkatsh - *Raymond James & Associates - Analyst*

And just to make sure I am reading between the lines properly on some of the shareholder-friendly activities you have talked about in the past, it sounds like deleveraging is going to be the priority. So if you are not going to change the debt-to-EBITDA ratio until Q3, does that mean we shouldn't expect any actions until 4Q, and what might those look like, would you lean toward dividend, share repurchase, or what?

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

Look, I will start, and then if Dave wants to add to it, and I think it's a good question.

I would say I'm not sure -- delevering to the point of getting down -- we ended the year with less sales and more inventory than we wanted. So, as we clean up, naturally clean up the balance sheet through the first half of the year we're in, 2013, and we naturally begin to delever as we are getting paid, I think my view is that notionally the range we've set as a interest coverage or whatever debt-to-EBITDA you have of, call it, I think we've said 2.0 to 2.5 times. I am sort of in the 2.5 times category.

So I think we want to delever down to the low 2s. And at that point, I think we'll have within our credit agreements, we'll have the ability to make some I'm going to say fundamental moves in regard to what we're calling shareholder-family actions, which would be one of two things or some combination of the above -- stock repurchase and/or one-time dividends at year-end after we've taken a look at what our requirements are for cash.

I think I've been pretty clear to people that we got ourselves into a mode of saying that we believed in significant growth opportunities, call it last couple of years. I think after 2012 for me and I know the management team is aligned with me and so is the board, that I just think that the global economic situation is fragile enough that I don't think and based on the level of activity and fragility of the consumer, that that is a reasonable assumption at this point, that it is a growth environment.

And so, as we've talked before about two-thirds of our free cash going into growth opportunities, both organic and energetic growth opportunities, we're going to be biasing that -- I'm going to call it roughly the inverse of, call it, about one-third to growth and about two-thirds to non-growth. And I think in the absence of something better to do with the money, we're biased and I personally am biased to return that money to our shareholders.

And so that, generally, I think is where we're going. There is a lot of work to do between now and the second half of this fiscal year, both with our board getting advice from our financial advisors, and then internally looking at what our CapEx and other growth requirements would be for the Company. So there are some steps to take. But I think directionally, that would be a fair way to look at it.

And just personally today, I'm probably more bias on one-time dividends than repurchases. Although I would say to the shareholder community that is on the phone, I would call Dave and, if you have a bias, tell us what you think.

So we're interested in what other shareholders think of how they'd like to affect these shareholder-family actions. And if people have a point of view, they ought to communicate it to us. It would be useful.

Dave, anything you want to add?

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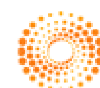

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Dave Evans - *The Scotts Miracle-Gro Company - CFO & EVP, Strategy and Business Development*

No, I think you captured it very well.

Operator

Olivia Tong, Bank of America Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Thanks for the sentiments about hurricane and storm earlier today, as well.

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

It is a pretty big disaster. It's like it's unbelievable. And I don't think anybody on TV is really seeing how bad it is there. I haven't seen a single Long Island Power Authority truck since we lost power in our community -- not one.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Yes, a lot of people have some pretty bad impacts on Long Island and across the region.

If I can transition more toward -- sorry, don't know how to do that.

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

Just -- easily.

Olivia Tong - *BofA Merrill Lynch - Analyst*

If we could talk a little bit about your statement in the press release about trying to get back to what you saw in terms of earnings two years ago, now that we have the 2012 base, if my math is correct, it looks like you're looking for about 400 basis points or so of margin improvement, or, more importantly, about a $100 million decline in costs.

So you've obviously got pricing plans next year. You've got advertising that will come down on a year-over-year basis, but presumably, variable comp will have some restoration, etc. So can you talk a little bit about the puts and takes beyond those three factors that will help drive you closer to potential restoration of EPS growth to targets that you made two years ago? Thanks.

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

Sure. And Olivia, I'd reiterate that the foundation is an assumption of reasonably flat units. So the path that we're defining to get there is going to be focused on probably three primary levers. We've talked about pricing, so we took some pricing increases for 2013. And we'd say we continue to believe that in a value-appropriate way for our consumer we will continue to explore opportunities to get greater realization pricing in future years. So we are focusing on that, not as an event just for 2013, but building an ongoing capability and capacity to do that moving forward as well.

The second lever is really product costs and supply chain productivity above our margin. Last February Dave Swihart went through in some detail and articulated a project that we had launched, and these types of things on product cost-out take a long time to manifest themselves in the P&L.

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It's a highly-coordinated effort between our supply chain, our R&D group and our marketing group in examining each of our products and identifying opportunities for taking costs out of our products that don't have a commensurate value benefit to our consumer.

And so some of the benefits from that project will begin to see realized in 2013. But it's the type of project where you get some momentum off. So we would continue to expect to see that favor while it comes from that in 2014 as well.

From a supply chain cost productivity, if you did look at our CapEx, so we're expecting to be probably a bit more restrictive in CapEx moving forward, I can tell you the area of CapEx that we are not spending less on is CapEx related to cost productivity.

So the supply chain and the other teams continue to request, we got a nice pipeline of requests for projects to drive increased productivity in the conversion and distribution costs and COGS as well.

So we have three levers that we anticipate we can drive improvement in our margin rate, as well as a continued focus on mixed management through both our innovation, as well as we've continued to make refinements, improvements on what we call integrated business planning where we're better collaborating amongst ourselves and with our retailers and focusing our promotional efforts on products and support of improved mix for both the retailers and us.

If you drop below gross margin, SG&A -- we took a couple of steps that we've already talked about that were one-time reversal of some of the rates, some of the increases from 2011 to 2012, from 2012 to 2013. So advertising -- we're trimming that back, focusing on where we received the highest value.

But our greatest focus now is more on SG&A productivity. We began to take some steps this year, and you did see some very small restructuring charges, which we're not calling out as an adjustment to earnings. But we incurred some costs as we began to improve the alignment of the organization based on the learnings we have had.

But there is a fairly significant focus on driving improved productivity throughout all areas of SG&A, and we don't see 2013 as the end-all of that process. We've laid our plans for 2013, and we are now, right now in Q1 of 2013, focusing heavily on what are the improvements we are going to make in 2014.

So there's a lot of effort right now on all those levers that is giving us the reason to kind of believe that we can get this profitability back to those levels, and in a best case scenario, we can do it by the end of 2014.

So that gives you a broad overview of the whole landscape of initiatives we're working on.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. Thanks for the detail. On the restructuring, would you expect to get more aggressive on that? Is there a potential that we see a more -- a bigger plan with a bigger charge and some detail around the timing and the payback and all that stuff?

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

I am just going to jump in for a second, and Dave can pick up the pieces if he has to.

You are seeing that Dave and I have made a decision in regard to restructuring definitely within the American business, although we've got a lot of work still to do on saying, what does the end state of the European business look like? But within the core of the business, I don't think we intend to make adjustments at this point going forward on actions that we're taking to make the Company more profitable and/or increase cash flows.

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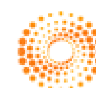

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And so while I think we'll talk about them as we discuss the financials with you guys, we will not be excluding them from our numbers as we have done in the past. I think we are tired of -- and maybe you guys are too -- of call these constant adjustments.

And so because we don't know what it means in Europe yet, we're not prepared to make that sort of commitment for Europe, but for the core of the business we are. And so we'll still talk about it. We just won't call it out as being separate adjustments.

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

That's correct.

(multiple speakers)

Operator

Bill Chappell, SunTrust Bank.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

One, I understand the hope of flat volumes going into next year, trying to be conservative, but do you look back and say, the only reason that our volumes were as good as they were or bad as they were in 2012 was because of the stepped-up advertising, and by cutting it 50% next year, that's going to actually mean volumes could decline?

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

Look, it would be fair to say that the assumption is based on flat volume, okay? So it's a factoid.

That being said, do I believe that that would be reasonable? No. It was very much in line with the stand we took on a budgeting point of view to say we just don't believe that we can count on growth. And it really forces us to take -- as we budget for 2013 and beyond, which -- I'm going to say I have directed that the operating community at Scotts use these assumptions for their budgeting drills.

I'd be very disappointed if that happens, to be honest, Bill, but it forces us to really look at our business. And I've also been very specific on my expectations on what levels of profitability we need to get to. Barry and I are in lock-step on that, and there's not differences of opinion. This is not one where the operators are shaking their heads and saying, what the hell?

But it is a fair thing to say. That would be a negative to our plans if unit volume declined. And so it would also be fair to say that, as usual, we operate this business with three sets of numbers. We have the numbers with you guys, we have the numbers with our board, and then we have our own internal numbers. And on top of that, Barry and I have a pretty significant contingency built in.

So what do I think? I think marginally we should be able to make our numbers, even if our assumptions aren't perfectly correct. I mean I think that's probably fair to say. So I don't think there's a ton of risk in it, put it that way.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Yes, I'm just trying to understand. I mean normally when you cut advertising by 50% and don't think that has any effect on volumes --

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

We're not cutting advertising by 50%. We took advertising up, call it, 50% going from 2011 to 2012. Half of that increase we're taking back and reinforcing -- it is still going to be roughly, call it, 25% more than it was in 2011, which was a high spend year. We weren't looking to save money in regard to advertising then. So --

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Unidentified Company Representative

2013 will be the second-highest advertising spend the Company has ever had, just to put it in that perspective.

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

So it is not a decrease of 50%. It is a decrease of 50% of the increase that happened from 2011 to 2012.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay. I'll move to -- just to make sure I understand on variable comp, can you give us an idea of the lower variable comp? What impact that had on 2012? I assume you're assuming it's a full-year variable comp for 2013?

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

Yes, so Bill, we've been fairly transparent in these discussions in the past. For 2012, there are areas of the Company, for example, our LawnService business, our Canadian business -- there's areas of the Company that performed well this year. And so we've not penalized them for the broader consolidated results, and that is a bit of a change from 2011.

So we have some payouts there. And then we also have, as an element of our broader variable comp, a discretionary element. That discretionary element is 20% of our total variable comp, and we are continuing to pay that out.

So I would say, as you recall in 2011, we virtually zeroed out our variable comp. In 2012 the payout that we have is probably closer to a third to 40% of our targeted payout given the factors I just told you.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

And then 2013 should be --

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

Just to be clear on that --

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

2013 will be --

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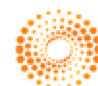

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Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

That will be -- parts of the Company that naturally would have performed had it not been for our corporate number that would've caused it to zero out, we elected, with the Board, to pay those out where the business units performed.

In addition, there is a personal performance fraction of it that we funded, and that is the 20% that Dave is talking about. So those are the pieces that got funded were the personal components, and those business that were naturally in the money, we just took the corporate number and pulled it out and paid them as they would have paid as if the Company had performed, which we thought was the right thing to do for them.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Got it. Thanks so much.

Operator

David MacGregor, Longbow research.

David MacGregor - *Longbow Research - Analyst*

Just to explore pricing, I'm just trying to get some clarification here. If we should get into next year and the consumer, let's say, explore the scenario where the consumer is a little bit better, the weather is a little bit better, you realized maybe you've got a little bit better pricing power at that point than you anticipated, do you have the opportunity to go back and revisit pricing, or is it pretty much cut in stone based on the negotiations that you are holding right now?

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

Generally, David, the pricing is an annual activity. So we go through that when we do line reviews with the retailers so they can plan their season. So for the most part, it's an annual activity.

David MacGregor - *Longbow Research - Analyst*

And then secondly, if you mention this, I missed it. I'm sorry, but raw material inflation for the full year, 2012?

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

So the way I will answer your question is to tell you how it affected our P&L. It's always a little bit trickier. Can you talk about what the current markets are, and the current markets because the inventory turns we have don't necessarily translate into the P&L?

What we saw for the full year in terms of increased material costs running through our P&L was around $70 million in 2012 relative to 2011.

David MacGregor - *Longbow Research - Analyst*

Thanks very much.

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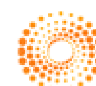

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Operator

Carla Casella, JPMorgan.

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

Move on.

Operator

Joe Altobello, Oppenheimer.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Just first question, I'll just follow up on the raw materials question. You said , Dave, it was up about $70 jump in 2012. Given that you've locked in almost half of your costs for next year, given where current spot rates are, what would that number look like in 2013?

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

Joe, we're seeing based -- like current market prices that we're seeing would imply the cost of materials as we buy them in 2013 will be reasonably neutral to what we would have bought them at at 2012.

But what we're going to see in 2013, particularly because we are carrying more inventory than we'd ideally like to have at this time, is we will continue to see if that inventory rolls out and is sold in 2013, we'll see the remnants, kind of the legacy of those increased costs in the early parts of 2013.

So probably for the first -- through the first two quarters of 2013, we will continue to see some year-over-year costs, which are a reflection of turning out that inventory that is on our balance sheet at the end September.

Once we get beyond that, based on what we see in the markets today, it should be closer to flat year over year.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay. So flat in the back half and up a little bit in the first half is what you are saying in terms of the P&L impact?

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

Correct.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay. And then just turning back to advertising, just so I understand, and I apologize for beating this to death, but advertising was up $30 million last year. You said you're taking back half that increase, so advertising in dollars will be down $15 million in 2013?

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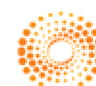

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Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

Look, a little bit of correction. Some of the advertising that we did that was focused on certain retailers we ran through basically above line. So the number you're seeing in advertising is not totally right because of some programs we did that were advertising but we did it through a retailer. And so I think the number is probably not right. But if you say, call it, that the increase was about $40 million, the decrease will be about $20 million, okay?

Joe Altobello - *Oppenheimer & Co. - Analyst*

Got it. Okay. And just one last one in terms of inventories and not necessarily your inventories but how we think about inventories heading into next year or 2013. Obviously, this year was a tough year for everybody. Would you expect retailers to be a little bit more conservative on inventories in 2013 versus 2012 given what they experienced, or has that already happened given the fact that POS was better than selling?

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

I am going to ask Lukemire or Barry to sort of jump in here. Ideally is that I keep hearing all this crap about inventory. What happened this year is every time there is a crappy year in lawn and garden, if you were a merchant or I was a merchant -- hold on I got to make my phone stop making noise -- one of the ways to solve a problem in a year is to not have a problem with your balance sheet, okay? And so I think merchants tend in poorly-performing years to want to poll inventory and end it as clean as possible, and they tend to be more focused in a bad year on inventory management at year end as you approach the fall, and they are cleaning up for either back-to-school or Christmas.

And so, what I don't sense is that there is a lot of pressure on reducing inventory in the spring. I think that pressure -- and I would expect it to continue, to be honest, which is that just like we are looking at our balance sheets, retailers look at balance sheets and try to say how can we run the business with less inventory and still sell product?

So I don't think that the bias toward ending is going to really change. I just think in a bad year, there's more intensity around it, and I don't think it affects shelf set in the spring. I don't know, Mike, if you agree with that.

Mike Lukemire - *The Scotts Miracle-Gro Company - President, US Consumer Regions*

No, I agree with that. And I think in-stock is becoming more -- we are getting to the point where we're starting to see in-stocks suffer at retailers, and we're seeing some retailers go back to focusing on in-stock. So we know the levels of inventory are approaching levels that may even actually hurt the retailer.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay. Thanks, guys.

Operator

William Reuter, Bank of America Merrill Lynch.

William Reuter - *BofA Merrill Lynch - Analyst*

Most of my questions have been answered. I guess I was just curious whether you guys see any potential acquisition activity over the next year or two, or whether that's not something that's really a focus at this point?

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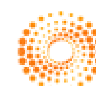

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Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

Well, I would say I can take the last part, which is it is not a high-focus item for us right now, okay? I think we are pretty clear on this call that both for our own personal stakes, for our reputation, for the reliability of our earnings, we're highly focused on earnings and cash flow for 2013 and 2014. That is not to say that there is no activity, though. And it would have to be within the bias that I talked about earlier, which is that about one-third of our cash flows can be used by Barry and Dave and the teams on what we call growth opportunities. But it would not be fair to say none.

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

I agree.

William Reuter - *BofA Merrill Lynch - Analyst*

Would any acquisition that you would complete, do you think you would still keep yourself in that leverage goal of 2.0 to 2.5 times, or could there be a potential huge -- or a larger acquisition that would push you up above that?

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

Consistent with what Jim just described, the types of deals we are looking at would be opportunistic and not significant. So I wouldn't see these types of deals being the types of deals that cause us to raise our leverage above what we do independent of an acquisition.

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

And I just want to say what I think is the obvious in these times, which is, based on the fragility of the global environment in regard to economics and the consumer, it is a stupid question to ask, but I don't personally think that higher leverage is the right answer in that period. And as we become more comfortable that growth is righteous and that the world is a safer place to be economically, I think our tolerance for higher leverage will be higher. But that's not the case today.

William Reuter - *BofA Merrill Lynch - Analyst*

: Okay. All right. Thank you very much.

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

You are welcome.

Operator

Alice Longley, Buckingham Research.

Alice Longley - *Buckingham Research Group - Analyst*

I think this is fairly new that you're going back to talking about some enthusiasm for one-time special dividends, and could you elaborate on that? Because I know that in the past, you have said -- of course, you did it once in a big way, and you noted that it gives you a boost and that it goes

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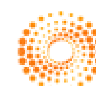

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away as opposed to raising your dividend on a more sustainable basis. And then also if you do pay a one-time special dividend, what's the thinking about doing it, maybe pushing your leverage ratios and doing it this calendar year because of possible changes in dividend tax rates?

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

I would say we are definitely not doing that, although if our leverage was lower -- like if we were sitting at 1.0 right now, I probably would say, hell yeah. But at the moment, whatever we do I think to some extent needs to be based on our agreements, needs to be in the second half of fiscal year 2013 as leverage ratio gets down.

Dave was very enthusiastic to answer the question. I'm not quite sure what he's going to say, so I am saying, let me hear it, Dave.

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

Well, look, I think it's hard to answer based on some hypotheticals of what might happen to the tax rate environment and when that might happen. I would just say that in terms of shareholder returns, it will be in the context of the leverage range that we've been describing, and I think there are some biases.

But my job is to be fairly agnostic to which one it is based on whatever makes sense at that particular point in time based on our current share valuation, based on tax policy. We'll look at all of that when that time comes, and hopefully we'll get to that sooner rather than later in the second half of next year.

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

I can tell you that where I stand now, Alice, is I don't see a massive recap like we did. What I see is in this period of where this Company is going to be extremely conservative and predictable, I see the year-end dividend as being a very convenient way to sweep money out of the Company at year-end once we understand how things have gone for the previous year, and that we spent a lot of time this summer looking at value creation. And I think in periods of what we keep calling shareholder-family periods in this Company's economic history and share price history, our share prices tend to perform very well, and we've created a lot of value when we've been in these periods of shareholder-family actions. And I think that -- maybe it wasn't a surprise to Dave. It was a surprise to me that there was such a high correlation between the two.

So I think at least for the period, I'm going to say 2013 to 2014 and with the proviso that everybody understands that there's still a lot of work to do with my internal team, with the board, our financial advisors to make sure that we think this is right and how to affect it, I feel very positive about it, and that it's the right thing for us to do, and it's a very safe thing for us to do, and basically gives credit to the owners of the Company and says the best person to hold onto money that we don't see a use for is our shareholder.

Alice Longley - *Buckingham Research Group - Analyst*

Okay. And then my next question is about margins, the direction for how we should be thinking about next year. You have gone back and forth on cost increases. I guess costs go up in the first half of the fiscal year and then are flat. And pricing it looks like gives you about $50 million. Is the gross margin expansion for next year mainly on the difference between the pricing and costs, or is it more driven by your cost-cutting programs?

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

Alice, we'll provide more details in December, but it's not heavily skewed toward one or the other. It's probably maybe more balance than we've given you the impression it is.

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Alice Longley - *Buckingham Research Group - Analyst*

Okay. And then similarly in SG&A, we've got this maybe $20 million reduction in advertising from a real high level in fiscal 2012. But you've said before that the variable compensation you are going to make sure is up because people haven't been paid for two years. So of that $20 million benefit in advertising, about how much of that is going to be swept away in compensation?

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

The two, in broad strokes, they are going to be offsetting.

Alice Longley - *Buckingham Research Group - Analyst*

So if they are offsetting, then where do we get the SG&A ratio benefit? Is that all cost-cutting?

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

Yes, ma'am. So you saw some of that with the restructuring that we took in the fourth quarter. We'll be getting to do some real and sustainable cost-cutting in other areas of the SG&A.

Alice Longley - *Buckingham Research Group - Analyst*

Okay. And then my final question is you talked quite a bit this last year about the unfavorable product mix because mulch was so strong and its margins are so low. What kind of mix do you think that you're going to get this coming year, and which products are you counting on driving whatever volume growth you do get, and what will that do for mix? Thanks.

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

It is a good question. Alice, I'd like to defer on that one until we get to December, and then we can share more broadly some of our thoughts on the mix.

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

But I think, Alice, that the scripts that we read I think lay the brick homes out there, okay? That the primary impact of whatever occurred -- and you heard my view, which is some combination of the consumer and weather, really impacted the second half of the lawn and garden season, which chopped out the second half of the lawn fertilizer business. And virtually the entire garden business -- the pest control business, the weed business -- did pretty well, as did the first half of the lawn business.

So you can -- and second, mulch was an important component within the business this year. We expect it to continue to be a growing category.

In addition, we would expect a more normalized season where you would get a more typical garden season in the second half of the lawn season. And I think those are the crumbs that you can use to take a look at what your assumptions would be on mix, I think.

Alice Longley - *Buckingham Research Group - Analyst*

All right. Thank you.

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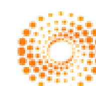

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Jim Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

You're welcome.

Operator

Connie Maneaty, BMO Capital.

Connie Maneaty - *BMO Capital Markets - Analyst*

How much European profitability declined, it's not segmented, so I guess I want really more to focus on the part of your business that is so important, the US. But to do that, I guess it's useful to know whether or not -- how far European profits sell, if you are making or losing money there, and then I have a follow-up?

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

Well, we make money in Europe, but the margin rate in Europe is significantly lower than the margin rate in the US.

Connie Maneaty - *BMO Capital Markets - Analyst*

Okay. So how much did the European pressure costs you in earnings this year?

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

It is probably order of magnitude, I'll say $0.10, $0.15.

Connie Maneaty - *BMO Capital Markets - Analyst*

Okay. That's helpful. Secondly, can you give us your perspective on where regionalization fits into the cost structure? Did it add to costs in the shortfall, or are you finding it an efficient structure?

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

Look, I'll take at least part of that, and again, this is when people can either correct me or add to it.

We didn't do it to save money. We did it because we looked at market shares around the country and particularly in the growing southern markets, and I'm talking from the West Coast all the way to the East Coast, we were seeing market shares that were sort of, call it, 5, 10 points lower than what we had in our more legacy markets, which would be Midwest, Northeast, mid-Atlantic.

So I think if you were to look back at over the three or four years we've been doing regionalization, I'm sure it has added cost to the business. We've gone from five regions to four regions, and the latest iteration of it is combining the southwest and the western regions. So effectively we're down to three regions.

So if you went back from the beginning and looked at our national sales structure prior to regionalization, we're probably getting pretty close to what it was I would guess. But I think since we started, there has been an investment. And we're not shy about saying that because it was about

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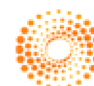

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chasing that sales down. We've made progress in every region against it and, particularly in our southwestern region, made huge progress, but made progress in all regions against it.

So all we're looking at now is, in a period where we think growth is harder to get -- and not just for us -- for all consumer companies that operate in North America and Western Europe, we're looking to take costs out of the system. And so Mike's job is to try to figure out how can he contribute to that cause without screwing up what we've built and the progress we've made? And I don't know if you want to add anything to that.

Mike Lukemire - *The Scotts Miracle-Gro Company - President, US Consumer Regions*

No, I think we've streamlined our focus on the key opportunities that are still there, and we're still developing. We've just prioritize them more.

Connie Maneaty - *BMO Capital Markets - Analyst*

Okay. Great. That's helpful. Thank you.

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

You bet.

Operator

Jim Barrett, CL King & Associates.

Jim Barrett - *CL King & Associates - Analyst*

Jim, how excited are you about your new products pipeline? Will 2013 be a year where you further emphasize existing new products like Snap?

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

Well, look, I'll give you my bias, which part of this is I am not talking to you, I'm talking to my own team. But a lot of the stuff we've done has been good. I think we continue as a lot of product development work goes to be dealing with legacy product development, meaning stuff that we started two, three years ago. And I want to continue to tell the group, good job. It would be nice to make equivalent or higher margin on innovation, not lower margin.

So I think part of our core convictions is we have to be the lowest cost operator with anything we're doing. And that needs to be factored into innovation is we cannot be at a disadvantage on an innovation, especially if it's not proprietary. And I'm really talking like these pump sprayers, which clearly are selling, and application devices generally and whether it is Ortho or Roundup or the Raid or OFF business are really, really important.

The other products that I care about is that what you saw with market shares are really important to us. We've seen like 200-plus basis points of market share improvement year over year, which is probably as high as I've ever seen since I've been in this business and really surprising to me.

I am looking at everybody around the table, they don't know exactly what I am going to say. But people didn't step away from brands. They made decisions that they wouldn't use their lawn and garden products because it was not a move to private label. Basically people stepped out of the market.

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So you look at a flat market where we had some unit volume growth and pretty significant share. And so it tells you what's really happening in the space at least in 2012. And what we need to be doing, unless people believe that Obama's programs, which I don't, are going to make the consumer rich, is a, how do we provide branded products to consumers and be able to do it my view, $5-ish, maybe $10, but for a lower how many bills they've got in their pocket with a branded product? That is an innovation requirement that I have passed to Lyski that he must satisfy.

In addition to that, just going forward, and this is pipeline discussion now, natural lawn and garden products are important to the future of this business. And it's another requirement that I have passed to Jim and his brand team that we need to further accelerate that both with our existing brands and with -- and I am not going to use the word non-branded, but not our core brands.

In addition, innovation in regard to plants, meaning our on unregulated biotech program, will continue to be funded. Because it is something that I think we're the only people in the world, at least in the United States, who have found a way to do what would be considered biotech, I think, but in a way that is not related by the United States government, and they have agreed that this is not regulated.

And so this is an opportunity to have very significant innovation over the next, call it, decade, that is proprietary and nobody else has figured out how to do.

And so to me, there is a lot of opportunities in active ingredients. What would I say in the next couple of years? Besides our secondary-branded products, natural products, some application devices and naturals that I think that's what you're going to see over the next couple of years is limited to that. I don't know, Jim, if you agree with that or not.

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

Yes, I would say, just to reiterate, we're going to put a lot of support behind our year two product innovations to retailers demand, multiple-your support, and they've been very favorable about getting behind Snap and the wand, especially with the wand associated with Roundup and natural fit.

We are going to produce a couple of new products this year. Our repellents line has been seeing very good retailer pickup. It's a natural line, to Jim's point, so very consumer-friendly; second generation of grass seed. Coated seed is a big gamechanger in the seed business, and it is where we have a substantial lead on all competitors.

And then to Jim's point, you're also going to see a $5 and under lineup that has been rolled out. SCJ has been able to get this placed at every account that they are managing for us. So a very good pickup there.

And then we'll have a couple of tests on plants. Not the biotech kind, but on other plants that will be testing out and (technical difficulty), and you'll see an effort in 2014 and beyond on those.

Jim Barrett - *CL King & Associates - Analyst*

Okay. Thank you. And a brief follow-up. Why do you think you gain market share in the fall on grass seed?

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

Well, the conditions were right. The economy came back a bit. The consumer was engaged. Retailers re-entered and started promoting the product, and our product is vastly superior. So I think that --.

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

I will throw that out there, we also spent ridiculous amounts of money advertising in a declining category based on the fact that we knew we were coming out of a very wet fall and that there was not a lot of stress on lawns coming into 2012. We spent because we had to because we were getting I think unfairly whipped on buying negative advertising, and we needed to respond, probably like Romney should have.

And so I think the effect of not only what Jim said, but the fact that we had spent quite a bit on advertising behind it, means that advertising works. It's just, what's the payoff?

Jim Barrett - *CL King & Associates - Analyst*

Right. Okay. Well, thank you both.

Operator

Jason Gere, RBC Capital Markets.

Jason Gere - *RBC Capital Markets - Analyst*

My questions have been asked. But I guess just thinking about getting back to that 2010 operating margin a couple of years from now, now is that rate of margin sustainable if the economy doesn't get better, if we see really sluggish net sales in the next four years? Can you talk about that?

And then secondarily, while we've heard in household products many of the companies today are really focusing on the next wave of restructuring, cost-cutting efforts, they benchmark against each other. So when you guys think about where gross margin should be, where SG&A should be optically over the next couple of years, who do you bench mark yourself to, and how do you think about that? Thanks.

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

It's a good question. It's one we spend a lot of time on internally. And I tell you we generally look at benchmarking as other peer group CPG companies. So in that pure group company, we look at our gross margin rate and believe that we must and should do better.

But we're also benchmarking our SG&A against those companies, understanding that there's unique differences between each of us in how we go to market and why we spend where we spend.

I would say that most importantly the number that we're most focused on is the operating margin rates because there's a lot of ways to get there. At the end of the day, that operating margin is what we're really focused on improving. And it's one that we've seen decline quite a bit over the last two years and one that we're very focused on trying to drive back up over the next two years to get closer to that peer company average.

So the types of changes we're making, we're making them in a way that we believe should be sustainable and then have some longevity to them.

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

And since this is the last question, Barry, do you want to add anything to that?

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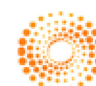

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Barry Sanders - *The Scotts Miracle-Gro Company - President & COO*

I agree with Dave. When we look at where we've been, I think you have to look -- we have been talking gross margin. But if you look above and below gross margin, we're making improvements I think at the balance. And I think the operating margins need to be in the mid to higher teens, and we think that that's sustainable on the business model that we have right now.

Jason Gere - *RBC Capital Markets - Analyst*

Okay. Great. Thanks.

Operator

Thank you. Right now, I'd like to turn the call back over to Jim King for any closing remarks.

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

Thanks, Amber, and thanks, everybody, for joining us. Again, we will see you on December 14. And if you've not registered for the meeting yet, please just reach out to us, investor@scott.com. We will see you then and look forward to the meeting.

Thanks for joining us today. Goodbye.

Operator

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

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