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SMG - Q4 2016 Scotts Miracle-Gro Co Earnings Call

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OVERVIEW:

Co. reported 4Q16 Co.-wide sales of $402m and adjusted pro forma EPS of $3.75. Expects 2017 sales to grow 6-7% and pro forma EPS to be $4.10-4.30.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good day, and welcome to the 2016 fourth-quarter earnings conference call. Today's conference is being recorded.

At this time, I'd like to turn the call over to Jim King. Please go ahead, sir.

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

Thanks. Good morning. Joining me this morning in Marysville, Ohio, are Jim Hagedorn, our Chairman and CEO; Randy Coleman, our Chief Financial Officer; and Mike Lukemire, our President and Chief Operating Officer. We'll get started in a moment with prepared comments from Jim and Randy, respectively; and, at that point, we'll open your call for questions.

I know that many of you have other calls this morning, so we'll try to move through the queue as quickly as possible. To help us manage our time, I'd ask that you ask only one primary question and one follow-up. If there are questions left unanswered, I'm glad to follow up with any of you later today, or tomorrow.

One bit of housekeeping before we get started. We are currently planning an Analyst Day event on Tuesday, February 21, at the Boca Raton Marriott in Florida. We'll start with a series of management presentations that will likely last about two hours, and then move outside and tour local garden centers. We'll get more information into your hands by the end of the year, but I wanted to make sure that all of you put this on your radar screen.

With that, let's move on to today's call. As always, we expect to make forward-looking statements, but I want to caution you that our actual results could differ materially from what we say today. Investors should familiarize themselves with the full range of risk factors that could impact our results. Those are filed with our Form 10-K which is filed with the Securities and Exchange Commission.

I also want to remind everyone that today's call is being recorded. An archived version of that call will be available on our Investor Relations website.

So, with that, let's get started with the business at hand, and I'll turn things over to Jim Hagedorn.

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

Thanks, Jim. Good morning, everyone. I'll jump straight to the punch line here: I'm extremely pleased with the results we announced today. Our performance continues to demonstrate the resilience of the category, the strength of our brands, and the drive of our people. I'm proud how far we've come in the past four years, but the last two in particular. It's pretty remarkable to me that in this call 12 months ago, we began hinting at a strategic shift in our business. Six weeks later, we laid out the specifics of Project Focus, a plan to reconfigure our business and drive shareholder value.

And what has transpired since marks one of the most productive times in the history of our Company. In fiscal 2016 we contributed SLS to a joint venture with TruGreen, giving us a 30% stake in the $1.3 billion market leader. We completed the acquisitions of Gavita and Botanicare in the hydroponics space. When combined with the acquisition of General Hydroponics and Vermicrop in 2015, our hydro portfolio has a run rate of $200 million in sales and nearly a 20% operating margin. And, by the way, it's growing at double digits annually.

We acquired a 25% stake in Bonnie Plants in 2016, giving us an opportunity to anticipate in the fast-growing edible gardening category and enhance the attachment rate of our soil products. We increased our recurring dividend by 6% and increased our share repurchase authorization by another $500 million to $900 million. We continue to explore strategic options for our European business as we maintain our bias that Europe is not a long-term priority for us. We accomplished all of these things while successfully managing our core North American business through a challenging weather year.

And if you look at just the things we control, excluding dilution for TruGreen, we would have earned just shy of $4 a share. Our strongest September on record allowed sales to come in slightly higher than we suggested during our last call. And on a full-year basis, consumer purchases of our US brands at our largest retailers increased 2% for the year. POS in our soils business was up 5%, continuing to benefit from positive trends in gardening and our new relationship with Bonnie Plants. And, by the way, Bonnie was up 4% this year and it was a difficult season for them.

The opportunities for us in live goods continue to be compelling, and we're beginning to explore whether other Bonnie-like opportunities make sense for us. Remember, the growth opportunity is not just live goods; it's also the ability to improve our attachment rates for soil and plant food products. In stores where we had the opportunity to cross-merchandise with Bonnie last year, we saw POS of our soils and plant food double. While that's not the expectation for the entire business, the test allowed us to deliver some good lessons that we can deploy more broadly in 2017.

In our lawns business, we saw a 10% increase in grass seed, and consumer purchases of our cleaner products increased by 62% due to better lifting and increased consumer demand. Our fertilizer business was a bit of a mixed bag. While we've done a good job over the years navigating weather, the lawn fertilizer business is the one area that is most susceptible to weather, given the brevity of the season. That challenge was evident in the early season as year-to-date POS of fertilizer declined more than 8% through mid-May. However, because of a second-half rally, the decline was only 4% on a dollar basis, and unit volume was nearly flat with last year.

Given the challenges we saw in April and May, I'm pretty encouraged by the outcome. In controls, Roundup saw a 1% POS growth; TOMCAT was up 33% again. However, our Ortho business slipped roughly 5%. Within that number, we saw solid gains in areas like fire ant control and indoor insect products.

We lost ground, however, in areas like the highly competitive selective weed control category. That said, we're confident that our programs for next year will allow us to regain momentum. We've also made some changes on the Ortho team. In fact, the person who led our TOMCAT marketing effort for the past two years, and just last month was named our Scotts Marketer of the Year, is now the lead marketer on the Ortho brand.

From a geographical perspective, we saw positive POS in every region in the US except the Southwest, but even that was only down 0.5%. The West and Southwest regions were number one and number two, respectively, thanks to a strong recovery in California and Florida.

On the retailer front, we had an outstanding year with the independent hardware channel and the home center channel, as was reliable as always. In mass retail, when you exclude commodity categories we chose to exit, we saw solid unit volume increases. All channels of retail finished with inventories that were essentially flat or lower than a year ago, so we're well-positioned as we think about initial shipments for 2017.

The results from the Hawthorne business were equally impressive. It's not easy to put a start-up organization inside a 150-year-old company; but we did, and it is succeeding. Now in its second full year, Hawthorne also had a great year. Sales increased by 170%, mostly driven by acquisitions. But organic growth was impressive, too. General Hydroponics was up 24% as the business continued to benefit from positive market trends. Remember, the economic case we used to justify this acquisition was assumed to be less than half this amount.

In addition to completing two more acquisitions this year to create the best hydroponics portfolio the world, I believe we also assembled the best collection of talent in the industry, as well. Hawthorne also introduced two new craft brands in 2016. They successfully introduced Black Magic into 165 Home Depot stores. And EcoScraps, a brand we acquired last year for only a few million dollars, got broad distribution that resulted in sales approaching $10 million. Those are the kinds of craft brands I began discussing with you all two years ago. While it will take some time to get enough scale for the craft business to add to the bottom line, these investments are necessary as we begin to market to the next generation of gardeners.

It wasn't just the sales and marketing teams that drove our results. Our supply chain did an outstanding job as well. This is especially evident in distribution, where our service rates increased, and our costs decreased. Many of you know we experienced some distribution challenges in the prior two years, so we're extremely pleased with our progress here. Their efforts, which Randy will discuss in more detail, helped our gross margin rate land on the high end of our guidance.

We had strong expense control throughout the entire Company. And all of this resulted in an adjusted EPS of $3.75, which landed in the guidance range we provided a year ago, even though the dilution from TruGreen was more than double what we had originally expected.

Let me spend a few minutes on TruGreen, because we'd be less than honest if we said we weren't disappointed. I want to stress that the JV itself is going fine, and we remain confident that the $50 million in cost synergies will be achieved over the next year. I am disappointed, though, because we told you the dilution would be $0.10, and the reality was $0.22. About half of that added dilution was based on a conservative view TruGreen took on their opening balance sheet. While we would have taken a different view, ultimately it's their call. To me, that matter is just noise.

The rest of the miss, however, is related to poor operating expenses down the stretch. To be clear, the JV earned about 20% more than last year on a pro forma basis. But execution in August-September was short of plan. As we head into the off-season, we are working closely with our partner to ensure the business gets back on track by the beginning of next season.

As I said earlier, though, when I look at the things we control, I couldn't be more pleased with how things came together this year. I'm proud of the team here at all levels of the organization, and I want to thank them for their efforts, and our shareholders should as well.

Mike likes to talk about the concept of one team when he's talking about our associates. And those aren't just words. I'm usually not a cheerleader type; when I look at what this group has accomplished in the past 24 months, I honestly shake my head. We've transformed our portfolio, our culture, and our attitude. We're bullish in the future, and everyone here buys into our plans.

Our rally in the back half of the year is further evidence of what I mean. I've been involved in this category for most of my life, and I cannot remember four consecutive seasons in which weather disrupted the entire industry. But that's exactly what happened again this year during a critical six-week period spanning the beginning of April through the middle of May. But for the fourth straight year, we were able to successfully navigate those issues.

The quality of our information, the transparency we've created in our daily communications, the commitment of our retail partners, and the character of the people on this team have allowed us to significantly reduce the seasonal volatility of this business. We'll never eliminate it, but it's become less and less of an issue in each passing year. This is one of the biggest headlines you can take out of this call.

Whether it's in the core business or in Hawthorne, I feel really good about the plans we've created for next year. Retailers remain highly engaged. And I can tell you, their support for our brands is evident in our top-to-top meetings.

As you saw in our press release, the midpoint of our EPS guidance for 2017 suggests about a 12% improvement. We continue to expect the same consistent performance out of our core business. We expect the hydroponic category to deliver double-digit growth. Gross margins should be a tailwind again next year, and we plan to repurchase roughly $300 million of our own shares. Randy will provide more details, but I feel good about the plans and our ability to execute it.

Before I turn the call over to Randy, I want to come full circle. My leadership team and I spent much of the last summer knitting together the strategy behind Project Focus. We did it because we believe we could deliver real value for our shareholders. The day before we announced the plan last December, our shares were trading at $65. Two weeks ago, they were at $89. And over the past year, we have also returned nearly $2 to shareholders in dividends. But we weren't looking to drive a pop in the stock. We were looking to drive long-term value.

I'm not going to sit here and try to put a price on our equity; I'll leave that to you guys. But I will say that we continue to buy our own shares because we continue to believe we have upside from here. More than that, we're making changes to our executive comp plans that more closely align our five-year plan and our incentive plan.

In other words, we're willing to put our money where our mouths are. We'll share more details about those plans in the months ahead, but our goal here is to more clearly and closely align our pay to driving shareholder value. We can't control the markets and macro issues that affect our valuation. But we can design plans that are more aligned with driving cash flow, operating income, and return of cash to shareholders, and other metrics that are fundamental to driving shareholder value.

If that sounds optimistic, it's because I am.

So let me just close on that thought, and turn things over to Randy to discuss the numbers.

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

Thank you, Jim, and hello, everyone. Like Jim, I'm extremely pleased with the results we're announcing today. When you look at the pure operating results of the business, there's a lot to celebrate. We hit our sales guidance with an increase in revenue of 4%. We hit the high end of our gross margin guidance with a 170 basis point improvement. SG&A up 4%, in line with sales growth, even with deal costs, higher variable compensation, and acquired SG&A. And adjusted pro forma EPS was $3.75 per share, even though our equity investment in TruGreen delivered a disappointing result. More on that later.

I'm going to briefly run through our year-end financials, but I want to spend the majority of my time focusing on our initial guidance for 2017, and to share with you some of the good news we see on the horizon. But let's start with the 2016 numbers.

Remember that we had a shift in our fiscal calendar this year which led to five fewer days in Q4. The shift reduced Company-wide Q4 sales by about $37 million; and, of that amount, $27 million impacted the US consumer segment. The calendar shift had zero impact on our full-year results.

Company-wide sales in Q4 increased 7% to $402 million. And as I stated earlier, sales increased 4% on a full-year basis to $2.84 billion. In US consumer, sales were essentially flat in the quarter because of the calendar shift, but we were up 2% on a full-year basis.

You might recall that we said our last call that we expected US sales to be roughly flat, so you can see here that the business really rallied in the last months of the year. The momentum we saw in September has carried into the new fiscal year. October POS was up 8% against a very strong comp. And I'll reinforce what Jim said earlier: retailers are working to make sure their inventory levels are clean at the end of the season, so we expect to enter the spring selling period in really good shape.

Our European consumer business declined 15% in the quarter, but if you exclude the calendar shift it would have grown about 4%. On a full-year basis, sales in Europe declined 10%, or 6% excluding FX. The decline was due to the closure of Solus, a small business in the UK. Absent that, the European segment was flat on an apples-to-apples basis for the full year. The best performance were in Germany, Austria, and Poland. Despite a difficult spring, the UK business recovered to finish in positive territory, excluding the impact from Solus. I'll come back to Europe in a few minutes and elaborate on where we stand with our efforts related to exiting this business.

The other category, which includes Hawthorne, Canada, Asia Pac, and a small supply agreement, was up 70% in the quarter and 33% for the year. Acquisitions drove the majority of that growth. That said, as Jim said earlier, General Hydroponics was up 24% and easily surpassed our internal expectations. That business continues to benefit from a fast-changing marketplace. The other hydroponic businesses we bought this year, Gavita and Botanicare, also grew north of 20%, although their results aren't fully reflected in our P&L this year, given the timing of the deals.

On the gross margin line, we had an outstanding result. Lower commodities, distribution cost reductions, and the new Roundup agreement, as well as pricing, led to a gross margin rate improvement of 30 basis points in Q4 and 170 basis points for the full year, both on an adjusted basis. But the most encouraging story on the gross margin line was product mix. For years we have suffered from a material level of negative mix, as our mulch business grew and our lawn fertilizer business struggled. At the midway point of the year, it looked like mix could be a headwind for us again. But the strong second half allowed mix to be essentially neutral on a full-year basis, which is an encouraging data point as we look ahead to next year.

The SG&A line is another good story. As we expected entering the year, SG&A mirrored sales growth as the organization remains disciplined on how we spend money. The equity income line of the P&L, nearly all of which is related to our minority investment in TruGreen, is the one area where I, like Jim, and disappointed. But it's also the one line where we have little direct ability to impact the result.

On an adjusted basis, excluding restructuring and other one-time charges related to combining Scotts LawnService and TruGreen, our equity income was $6 million in the quarter and $19.5 million on a full-year basis.

Let me elaborate a bit on Jim's comments regarding dilution. The difference between our initial expectation of $0.10 and the actual dilution of $0.22 is divided roughly evenly between a higher-than-expected level of non-cash amortization and lower-than-expected operating results in August and September. Recall on our last conference call, I adjusted our outlook and said the dilution would be at least $0.15. That was related to a moving target for amortization, but I did not believe the number would be any greater than $0.17.

The operating results in the last two months of our year led to the additional dilution, and I did not have visibility to that during our last call with you. Let me reiterate, however, this recent operating performance has no impact on the $50 million of cost synergies we still expect to realize by the end of calendar year 2017.

Getting back to the P&L: interest expense, tax, and share count all finished in line with our previous outlook. That gets us to a seasonal fourth-quarter loss from continuing operations of $20 million or $0.33 per share on a GAAP basis. On an adjusted pro forma basis, the loss is $19 million or $0.30 per share. For the full year, GAAP earnings from continuing operations were $253 million or $4.09 per share. On an adjusted pro forma basis, we earned $233 million or $3.75 per share. That compares to $219 million or $3.53 per share last year.

So the income statement is a good story for us. Cash flow, however, was a bit weaker than we expected. We're still finalizing a few things here and there, so the cash flow statement is not included in our results today.

Given the amount of time between today's call and our filing of the 10-K, I wanted to tell you what to expect. Operating cash flow, which I'd expected to be at least $275 million, will likely be less than $240 million. All aspects of working capital were negatively impacted by the timing of the season, and fell short of plan. While the shortfall is not huge, this disappointment is exactly why cash flow will become an area of much greater focus for us going forward.

For 2017, a portion of our variable compensation will be tied to cash flow. And our long-term equity plans will evolve to have a performance metric tied to cumulative cash flow over the entire vesting period. We've done a great job over the past several years driving consistent performance out of the P&L. and now we've got to put that same level of focus of cash flow.

Since I breached the topic of 2017, let me shift and provide a more detailed look at our initial guidance for the year.

On the top line, we expect sales growth in the range of 6% to 7%. This is what you've seen in the past; roughly 1% to 2% from our core business. and the balance from Hawthorne and related M&A from deals that have already closed. Roughly speaking, M&A is worth about 4% and organic growth from Hawthorne will be adding 1% on a Company-wide basis. We expect gross margin to improve another 50 to 100 basis points due to favorable commodities, supply chain improvements, and pricing. M&A will be a slight headwind to the gross margin rate, and we expect product mix in the core to be neutral.

On the equity income line, we expect the year-over-year results to be flat. We expect about a $14 million contribution on the other income line, attributable to various licensing agreements as well as our investment in Bonnie. Interest expense will increase approximately $20 million next year, reflecting an assumption that we'll have more fixed-rate debt, and this will more than offset the effect of share repurchases.

Given our current plans, we expect share count of roughly 60.2 million. Taking all of this down to the bottom line, we expect pro forma earnings per share of $4.10 to $4.30 per share compared with $3.75 this year.

As we look ahead, I want to clarify a key point we've been making related to our long-term operating margin goals. When we outlined Project Focus last year, we said we believed we could take our operating margins from 12.9% in 2015 to 18% over a multi-year period. When we first announced that goal, we expected our earnings stream from TruGreen to be booked as other income.

As you know, our earnings from the JV are actually being booked as equity income, which means they are not considered income from operations, and should not be included in the operating margin.

Instead of creating a complicated calculation to match our original guidance, and to avoid confusion going forward, we are now excluding the equity income line from our future discussion of operating margin. While that negatively impacts the operating margin goal we originally targeted for 2016, it does not impact our long-term goal.

On an adjusted basis for 2016, income from operations, divided by sales, gives you a margin of 14.8% compared to 12.9% a year ago. That number includes corporate costs and amortization.

Using this calculation, which is consistent with what has been on the face of our P&L for years, the guidance I just provided for 2017 would deliver margin of roughly 15.5%. If you assume that we eventually exit our European business, you pick up another 100 to 120 basis points on top of that. On a pro forma basis, that would be 16.5% or slightly better. That gives us three years to achieve our 18% target, which we believe remains achievable, absent a major disruption to our business.

Since I'm on the topic, let me elaborate a bit more on what's happening with Europe. As you know, our discussions with a potential JV partner broke down in early spring. At that point, we decided to keep our heads down through the season to focus on the near-term tasks at hand. As the summer wound down, however, we began a formal process to explore our options for this business.

As Jim said earlier, we are confident that our business is the best in the European lawn and garden marketplace. So we believe our business would be extremely attractive to either a strategic or financial buyer, and we've had preliminary discussions with both types of investors. While the outcome is still unknown, our goal is to have a final answer on how we'll move forward with Europe in the near future. Our bias to exit has not changed, but our commitment to getting an attractive price for this business has not changed either.

Before I close, I want to thank our analysts and shareholders for their patience this year. We've had a lot of moving parts as we've executed Project Focus, and at times it's been a complicated story. But as we began to wind down our M&A efforts, work through the integration of the deals we've done, produce better results with our new partners at TruGreen, and bring closure to our efforts in Europe, we will be a stronger and better company.

This year will mark my 18th year with Scotts, and my third as CFO. And I'll tell you, as objectively as I can, that I've never felt more confident in our plans. The challenge going forward is to continue to execute those plans. And based on my knowledge of the people I work with every day, I'm confident we'll succeed.

With that, let's open up the phone to take your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Olivia Tong, Bank of America.

Olivia Tong - *BofA Merrill Lynch - Analyst*

First, just two housekeeping questions. Given the shifts in days for fiscal 2016, can we talk about just the cadence of core through 2017? Is it similar to 2016, or is there a different base now? And then also, can you provide what's the ex-acquisition sales growth? You guys talked about it for the outlook, but just wondering what it was for Q4 of fiscal 2016 as well. Thanks.

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

Sure, Olivia. So your first question on the day shift, actually there will be no impact next year, so it will be apples to apples 2017 versus 2016. And we won't have to talk about calendar shifts, thankfully. That will make life easier for everyone. Regarding your question on Q4 sales, the impact of acquisitions in the quarter was about $32 million.

Does that answer question?

Olivia Tong - *BofA Merrill Lynch - Analyst*

That's perfect. Thanks for the clarification. I appreciate that there's no day shift impact in fiscal 2017. A few other questions. First, in terms of the fertilizer business, you guys said sales were down 4%, but volume flat. So can you talk about the pricing environment there?

Mike Lukemire - *The Scotts Miracle-Gro Company - President, COO*

Mike can't talk?

Olivia Tong - *BofA Merrill Lynch - Analyst*

Oh, sure.

Mike Lukemire - *The Scotts Miracle-Gro Company - President, COO*

(laughter) No, these guys were watching baseball last night, so they are acting a little stunned.

Olivia Tong - *BofA Merrill Lynch - Analyst*

It's been 108 years, so (laughter).

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

No, it's not -- on POS, there's actually -- as we cleaned out the inventories, the POS numbers are actually -- look lower because of discounting to clean out the inventory. It's not a matter of pricing at all. So, we're very bullish about where we're at on fertilizer. We did take our pricing and we had a really good summer on SummerGuard. We reintroduced that, which lifted sales and brought us back to flat.

But listen, Olivia, what I would say is, it is a competitive marketplace out there at the retail level. And so my expectations -- and I don't think they should blame us; I think they should look at themselves in the mirror -- is they want to play in these categories and they are willing to play hard. I think what you saw in the second half of the season -- and that's the difference between minus 4% on dollars POS at the end of the year, and flat on units -- is just a very competitive marketplace at retail.

So I think there continues to be very competitive processes at the retail level? But I think, for us, when the weather -- and it was a really nice summer and fall for us, so I think the business recovered a lot better than we thought it would. So I think it's more at the retail level that you continue to see a lot of pressure on pricing. I'm not saying that's a good thing or a bad thing; I'm just saying that the retailers shouldn't blame us; they should look in the mirror.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it.

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

(multiple speakers) piece of that?

Mike Lukemire - *The Scotts Miracle-Gro Company - President, COO*

No. I'm really pleased with our retailer support on all our businesses right now.

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

No, they just want to play (multiple speakers).

Mike Lukemire - *The Scotts Miracle-Gro Company - President, COO*

So I'm very happy with our partners, yes.

Olivia Tong - *BofA Merrill Lynch - Analyst*

What's embedded in terms of your outlook on pricing for fiscal 2017?

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

We'll, as we indicated, continue to look at pricing. So we will see some benefit next year. We haven't absolutely finalized conversations with retailers yet. But we feel good about the margin accretion we'll see next year through a combination of commodities continuing to be favorable and pricing that we will take on a targeted basis in certain categories.

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

But if I could just challenge the group, I would be disappointed if I wasn't seeing sort of 0.5% of margin accretion on an annual basis.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. And then just in terms of the JVs and the M&A, and things like that, and then I'll hand it over. But two things you talked about. First, what does more Bonnie-like acquisitions mean for margins, and also the supply chain, given the live goods? And then your fiscal 2017 outlook, which suggests that you have embedded in your expectations what seems like a slight loss for TruGreen at the midpoint. And you talked a lot about obviously you're disappointment with where it ended the year, but a lot of the activity that you're doing in terms of the quiet -- the off-peak part of the season.

So, can you marry those two statements in terms of where you're starting point is, and what you are planning to do yet in the expectation for perhaps a slight loss from TruGreen in fiscal 2017? Thanks so much.

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

All right, Olivia, thanks. That's a lot. I'll take the plant one, and I think I'll hand over TruGreen to Randy. Look, I think if you look at our -- what I think we've been calling reconfiguration, which is primarily a North American exercise, here -- whether it's hydro, rodenticides, live goods, what we're really doing, if you look at it, is we're acquiring into growth; higher growth than we're seeing in our lawn and garden chemical business. And I don't mean that in a bad way. I love that, okay?

So, we like live goods. And we're seeing, particularly with Bonnie, a growth rate that is, I'm going to say, 150% to 200% of what we're seeing in our core. And we're seeing a lot more than that on the hydro side. So what we're really doing is saying we're not going to be left behind in growth. If we see categories that we like that are getting above-average growth, we're going to buy into that space.

We like, I think, the creativity. And I'll give Randy a lot of credit for it, of how we did the partnership with Alabama Farmers Co-Op and Bonnie. And Mike and I, as operators, I think, both like live goods. And we think there is very interesting areas. And I don't want to go too specific, because we're in some discussions and I don't want to shoot myself in the foot.

But we do believe that there are other, not huge, acquisitions that involve similar kind of deal structures, where we take a minority interest in other high-growth categories. And so I think you are probably likely to see some, I would say, modest coastal deals, both East Coast and West Coast, as we continue to fill out to the areas. And I'd be happy to talk, next call, more specifically about it. I think it will become more clear. But I just think the problem is that because we're in discussions and pricing is an issue, I just would rather keep clean on that, and I'll tell you more later.

But I think Mike and I like live goods. They are growing at a rate, call it, 2X what our core is growing. And I think that's all we're doing, is we're discarding some cards that are lower growth or maybe better that somebody else could run, like TruGreen. And we're acquiring cards, or picking up cards that we think have higher growth rates.

Now, on the margin side of it, this is a little bit the conflict with Randy, who if you look at really what my job and Randy's job is, it's very much a corporate allocations issue of allocating resources, capital, et cetera. And Randy has a giant, outsized vote in that, even with me.

Margins on live goods, they are better than dirt. But they do challenge this 18% that Randy throws out there. And so, that's part of the internal discussion, is when we look at pricing of this allocation of very finite acquisition dollars relative to hydro, Randy is a pretty tough partner on this. So it's something that we're discussing now.

But I'd say, in general, live goods, whether it's Bonnie or any other deal we are looking at, those margin rates tend to be challenging for the 18%. And I don't think it means we don't do it. It just means that we have to look in that relative to our entire long-term plan.

And remember, we look to close the M&A book pretty tightly in this quarter, or damn near. And we got to get it from Randy. So Mike and I are pretty enthused. Randy, we need a little more work on. And that just means that I think there's a good process internally.

And I don't know if you want to pick it up at that point.

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

Maybe that's a good transition to the TruGreen question, how about that? (laughter) Olivia, regarding your question about TruGreen, when you think about putting together two organizations that are as decentralized as they are -- we had 100-plus branch integrations over the summer -- and, not surprisingly, we're seeing some challenges that come out of that as we focus on the fall.

Mike Lukemire and I were in Memphis yesterday, and confident the team's on top of what we need to do; that we're going to get the execution where it needs to be for next year, especially heading into 2017.

And in the long run, still think this is a fantastic deal. The $50 million of synergies, we will have that realized by the end of next year. And to keep some perspective, even though August and September didn't finish as we expected, we're still expecting full-year earnings for this business to be up 20% year-over-year on a pro forma basis. So the outlook is bright. We are having some recent hiccups that we're dealing with.

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

But the bottom line is this balance sheet issue is going to go into next year, as well. And I think we probably reduced our expectations a little bit in our internal budgets for TruGreen for next year, as a result of what we're talking about.

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

Right. The non-cash amortization piece, which Jim referenced as the balance sheet -- we will continue to see that going forward. And that will be a permanent drag on EPS of $0.05, $0.06, $0.07 versus what we had assumed, call it, a year ago when we were originally planning the deal. That is what it is.

We're focused, like Jim said earlier in his script, we're focused on operations and executions, and making sure the business is going to run well. And we think, in the long run, we're still in a really terrific place.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Understood. Thanks, guys, for the color. Appreciate it.

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

That was question one? (laughter)

Operator

Joe Altobello, Raymond James.

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

Since you are talking about that TruGreen JV here, if you could help us out, tell us what that business earned in fiscal 2016, and maybe what you guys are thinking in terms of what that equity income line will look like in 2017.

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

Sure, Joe. When we think about TruGreen, we think about it on a calendar-year basis, which is the way that that business reports. And on a pro forma basis, last year calendar 2015, the EBITDA of that business was about $125 million, combined. And we expect that number, calendar 2016, to be between $150 million and $155 million. And that's with synergies of that $50 million bogey that we talk about. There's only about $10 million that's been realized in 2016, so we should see another $40 million in 2017.

But in addition to that, the way we are booking our equity income, there's a lot of interest from the partnership being highly levered. So we'll see a year-over-year increase in interest from another six months. And in addition to that, the non-cash amortization will have another six months. So you factor all of that in, and perhaps we are taking a conservative look when you add it all together, but we're planning right now for our equity income from the investment to be flat next year. And I think that's a reasonable outlook right now.

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

So when you say flat, you say flat with the $19.5 million?

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

Yes, flat with our result that we'll deliver for fiscal 2016.

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

Got you. Thank you. And shifting gears a little bit to hydroponics, obviously a lot has been written about states voting for marijuana legalization from a recreational standpoint. And there's a very small sample size; I think four states have approved it for recreational use. But in your experience, what's been the impact on the market, and demand for hydroponics, when states do vote to approve it for recreational use? Is there a big increase in the size of the market, or everyone who uses it is already using it, at this point?

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

Hey, Joe. My lawyer is sending -- we only sell dirt and fertilizer (laughter). No plants. That's the legal part. I got that thrown out there.

Joe, I think that we figured this question, and we're asking the same questions to our team as well. I think our view is that -- and this doesn't mean we get all this, but you're seeing numbers I think anywhere from -- expectations if California, which is pretty robust and a low bar for getting a medicinal referral, which is what they call a prescription, is a pretty established market.

I think that view is, you see as high as it will get 3X. I think what we're saying is we feel pretty comfortable saying that the legal market, in states where they go recreational is -- I'm going to say at least 2X the size, after going recreational. And that's based on our folks, who I think are pretty experienced saying --. That doesn't mean that the illegal market goes away, but that the legal market benefits pretty greatly from that. And we're not saying that we move along with that. But I think if you are saying, what do you think happens, I'd start with saying, at least for people who sell into the hydroponics category, it's good.

So it's not neutral or negative; it's positive. And I think if we were saying to you, what's a pretty reasonable number, we'd say 2X.

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

And long will it take that doubling in the market to occur? Is that in one year or two years?

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

See, this is the one where I'd say it's a little harder to say, in that some of these recreational markets that basically started out, like, it just went recreational, I think you are seeing real fast growth up front. I think that it depends on the laws, which is how long does this stuff phase in?

We were out in Las Vegas -- I guess that was last week? Seems like a month ago now -- and met with the governor. One of the things we were talking about, in addition to water, was what's happening on their laws. I think if it passes in Nevada, I think you'll probably take -- it phases in over a year.

So I think it depends on the states and it depends how established the medicinal market is and how tight the medicinal market is. But I would say a couple years, probably.

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

Okay. Great, that's helpful. Thank you, guys.

Operator

Bill Chappell, SunTrust.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Just a couple things. Looking at this clarification on your guidance for next year: one, on share repurchase, if I do roughly $300 million at $90 a share, it takes about 3 million shares, 2.7 million. That seems like that your share count would be lower than what you're forecasting. So, didn't know if there was any change in terms of the pace that you were thinking about as the stock has moved up, or just trying to be conservative, or if there are new stock options that Jim is getting that I haven't accounted for.

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

Don't blame this on me, dude (laughter).

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

Bill, it's a couple things. One is we need to repurchase about 50 million a year just to offset the impact from dilution from stock options being exercised. That's a pretty consistent number over time. And the other thing is, we do expect to see the majority of that $300 million to be more in the back half of the year. Not because of where the share price is right now, but just as we manage through our M&A pipeline over this quarter, and likely now into the second quarter, we just want to make sure we're managing our cash appropriately.

But the $300 million number is solid. And it is somewhat the phasing, which is going to help you with your math as you reconcile back to that number.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay. And did you do any share repurchase in the fourth quarter?

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

We did about 50 million in the fourth quarter, and we are planning another 50 million in the first quarter with a 10b5-1.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay. Second, just as it looked -- you talked about pricing; but on the commodity basket looking forward, with urea at, at least, seven-year low, I think you are largely locked in on most of your commodities. I don't have an update on Canadian peat. But can you maybe give us an outlook on where you stand? Because I would think there's a pretty nice tailwind.

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

It is a nice tailwind, and I would quantify it as a double-digit number again. Not as significant to the P&L as what we saw in 2016, but will be a nice accretion again. A lot of that coming from fuel, a lot of that coming from urea. Peat is a slight headwind, but not materially so. And then typically in our grass seed business, different varieties are up and down. And then resin is always a bit of a wild card because we don't hedge that one; so that one, we'll see as we go. But confident in the number of, call it, $10 million of benefit to the P&L for next year.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay. And then last one: on the acquisitions, are you expecting them to be -- the ones you've done over the past six months -- neutral to earnings, dilutive to earnings next year?

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

They will be accretive to earnings. On the gross margin rate, depending on the deal, they can be a bit dilutive to our average, which continues to get higher. But from an operating margin rate, the deals we've done will all be accretive, and they will be accretive on an EPS perspective next year.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Got it. Thanks so much.

Operator

Eric Bosshard, Cleveland Research Company.

Eric Bosshard - *Cleveland Research Company - Analyst*

Curious in the hydro space -- I know you've talked about really sitting tight with the acquisitions in the portfolio you've put together. But curious as the market goes from -- call it an individual, personalized market to perhaps a more of a commercial market, if you have the right assets or if there are opportunities for you, or a need for you to acquire additional assets to participate in what looks to be an industry that's going to grow pretty significantly and perhaps change in terms of who the players are.

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

Good morning. What I would say is, it's a good question. I think we have the right assets. Start with that. The question is, do we need a little bit more? And within our existing pipeline -- and this is becoming, I think, more and more clear to us. I don't think that Chris and his team, whether it's in New York or in California, believe they need a lot more stuff.

I do think that there are some opportunities. We are continuing to work with both individual states and the EPA for special -- for the first time ever, registrations that allow pesticidal products to be used on -- and we'll be the only one offering pesticidal products that can be used on cannabis. So I think that's an opportunity for us.

If you look at what we're really trying to create -- and again, I'll go back to Ivan -- and it's fertilizers and growing media, lighting, hydroponic plastic systems; to some extent, precision irrigation, which is an element or an offshoot of hydroponics, but it's drip systems for use.

These are professional growing systems. And so I think if you say we want to be a great partner to people who grow stuff, but also high-value stuff, I think there are some opportunities for other stuff that are used, especially in indoor growing environments.

And I don't think -- these are not huge. But I think there's types of air handling equipment and other stuff that would fill the line out. Some other kind of pots, which is what people would put the smaller plants in, that are opportunities. Again, not huge; but I think that -- our view is that -- the deals that we've wanted to get, Eric, we've gotten done. And we've retained the leadership group in all these companies. We've retained -- and I really view this as a massive brain trust. And it's not like a bunch of Marysville people; these are, I think generally, really good businesspeople. But they're younger, and they are more tattooed up, and they're pretty aggressive. I know Luke likes to hang out with them.

And I view them as pretty good people. And they know what they need, and they don't have a giant basket of stuff they need. I think their view is that what we need to do in the next year is integrate this stuff, maybe a little bit of just filling in some gaps in the line. But I think within where the law is today, at least for us as a national public company, I think nutrients, lighting -- we're looking at potentially filling out with a little more lighting, especially on the mid-tier side; plastic, pesticides, irrigation, hydro systems, and more -- some products that would be used in the greenhouse for control of temperature, and humidity and air, just movement in general.

So again, so not huge; but I think you fill that in, put it together with a highly professional, technical salesforce, and I think you've got something going there. And then combine it with I think the best management team, both within Chris's part of the business and then all the hydro deals where we have retained people who are the owners. And they want to play and they see where this goes.

Chris has a meeting next week of what we're calling all his warlords to plan out the future and how to manage this, how to organize this, how to fully exploit this position that we've created.

And I got to say, I wasn't invited. I get to come in and rah-rah, and then I'm supposed to leave and go to our Board meeting in Florida. But I'm really looking forward to hearing what comes out of it. Because I think this is where very experienced hydro people are going to get together and say what does -- what do we need to do over the next two or three years to fully exploit these investments?

Eric Bosshard - *Cleveland Research Company - Analyst*

That's helpful. One follow-up. And to take a half a step back, strategically your existing legacy business has 50%-plus market share with the do-it-yourself customer, and is geared to supply the do-it-yourself customer. In this new space, all there's been is essentially a do-it-yourself customer. And as the market grows markedly going forward, are you trying to position this for the do-it-yourself, grow-it-yourself? Or are you trying to position it for the commercial market? In other words, where do you think the business is going, and where do you position yourself to participate?

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

All right. So, this is one of those questions where I could get -- my son could try to grab me through the wire of the phone and try to strangle me. I disagree, Eric, with what you said. I don't see that this marketplace has -- if you go to places like California, Washington, Colorado, Oregon, Nevada -- so I'm going to say Rocky Mountains West, where I think if somebody said 80% of the market is there, I wouldn't be surprised by it, but I could be wrong a little bit. I don't think it's very much a consumer market there.

There are people who grow for themselves. But I think, largely, these are people who are lots of small growers supplying into the legal dispensary market. And I see that these are small but professional growing operations. So, that's just looking backwards.

Looking forward, we are focusing this business more as a professional supply business than we are a non-expert category. So I think we're very much seeing that we believe there will be a professionalization of the space and that we aim to please in that market.

And we've done that before. Remember, our pro hort business was, at least in the spaces we operated -- which we sold, as we focused on consumer, to the Israelis -- we were the world leader in these kinds of products. So this is a kind of business we understand well. So we're looking -- I think I have answered the question.

Eric Bosshard - *Cleveland Research Company - Analyst*

Okay. Yes, you have. That's helpful perspective. Thank you.

Operator

(Operator Instructions). Jim Barrett, C.L. King and Associates.

Jim Barrett - *C.L. King & Associates - Analyst*

Randy, I think this is a question for you. TruGreen, on a calendar year-to-date basis, or however you think about it, can you tell us what the top line was, and how much of that was price, how much of that was customer growth? And then, finally, what are the customer retention rate trends at TruGreen currently?

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

Yes, sure. So on the top line, we're expecting the business to grow about 1 point this year, combined; so on a pro forma basis. And as far as pricing, there is essentially no real net pricing in that number for 2016. We do anticipate pricing as part of the plan for 2017, though.

And as far as retention, retention has been pretty consistent with what we've seen in history, whether we're talking about LawnService or TruGreen. Some of the challenges we've had on the sales line haven't been retention as much as just the sales process, and trying to add new customer count.

And I think that's related largely to just integration of branch by branch. And part of what we're doing for next year is figuring out what that selling story is going to be when someone knocks on the door, or contact consumers in different ways. We're working on the marketing for how we talk to consumers in the mailers that go to homes and online. So, a lot of work being done on that right now.

And we're thinking next year that we'll see an increase in the top line again, more consistent with what we've seen in the past, which is, call it, in the mid-single-digit range.

Mike Lukemire - *The Scotts Miracle-Gro Company - President, COO*

A more focused marketing approach for next year.

Jim Barrett - *C.L. King & Associates - Analyst*

And as a follow-up, do you think the market currently is growing 5%?

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

Well, when we think about -- from competitive issues or market share, we don't think there's been any kind of a move from the one national lawn care provider now of TruGreen to smaller businesses. I think in the past, when we've been growing faster than that, we've been growing the category as well. It hasn't necessarily been a market share move from folks with pickup trucks to the national lawn care. We think we've been growing the category, and we expect that to resume again next year.

Jim Barrett - *C.L. King & Associates - Analyst*

Thank you very much.

Operator

Jon Andersen, William Blair.

Unidentified Participant

This is actually Luke on for Jon. Most of our questions have been asked, but we just had a quick one on the gross margin guidance. I know we talked a little bit about commodities. But can you just walk us through the other parts and takes to the [50] basis point increase in gross margin next year? Thanks.

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

Sure. So in addition to commodities, we will see pricing -- and Jim put a number on it of about 50 basis points increase across the Company. Those are the two primary drivers. We continue to see supply chain savings from projects in six-quarter plan processes that we do. Some of that will be offset by raises across our 40-plus plants across the US footprint. But it's largely commodities with a better pricing that are the two key drivers for what's going on next year.

Unidentified Participant

Got it. Thank you. That's all for us.

Operator

With no further questions at this time, I'd like to turn the call back to Mr. King for any additional or closing comments.

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

Thank you, I appreciate it. Thanks, everybody, for joining us this morning. If there are follow-ups, or things that we didn't get to, feel free to reach out to me directly either by email, Jim.King@Scotts.com, or call my office directly at 937-578-5622.

Thanks for joining us today. The next scheduled call will be at the beginning of February. And then a reminder to everybody that our Analyst Day event will be in Boca Raton on February 21, and hope to see a lot of you there. Thanks, guys. Have a great day.

Operator

And again, that does conclude our call for today. Thank you for your participation. You may disconnect at this time.
