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SMG - Q3 2014 Scotts Miracle-Gro Co Earnings Call

EVENT DATE/TIME: AUGUST 05, 2014 / 1:00PM GMT

OVERVIEW:

SMG reported 3Q14 Co.-wide basis sales of $1.12b and adjusted net income from continuing operations of $146m or $2.34 per share. Expects 2014 Co.-wide basis sales growth to be 1-2% and to land in high-end or slightly exceed full-year guidance of $3.05-3.20 per share.

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CORPORATE PARTICIPANTS

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

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

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

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

Mike Lukemire *The Scotts Miracle-Gro Company - EVP of EVP of North American Business Unit*

CONFERENCE CALL PARTICIPANTS

Jason Gere *KeyBanc Capital Markets - Analyst*

Alice Longley *Buckingham Research - Analyst*

Joe Altobello *Oppenheimer & Co. - Analyst*

Olivia Tong *BofA Merrill Lynch - Analyst*

Connie Maneaty *BMO Capital Markets - Analyst*

William Reuter *BofA Merrill Lynch - Analyst*

Jon Andersen *William Blair & Company - Analyst*

Jim Barrett *CL King & Associates - Analyst*

Andy Brown *Longbow Research - Analyst*

Bill Chappell *SunTrust Robinson Humphrey - Analyst*

PRESENTATION

Operator

Good day, everyone, and welcome to the Q3 earnings conference call. Today's conference is being recorded. At this time, I will turn the conference over to Mr. King. Please go ahead, sir.

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

Thank you. Good morning, everybody, and welcome to the Scotts Miracle-Gro third-quarter conference call. With me today in Marysville are Jim Hagedorn, our Chairman and CEO; Barry Sanders, our President and Chief Operating Officer; Randy Coleman, our Chief Financial Officer, and several other members of the management team. In a moment, Jim will provide a high-level overview of the current state of the business. Barry will provide the details and context of our Q3 results, as well as our overall progress year-to-date; and then Randy will walk through the financials and the implications of our year-to-date results on our full-year outlook.

After their prepared remarks, we will open the call to your questions. In the interest of time, we ask that you limit your time to one question and one follow-up. If there are questions that we don't address, we are glad to handle those with you off-line.

I want to remind everybody that our comments this morning will contain forward-looking statements. As such, actual results may differ materially. And 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.

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

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

Thanks, Jim. Good morning, everybody. I'm going to keep my comments brief this morning and leave the details to Barry and Randy. But I did want to take a few minutes to say -- and I'm very pleased with the results we announced today; even more pleased with the focus that the team has shown throughout the season.

Pleased probably isn't the right word, come to think of it. I should say I'm proud of the results we posted today, and I'm proud of our team for getting it done -- again. Two years ago, after our Q3 results in 2012, I told you we'd refocus the business. In recognizing that it's a flat world, we weren't going to swing for the fences any more. We'd manage the business for 1% to 2% growth. We'd focus on getting our margins back in line. We'd focus on cash flow, and we'd adopt a capital structure that returned more cash to shareholders.

Since then, we've had back-to-back years of extremely poor spring weather. In fact, record bad weather. Sales in both years got off to a slow start. And by May of both 2013 and 2014, it was clear we'd fall short of our sales goals as a result of the delayed start to the season. But we clawed our way back into the game day after day, week after week. In each of these two years, the team stayed focused, stayed patient, made smart decisions, and got us back on track to achieve our bottom-line goals. In fact, we are once again in a position that we might even exceed our original guidance.

While volumes will be short of our original plan, they will be better than we expected when we updated our guidance in June. POS over the past two months has been positive, despite double-digit comps. In fact, we just finished a record July, and that momentum has carried into August.

Additionally, we'll achieve the margin benefit we predicted, and we'll do better than expected in controlling SG&A, while also benefiting from lower than expected interest expense. And finally, our operating cash flow, combined with the flexibility of our balance sheet, will allow us to make good on our commitment to return $125 million to shareholders. We will be finalizing this issue with our Board later this week, and we will communicate more as soon as possible.

Even in committing to return more cash to shareholders, we were also focused on making sure we were properly investing to grow the business. At the beginning of this year, we acquired the TOMCAT brand from Bell Labs. And this fall, you'll see a creative new advertising campaign designed to take that brand to a new level. During the third quarter, we acquired some small brands in the UK that will improve the market position and profitability of that business. And we are close to finalizing another transaction that would be a nice tuck-in for our North American business.

Despite two of the worst spring weather seasons in my career in this industry, we've accomplished exactly what we said we would do. We made a commitment to our shareholders and we delivered. We made a commitment to our associates and we delivered. We are a stronger, smarter, more agile company than we were two years ago. And as I look ahead, I continue to like the path that we are on.

Over the past several months, we've aggressively attacked our expense structure. We've made some tough decisions and parted company with some old friends and talented co-workers. These were not decisions that I or anyone else here took lightly, but they were the best decisions for the long-term of this business. Heading into 2015, we are in a better position to support some of our core brands, like Ortho, that could benefit from a higher level of investment. And we're in a position to invest properly in quickly emerging areas like urban, organic, and hydroponic gardening.

We are not going to be too specific today about 2015, and we're not providing any guidance. But what you'll hear from Barry is that we feel good about the outcome of line reviews, of new product introductions, and of retail engagement. You'll hear from Randy that we feel comfortable with the commodity environment and our overall cost structure. So we continue to believe that we have some nice forward momentum, and that we can continue to deliver solid returns to our shareholders in what remains a pretty crappy environment for growth.

Our overall philosophy about the category in the marketplace remains pretty much the same. Growth remains hard to come by. So if we can do slightly better than GDP, we think that's a pretty good outcome. And our capital allocation strategy also remains pretty much the same. Returning cash to shareholders will continue to be a critical part of that plan.

Barry is going to cover the details, but I want to preface his comments by saying it's been a pretty good year, all things considered. So with that, let me turn the call over to Barry to share the details.

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

Thanks, Jim. I want to start by sharing the results of our European business. What we've seen there is exactly the opposite of the US when it comes to the impact of weather. While the US had a long winter and a delayed spring, Europe had just the opposite. The business got off to a strong start and they've maintained their momentum all year long. In the UK, our business is up 12% so far this year. We saw strength in every category and every brand. We are especially happy with our lawn care business, which exceeded even our stretch target, with sales up 17% in the quarter and 15% year-to-date.

In France, we've seen similar outcome, thanks to the strength of our pest control business. In that category, sales were up 37% for the quarter and 17% for the year. While we saw similar results across Europe, I won't give you a country-by-country breakdown, since the UK and France are by far the largest markets. All-in shipments for our international business are up 9% on a year-to-date basis, with earnings more than doubled from a year ago, which Randy will elaborate on in a few minutes.

Let's switch gears and focus on the US. The trends I shared with you on the last call are holding true entering the final two months of the year. We have had a strong year in our lawns business, a solid year in gardens, and we've seen some challenges in our control business. I'm especially encouraged by our lawns business. This is a category that had declined several years in a row, and then began to turn back in the right direction last year. The trend continues.

Overall, lawn fertilizer was up a little more than 1% in the quarter and is up on the same on a year-to-date basis. While this sounds minor, it's a pretty good result. Remember that fertilizer, historically, is the most important product at the break of the season. So to start with such a lousy results in March and April, and get to this level, is a good outcome.

Embedded within our fertilizer business is our Bonus S product, which is the single most important product we sell in the southeastern United States. We told you earlier this year that we were test marketing a new and improved Bonus S in two Florida markets this year. Consumer POS in those markets on average is up 9%, which is well ahead of the overall Bonus S business. The new formula is now being rolled out throughout the entire region for 2015. It will be an important new product launch that is being well-received by our retailers during line reviews.

We are optimistic that it will continue to lead positive momentum in the fertilizer segment. Grass seed and spreaders are the other two segments of the lawns category. In grass seed, POS was up 6% in the quarter and 4% year-to-date. And spreaders, which were flat in the quarter, are up 5% year-to-date as we continue to see strong consumer acceptance of Snap. I'm optimistic about Snap entering 2015 as we introduce a new lower pricing strategy that we are funding through related cost-out projects. We believe this decision will drive even more trials and enthusiasm for these spreaders.

In our growing media business, consumer purchases of soils were down 3% both in the quarter and on a year-to-date basis. When you break down these numbers, the business is slightly up in the home center retail channel and slightly down in mass retail. This is a trend we saw in most areas this season and is a point I will come back to in a moment.

The other big story in gardens is related to our new organic line. Recall that we were testing two concepts this year -- a new sub-brand called Nature's Care, against a sub-brand called Organic Choice that has been in our portfolio for several years. In head-to-head tests, consumers preferred Nature's Care by nearly a 2-to-1 margin. So we will put in national support, including media, behind the Nature's Care brand next year.

We continue to see the organic space as one that holds great promise, especially with consumers who enjoy growing their own herbs and vegetables. We've seen that the Nature's Care brand and the positioning resonates with consumers, and we believe there are strong opportunities for us with this brand, not just in 2015, but for the next several years.

Once again, this year, we've seen extremely strong performance in mulch. POS was up 19% in the quarter and are up 16% year-to-date. This is far better than we expected, so that's good news. On the flipside, mulch is a lower margin business, and so this level of growth has caused product mix challenges from a margin perspective. Randy will elaborate on this in a few minutes.

In controls, POS for our Roundup business is off slightly, down 2% for the quarter and on a year-to-date basis. But the category got off to a slow start that has come on strong in recent months. We are pleased with the consumer acceptance of our new Roundup 365 product, and expect even better results next year. The challenge in controls has been with Ortho. Our weed control business was down 13%, both in the quarter and on a year-to-date basis. Our outdoor insect business saw even steeper declines.

This has always been a highly competitive space, and that is certainly true for this year. Frankly, our competitors did a great job on price, on promotions, and on placement in the store. As Jim said earlier, our efforts to attack our expense structure is designed to free up dollars to better support those areas of the business that need it. And Ortho is the best example. For competitive reasons, I'm not going to elaborate, but I will tell you that we are focused on getting this brand turned around next season. It will be a primary focus for us.

Before I turn things over to Randy, I want to elaborate on my comments that we're seeing in different retail channels. In those retailers where lawn and garden is a clear destination category, we've seen solid performance. To be more specific, the overall growth we'll see in the home center channel in 2014 is in the low-single-digits. It will be slightly -- will be only slightly lower than we originally anticipated entering in the year.

Retailers in the home center continue to provide strong support for the category. And their consumers, who tend to be more affluent, and are going to those stores specifically to make lawn and garden purchases, remain highly engaged in the category. That, in contrast, is what we saw again this year in the mass retail channel. Even though retailers' support in this category has been strong, especially at the break of the season, consumer engagement has been weak. Right now I see a best case scenario of being a high-single-digit decline in consumer purchases in this channel of trade for 2014.

From a market share perspective, we are continuing to do okay, as we are flat with last year. So, the economically stressed consumer shopping at mass retail is not trading down. However, they continue to be more inclined to simply step away from the category. I've been holding top-to-top meetings with all of our retailers. In every channel, including the mass channel, they remain committed to the category. They remain committed to our brands, and we will see upside for 2015.

All in all, I agree with what Jim said earlier. We had to overcome a lot this year. We'll hit our bottom-line guidance, although with slightly less topline growth than we originally planned. Regardless, I'm encouraged by the resilience of our business after a slow start to the season, and I'm confident in our planning as we look to next year.

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

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

Thanks, Barry, and hello, again, everyone. Before I begin, I want to remind everyone of the divestiture of our wild bird food business earlier this year. So the numbers I'll be discussing, both for 2014 and 2013, exclude the impact of that business. For those of you who have not adjusted your models, we filed an 8-K about a month ago that will help you reset your historical figures on both an annual and quarterly basis.

As I go through the P&L this morning, I'll focus on our third-quarter results, as well as year-to-date numbers. Where applicable, I'll also give you an update on where we see the full-year performance in relation to our original guidance.

On a companywide basis, sales in the third quarter declined by 2% to $1.12 billion; but on a year-to-date basis, were up 2% to $2.39 billion. The Global Consumer segment declined 3% in the quarter. Behind those numbers, sales in the US were down nearly 6%. Canada increased 3%, and Europe in total was up 14%, excluding the impact of foreign exchange rates. If you recall from Q2, we had significant early-season shipments in the US to our key retailers. So on a year-to-date basis, Global Consumer is up 2%, with half of the increase coming from the US and half coming from Europe, which has a nearly 7% year-to-date improvement.

After a slow start caused by weather, Scotts LawnService has begun to regain its footing and was up 3% in the quarter. Year-to-date, SLS is flat. It's a certainty at this point that SLS will fall short of its original plan, but we would expect about 1% to 2% growth for the fiscal year. On a companywide basis, we'll probably do slightly better than the updated outlook we provided in June, when we said sales would be flat to up 1%. Right now, I'd say full-year sales will increase 1% to 2%.

The biggest reason for the improved sales outlook is stronger-than-expected POS in the second half of June and the month of July. Pent-up demand and mild summer temperatures in the North region allowed us to beat a prior-year comp of 19% in July and 14% in June. Another key driver for the improved outlook is the continued strength of our mulch business, which, as Barry said, is doing better than we expected. However, the double-digit increase in our relatively low gross margin mulch business is one of the reasons we've seen more pressure on our gross margin rate.

On an adjusted basis, the gross margin rate was 37.9% in the quarter, down 100 basis points from a year ago. On a year-to-date basis, we are up 100 basis points from 37.3%. The margin pressures in the quarter were two-fold. In addition to product mix challenges, distribution costs were significantly higher than a year ago, and higher than we had projected entering the year.

We told you during the last call that rates climbed sharply beginning in April, as a large imbalance between supply and demand developed in the freight marketplace after the long winter. Trucks were far less available; and when they were available, the costs were significantly higher. The pressure on availability began to moderate as the season wore on, but the higher cost pressure remained in place.

Right now, our purchasing team believes this cost pressure is unlikely to moderate much further as we plan ahead for next year. However, on a more positive note, the team did a good job of managing commodity costs all year long. So the price increase that we had entering the year has offset the overall margin pressure we've seen from distribution and commodities. The combination of pricing, as well as continued cost-out opportunities being executed by our supply chain team, should allow the year-to-date 100 basis point improvement in gross margin rate to stick for the entire year. In fact, five weeks into Q4, we continue to track against that same number.

Without getting into too many details, let me talk about some of the trends that will impact the gross margin line as we think about next year. While we still have upside, the rate of improvement is likely to slow from what we've seen in the past two years. Urea costs will almost surely be lower, but our overall basket of commodities will likely be slightly higher. As we enter August, we have about 40% of our commodities locked for next year, including 50% of urea. Net pricing will be consistent with commodity changes, though supply chain efficiencies, including improved logistics planning, will likely help us on the cost of goods line.

With line reviews and our budgeting process still underway, I won't share any specific numbers today, but I would say any improvement on the gross margin line next year is likely to be modest. Back to the quarter, SG&A in the quarter was flat from year-ago levels, and were up just 1% on a full-year basis -- or year-to-date basis, that is. Recall that we had originally forecast SG&A to be up 3% to 4% for the year. Lower legal and IT costs benefit from restructuring, and execution of contingency plans throughout the enterprise are allowing us to hold expenses roughly in line with last year. That trend should continue through the end of the fiscal year.

As Jim said earlier, both interest expense and taxes are trending better than we expected. Interest expense declined $4 million to $12.8 million. And our effective tax rate in the quarter was 35.8% compared with 36.4% a year ago. On a year-to-date basis, interest expense is down $9 million to $38.7 million, and we expect the full-year number to be roughly $48 million. Our effective tax rate was 35.2%, which is in line with what we expect for the full-year. The lower rate this year is the result of some one-time benefits, and I would expect to return to a more normal rate, probably 36% to 36.5% next year.

So when you bring all this down to the bottom line, adjusted net income from continuing operations was $146 million in the third quarter or $2.34 per share. That compares to $153.4 million or $2.45 per share a year ago. On a year-to-date basis, adjusted net income was $217 million or $3.46 per share. That's an 18% increase from last year. As we said in our press release, we now expect to land in the high-end or slightly exceed our full-year guidance of $3.05 to $3.20 per share. But September is an important month for us; so it's too early to be more specific.

Let me move on to the balance sheet, where I want to point out two important things. First, you'll see a pretty significant increase in Accounts Receivable. That's simply the result of the timing of shipments in the quarter. The quality of the receivables remains consistent and there's really no news here. The other thing I want to point out is that inventory levels are essentially flat from last year. This is actually a pretty good story, given the sales shortfall from our original full-year plans. However, entering the year, we had planned for full-year inventory levels to decline. This is the primary reason that our operating cash flow will fall short of the $275 million that we had projected entering the year.

At the end of the quarter, our leverage ratio was 1.9 times. So the full-year operating cash flow that we will report, combined with the flexibility we have on our balance sheet, will allow us to increase our return of cash to shareholders. As Jim said, we are targeting $125 million. We are still contemplating with our Board the form and timing of any action we take, and will communicate that when we make a decision.

I told you during our Q2 call, my first as CFO, that a smart capital allocation strategy was a primary focus of mine. We feel more comfortable taking our leverage ratio to 2.5 times. That gives us continued flexibility to invest in appropriate capital projects and pursue acquisitions for incremental growth, while continuing to have the ability to return even more cash to shareholders. With the opportunities that are in front of us right now, I don't see any near-term reason that we would take our leverage significantly higher, but we definitely have the flexibility to do so if the right opportunity comes along.

I want to end my comments where Jim began his. Two years ago, I was a vocal advocate of the strategy that Jim talked about: don't chase growth that isn't there; focus on fixing our margins; run the business to generate cash; maintain a disciplined approach to M&A; and return cash to shareholders. Now, as CFO, I feel good about the path that we're on. It's too early to talk about specifics for 2015 on this call, but we will be able to do so on our Q4 call.

And with that, let me turn the call over to the operator, and we'll take your questions. Thanks.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jason Gere, KeyBanc Capital Markets.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Guys, I guess I have two questions. One, I'll start off with a housekeeping, and two then will be more kind of bigger picture. In terms of the consumer business, could you break out how much TOMCAT helped? And what was the break between price and volume in that business? So I guess price, volume; and then the TOMCAT acquisition, how much that contributed.

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

So TOMCAT specifically, Jason, on a year-to-date basis, we are up about $17 million from that acquisition through the third quarter. And for the full-year, we are expecting it to be in the range of about $30 million of net sales.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay. And then the price and mix component?

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

Related to TOMCAT or --?

Jason Gere - *KeyBanc Capital Markets - Analyst*

No, no, no. Related to the overall consumer. When I look at organic sales, just between price and volume.

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

So if you look at our 2% year-to-date total company net sales number, so TOMCAT is worth about a point; pricing is worth about a point. And offsetting that is volume declines that we've seen in our US consumer business for the most part. I'd say Europe is worth about a point of increase. And then the US numbers, essentially the net of that to get us to a plus-2 number overall.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay, great. Thanks for the color. And then I guess the second question is really kind of bigger picture. As we think about -- and I think longer-term, the top line obviously has been harder to come by. You've seen kind of this 1% to 2% this year, which I think is a nice rebound. But as you talk a little bit about 2015, you're saying gross margins could be a little bit harder maybe to come by there; especially on the distribution costs, I know you've relied on pricing.

It just seems that the SGA side, the cost control has been good. How much more can you really pull out on the SG&A as you think about next year? And how much do you have to rely, I guess, on additional acquisitions, maybe to get more leverage on the SG&A side? So I was just wondering kind of bigger picture, just how we should think about the model going forward with more -- I guess what I would say -- more modest sales, and obviously, the weather is kind of out of control a little bit?

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

Well, I'm not sure I would say it's out of control. It's definitely been a headwind for us the last couple of years. Hagedorn here. I'm not sure that I see the world much different except probably on sort of the margin front. But then if we had sort of talked out loud, we would assumed that margin was probably a little more positive than what we're seeing today. But I think otherwise, I would say I see the world pretty much the same way, which is kind of a 0% to 2% is kind of the market of consumer goods. I don't think many people are seeing different than that or saying different than that.

The work we're doing on sort of restructuring is really to put money into areas where we believe, both within the core and within adjacencies in new categories, that we can get higher than average growth, higher than 0% to 2%. And so, I think a lot of work we are doing on sort of the brand side, within Mike Lukemire's business, we believe if we can get another sort of 1% to 2% out of the core over the sort of 0% to 2%, that the financial output of that, with maintaining discipline on the financials, is actually really interesting.

In addition to that, you have sort of the adjacencies that are probably worth a point or so. You have other focus areas which -- remember, if you look at sort of how the business reports into sort of Barry and myself, Mike is running the North American business -- Mike Lukemire reporting to Barry; but directly to Barry are all our growth areas. This would be sort of urban indoor, organic hydroponic, service business, and our European business. I think that's it, Barry.

So we believe that there is -- in a lot of those business, there is above-average growth opportunities, which we'll invest in. And say that's worth another point or two. I mean I'm just sort of looking at my sort of team and they're nodding. And I think that's how you sort of put it all together into sort of GDP on the core with the objective of our -- the work we are doing to get sort of GDP plus a couple on the core. Then add in sort of these growth areas, and I think it actually turns out to a pretty interesting number. And we like that.

I think that the issue on margins is -- I would say a little bit of a disappointment from my point of view. But it's not -- it's basically, we just looked at our competitive set. And I think we need to make some investments in some areas, and some of our commodities are just, I think, unfortunately not -- this is not urea, but this would sort of be everything but urea -- is a little pricier than we thought, probably to the tune of like a dime or something like that. So, call it maybe $10 million.

We got a little bit of pricing going into the market basically to offset kind of commodities. But that probably is just when we offset it, it's slightly margin dilutive. And that's kind of how I put it all together. But it's a pretty interesting and not particularly challenging things to do. We need to do things more right than wrong. But again, it's not a swing for the fence. And I think it adds up to kind of 3% to 4%, maybe a little more percent increase on the top line globally, that -- it's pretty satisfactory.

Jason Gere - *KeyBanc Capital Markets - Analyst*

(multiple speakers) And just I appreciate the color on that. Just as the follow-up there. I think you guys have said before, yes, if you did kind of that 2% to 4% sales, you could get more leverage on the SG&A. But I mean, is that still the case that, beyond the cost-cutting that we've seen with the restructuring this year and last year, it seems the go forward where there's still opportunities, you do need to see kind of that sales kind of come back. Is that fair? Or if we have another year --?

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

That sounds fair, only because -- I think that -- I don't want to kiss your ass here (laughter) but I would view this -- it's a good question. It's kind of what we're all about right now, to be honest. This is our life right now, and what do I know? I sort of provide this direction, and it's consistent with the discussion we've had until now. And it's up to Barry and his team to sort of say I get it, let us go execute it.

But, you know, I think this is a world where you've really got to be more on your A game than be on like your B or C game. And so a lot of the changes we're making are saying, we need to prioritize on the things we think are going to give us growth, and sort of are additive to the value of this business. And that's really what we are after. And I'm really pleased with where Barry is at in saying he sort of gets it. And we continue to evolve kind of our vision of what it means. But it's all about driving value in kind of a crappy environment.

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

Yes. Jason, if you go back to our investor presentation from last December, we've been saying for a while this is a flat world, and we've rationalized our planning so that we are not over-investing. And as part of what Jim said, we've lowered our cost structure appropriate to where we think the business needs to be right now. And what you'll see going forward is, we are going to effectively deploy the capital that Randy talked about.

And we think the core business, due to some pressures this year -- which, next year, we will address -- I think gardening was delayed; I think we saw some pressure in our Controls group. I think we can grow the quarter, both in the US and in Europe 1% to 2% -- you know, combined, 1% to 2% a year. We said we're going to look at close-in acquisitions, things like TOMCAT, that we can add to our business and effectively leverage our SG&A structure.

We said there's new markets that Jim talked about, things like hydroponics, urban gardening, that we think can add another point or two of growth a year. And then, with our SOS business, we are very excited about that business. It was affected by weather this year, but we are looking at both organic growth and growth in the pest area. So when you add those up, we said, you know, that's in like the 5%, 6% range. But that's not going to come linear; it's going to come over time.

And so we are comfortable looking at our Company kind of in that 3% to 5% growth on a long-term basis. And I think what you said is appropriate is, we've rationalized our SG&A structure. We think we can leverage that structure and improve our operating margin. So, we think we are in a good spot, and we think we have the right plan going forward.

And we fixed some of the things. And it's -- margins will -- are not going to improve 100 basis points a year, but we'll effectively look at gross margins, but also leverage that overhead structure to make sure we're driving -- that we're driving our operating margins as well.

So, that's kind of a summary of the plan. I think we're on track with where we said. And like Jim said, I think we're pretty proud, given the circumstances this year, of what we've done. But I think we're right on track with our strategic plan where we thought we'd be.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay, great. Thanks a lot. I'll pass on the call.

Operator

Alice Longley, Buckingham Research.

Alice Longley - *Buckingham Research - Analyst*

I just didn't get one of the numbers. Year-to-date, how much are your US shipments up or whatever?

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

If you were to include both pricing and TOMCAT on a year-to-date basis, we are effectively flat. So, I think that reflects a lot of different things going on. The category is about flat. Our share is about flat. QS is about flat. Retail inventory is about flat and we are about flat. So I think that's essentially when you net it all out, what that (multiple speakers) --

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Alice Longley - *Buckingham Research - Analyst*

But if you are flat year-to-date, if I take out pricing in TOMCAT, how much is your volume down year-to-date?

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

I'm sorry, can you --?

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

Actually I think she's asking units. (laughter)

Alice Longley - *Buckingham Research - Analyst*

Units.

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

Couple percent.

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

It's a couple of percent.

Alice Longley - *Buckingham Research - Analyst*

Year-to-date units.

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

Couple percent, Alice. Down.

Alice Longley - *Buckingham Research - Analyst*

Down 2%?

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

TOMCAT and pricing, that's effectively a couple of points.

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

In the US.

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

In the US.

Alice Longley - *Buckingham Research - Analyst*

In the US alone. Okay. And why is volume declining? Do you think it's mainly the less affluent consumer in mass channels holding back? Is that the major reason? Or is it sort of more widespread consumer shift to urban areas? What do you think the major reason is for this 2% volume contraction?

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

Yes, I would say, Alice, it's three things. One is, we did see some decline in mass. That's three things. Decline in mass -- when I look at the gardening business, it did not come back the way the lawns business did. So I think with the push in the weather, I think the gardening business was affected, and I think that was primarily weather-driven. If you look at live goods, it's the same way.

And we saw some pretty aggressive pressure on the Controls business from one of our good competitors, which we'll address that next year. And so you look at those things and you say, I'm confident. I've talked to the guys at mass. I think they have a good plan. Weather is what it is and we are going to be much more competitive next year on Ortho. That's what I think the issues are.

Alice Longley - *Buckingham Research - Analyst*

So, if I'm fiddling around with my fiscal 2015 number, I shouldn't use negative 2% units for fiscal 2015?

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

Look, I just want to jump in. Alice, I wouldn't make things much more complicated. You know? If you sort of say is the consumer environment particularly buoyant? I don't think so. So we continue to believe it's kind of a flat world. Okay?

The weather -- like it just sucked. I think Barry said in the last call, it was like the worst season we've ever seen. And I think we believe that now. The good news is it just didn't get hot that fast, and I think it continues not to be particularly hot, which has been good for the business. So we are clawing it back.

But weather blew. I think the consumer environment was pretty negative. I think mass retailers in general don't have their act together yet. And they've made changes on the management teams, both of whom Barry is -- I think Barry is tight with these guys and feels confident that there is a plan to work that business. So I wouldn't read anything more than that into it, to be honest. I just don't think it's -- this is not hard to figure out.

Alice Longley - *Buckingham Research - Analyst*

So, sort of going ahead is the norm. You assume more like flat volume is the norm rather than declining volume? (multiple speakers)

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

What I said is 0% to 2%. And we still believe that. Now, do we think the weather -- please knock on wood -- has got to be better next year? Yes. Do we believe that the sacrifices that have been made here -- and I mean that -- where we have pretty aggressively attacked the officer core of this Company to take money out, that money is not going to reinforce the bottom line. That money is going into doing the right things with the business.

So this is really mostly tools for Mike Lukemire to use in driving his business. We believe that's worth 1% to 2%. And that when you add that up, it looks pretty good. So that's -- if I was predictive of the future, I would say we continue to believe 0% to 2%, and that we can get another 1% to 2% by just being smarter than we have been.

Alice Longley - *Buckingham Research - Analyst*

Okay. And then just one other question. You said a good starting point is gross margins up modestly in fiscal 2015. What does modest mean to you? Is that up to 50 basis points? Or is it like 10 basis points? What does that word mean to you?

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

Alice, I think at this point, it's still really early. There is a lot of moving parts. We're just really now working on detailed planning below, like the high-level assumptions that we are working toward. And I think at this point, it's premature to really answer that question with any kind of real precision.

Alice Longley - *Buckingham Research - Analyst*

All righty. Thank you.

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

Thank you.

Operator

Joe Altobello, Oppenheimer.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Just wanted to dive into Ortho a little bit and understand the issues there. Were you guys out-marketed? Were you out-innovated? Or a combination of the two? Was it just a lack of spending that really caused one of your competitors to take some share there? Or was it other issues?

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

Look. Joe, I -- I mean, it was kind of a little bit of everything, I guess. But I'm not really proud of what's happened there. I will look at the operators and say, I told you. That being said, what do I think the real issue is? I mean, listen, maybe the best thing is to ask Mike Lukemire; it's his responsibility to sort of fix it.

I think Barry, this morning, we were talking earlier, and he's like basically saying, you know we live -- so I'm going to use a bad word -- you know, we live in this (expletive deleted) hole like every day, and this is just one of the seasons that it was just like that. You know? It's like one firefight to every firefight. The result is good, actually considering how bad it's been. But it grates on you a little bit. You know?

And if you live here every day, you'd think we have all these issues, okay? -- of which Ortho is clearly one of. But the results are this team did what we get paid to do. We worked our way through the season and we produced a reasonable result. I think this even surprised us. And we still have some time to go, and we feel pretty good about the sort of time between now and year-end.

But Ortho is one of the stories you look at. And I know what I would say. I think the labels are overly complicated. I think our price -- you know, we have really put quite a bit of money into innovation and packaging, which I think, ultimately, we couldn't price the way we really wanted to, so we didn't get the margin we wanted on the product. And it still made us more expensive than our competitors. And it's a really like competitive space -- against a competitor that has like done pretty well, and I'm just going to throw out there, who we don't really compete against that well.

And that we -- like it's like us and Central and Bayer are all kind of competing on the value-added side, and we leave these guys alone on the opening price point. And I'm telling you I've got spare capacity. Those days are over. And so in the discussion with Barry, he's like, you know? All you need to say on this stuff, Jim, is like we are going to fix it. We know what our issues are. We are going to fix it.

Now, Mike, are we going to fix it?

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP of EVP of North American Business Unit*

(laughter) We're going to fix it.

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

But -- I don't know. You just want to get sort of the high line of what needs to happen on Ortho?

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP of EVP of North American Business Unit*

I think it's the design for value and to compete, and making the correct investments to ensure that Ortho is a great brand for consumers to buy. I think we lost some fundamentals there.

Joe Altobello - *Oppenheimer & Co. - Analyst*

So you effectively have to fix that price value equation and get more price competitive?

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP of EVP of North American Business Unit*

Yes, right. Yes.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay. And then switching to the mass channel, it sounded like, obviously, it's been pretty bad this year and you're expecting something to look better next year. Why would the mass channel get better next year?

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

I think better execution. I don't think there is a fundamental problem. I just think we need to execute better.

Joe Altobello - *Oppenheimer & Co. - Analyst*

So it's not all macro? (multiple speakers)

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

(multiple speakers)

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

Combination.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay. Just one last one (multiple speakers) --

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

He's talking a lot, Joe, about sort of less than $10 SKUs. Actually those products have done pretty well for us. I think the side of it for us is to have the right SKUs for the right demographic. I think that's our issue, is we have to continue to be sensitive to the fact that some of these retailers have a -- maybe even different than they would like -- demographic of people who are shopping there.

I think that's our job, is to have the right products for the consumer that shops there. It's clear these folks will leave before they buy an off-brand. It's not like we're losing share. But it is -- I think we're -- people are down to their last $20. We've had this conversation before. We've got to have products that they can afford. And then there's the -- I think, the issue, which is a big one, of just the retailers' execution. And that, I think we really don't need to talk about. You guys know as much as we do or more about the problems some of these mass retailers have had.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay. That's helpful. And just one last one. Randy, you did a good job, I think, on the puts and takes on the gross margin line. But your incentive compensation tends to swing from year-to-year, given what the top line does. So if this year you do 1% to 2%, as you're talking about in the top line, and next year let's say we do 3% to 4%, what does the incentive compensation look like in terms of SG&A? Thanks.

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

Sure. So this year, incentives roughly are going to be in line with where we finished last year. And as we look at the next year, they'd be again roughly in line. So, unlike several years in the past, incentives are really kind of a nonstory at this point.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Great. Thank you.

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

Thank you.

Operator

Olivia Tong, Bank of America Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch - Analyst*

I was hoping you could walk through some of the components of how you get your gross margin guidance for this year? Because it looks like it implies a pretty big acceleration in Q4 after the decline in Q3. And you mentioned you expect sales to improve. So is that primarily it, a function of cost leverage? Or is it savings accelerating? Or is there something different in price or mix?

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

Sure. So, Olivia, on a year-to-date basis, we are up about 100 basis points versus last year. And actually, as we close out the month of July, we are still tracking to being up 100 basis points for that month and on a year-to-date basis. So that's where we expect to finish the year too. And the primary drivers are continued pricing that we had going into the season.

We still have cost-out projects that we are seeing the benefits from, which are running into some comps here as we head into Q4 from last year. But we'll still see some benefits from that. And it looks like the distribution and the mix issues that we've dealt with in Q3 are largely out of the way at this point. A little bit of pressure still on distribution, but we think we'll finish the year more or less exactly where we've finished June and July. So I think we are in good shape with the guidance we've provided.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. Thanks. And then I just want to clarify a couple of things. You said at the beginning, we're not going to swing for the fences. US mass is tough. You mentioned lower pricing in spreaders to sort of build the trial. But then you also talked about sort of comfort with a long-term 3% to 5%-ish level of growth. So, can you help marry those two things where it seems like on one end, it's -- near-term, it's pretty dour, but on the long-term, you're still expecting a pretty big acceleration in terms of your growth rate?

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

Sure, Olivia. This is Barry. I think we are consistent with we think the core can deliver 1% to 2%, and that's across our entire consumer business. But then how you get to those higher numbers is through M&A. And so, expansion of things we're doing, like we've done with TOMCAT, getting into some new markets like hydroponics, and then organically growing our SLS business, plus making some acquisitions there, maybe in the core but certainly in the pest business. And so how you get to those numbers is, think of it 1% to 2% in the core, a little bit from SLS, and then the rest of it is M&A.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. That's helpful. And then, Jim, on return of cash to shareholders that you are planning later this year, what goes into the decision-making process for you and the Board to decide how to do that, whether special dividend, share repurchase, et cetera?

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

Beats me, to be honest. (laughter) I would say negotiating with the barbarians. I think that if you look at where we are at, it sort of depends on how you look at leverage; I think that's -- we spent quite a bit of time this morning just talking about, has anything really changed? And it's just sort of this pro forma view of Leverage. And to some extent, to me, getting rid of those bonds that we have, that last tranche of bonds.

So, the answer is, I think we are doing what we think is reasonable. I wish it was a little bit more, to be honest. But if you take the sort of $25 million that probably is going to be in inventory that we hadn't anticipated, just as a result of kind of a slower spring than we would've anticipated, we're -- the amount of money we're talking, call it [$150 million minus $25 million], which is just being a little safe, plus I think we did a 40% increase in the dividend -- I feel pretty good about that.

And we are not backing off on this. So this is absolutely consistent with where we said, but how do you get there? Look, I probably would have levered up and go to $5.00 a share myself. But I have to negotiate with our banks. I have to be cognizant of our bonds and limitations that are a result of that. I've got a Board. I have other shareholders.

And I think -- I also have a view, I think, on my management colleagues, a view like we don't have to sort of swing even too hard on cash to shareholders. It's just -- and I think that, just to throw out there, that just on the M&A side, I think that there's opportunity out there. And that doesn't mean anything sort of crazy. But I think that a little powder dry is probably not a horrible thing, and I think Randy kind of referred that toward -- at the end of his comments. So I think it's a combination of all those factors and then negotiating with the barbarians.

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

When you look at how we're we've used our cash this year, we are planning to do capital expenditures roughly in line with what we've done in the past. We bought TOMCAT early in the fiscal year. We have other potential M&A that's pending. Our dividend on an annual basis is over $110 million a year. So we've returned cash or used cash in a variety of ways. And we are still trying to finalize exactly what that outcome is going to be. And we have a Board meeting later this week to do that.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. If I could just follow-up. Specific to that $125 million that you plan on returning to shareholders, you had mentioned in previous calls or in previous public statements that perhaps special dividend is the way that you would sort of gear towards it. Is that still the way that you're thinking?

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

Well, it's certainly an option. We've reached out to our larger shareholders. We've got a call with the Hagedorn Limited Partnership at 1 o'clock this afternoon to sort of understand their preferences. That will then go into our Board meeting that's later this week. And I think what you'll see is Randy and I make a recommendation to the Board, which I have no doubt will be approved. And that will be that.

But I think -- we've always said -- and I think the one thing we've kind of said is, let's do one or the other, either share repurchase or a special. And I think we kind of still feel that that's the case. But I've got one more conversation with the control shareholder that's this afternoon, and then we make a recommendation to the Board and get their approval for whatever we all see fit, including the Board. So that's how. So, the answer, I guess, Olivia, is yes. For sure, that's one of the options.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it, but --.

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

We're just (multiple speakers) --.

Operator

Connie Maneaty, BMO Capital.

Connie Maneaty - *BMO Capital Markets - Analyst*

Can you remind us what the accounting treatment is going to be of the inventory that's left over at the end of this year? It's probably fertilizer, right?

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

Right. There won't be any changes from what we've historically done. So, for inventory that's still in retailer stores or DCs at the end of the fiscal year, we've set up sales return reserves estimating what that should be based on POS to follow in October and November. And that's what we've typically done. You're right. Most of that is largely fertilizer, but we also take returns on certain other products also. But I don't see anything unusual this year. And we are expecting retail inventories at the end of the year to be again consistent with where we finished last year. So nothing unusual.

Connie Maneaty - *BMO Capital Markets - Analyst*

Okay. And then on the organic side, what is the size of the market as a percentage of total? And the decision you made to focus on Nature's Care versus Organic Choice, was Nature's Care in tests nationwide next year? Are there -- are you closing down Organic Choice? And are there charges associated with that?

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

So, Connie, this is Barry. We estimate the market to be about 15% of the total market. When you look at regionally, that tends to be concentrated on the West Coast and the East Coast, although there is business across the United States. That's where it's the highest market share. So when you get out to those markets and you're in those markets, it may feel more like it's 30%, 40%, but that's because of the regionally of it. So, that's kind of the size of it.

We believe that we need to market nationally, including supporting that with media, and have a full line of products. That will be our Nature's Care, and that will be ubiquitously available everywhere to all retailers. And the Organic Choice brand will not be discontinued. It just won't be that national brand. And that will be at some select retailers that want to continue on with that brand. So there won't be any charges associated with it.

So we view it positive. The Nature's Care brand did really well. And so that's where we're going to put our national support behind.

Connie Maneaty - *BMO Capital Markets - Analyst*

So, is Nature's Care already national?

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

No. It was -- I think it was selected like 10 DMA markets, Connie, that we did control tests against to test it. So we tried to get a national perspective on the test, but it was only about 10 markets.

Connie Maneaty - *BMO Capital Markets - Analyst*

Okay. And just finally, how fast is the organic segment growing?

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

It's growing -- it's small, like I said, but it's growing double-digits -- 10-plus-percent a year.

Connie Maneaty - *BMO Capital Markets - Analyst*

Okay. Thanks so much.

Operator

William Reuter, Bank of America Merrill Lynch.

William Reuter - *BofA Merrill Lynch - Analyst*

Following up on one of your earlier comments on M&A, you said that this doesn't mean you would do anything crazy. I guess if you could talk about what that might have been referring to? And I guess in terms of scope or size, how large an acquisition you would consider?

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

I guess crazy means life-changing. I think right now, our focus is on pretty tight-end adjacent deals that have the effect of what Barry and I think I have both described is we pick up 1% or 2%. That is what I consider to be not life-changing. Okay?

I think the environment is fairly positive and the -- I think work that -- just to be fair and be completely open book with you all, but I've got a Board meeting this week. Barry and I have spent actually quite a bit of time talking about this, and Randy is my finance partner. And to some extent what

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Randy and I do here is capital allocation, which is how to sort of express ourselves and the management of the portfolio of businesses that we participate in, and meter that money out sort of as we and the Board, to some extent, see fit.

I do think that there is opportunities out there in this regard and I want to talk about this with my Board. I want to talk about this with Barry and Randy. And I think we will -- and this is not consistent. This is the hard part of, I'm going to say, an ex-fighter pilot running a business to be fair. And I'm -- just that how to balance our desire and commitments to shareholder-friendly into a world of where we believe we can get some growth is going to be sort of what we have to decide.

But we just -- we're not in a position at this point to do anything other than say, at the moment, we are looking at sort of 1% to 2% growth opportunities in kind of adjacent categories of these growth areas, like hydroponics or service. Anything beyond that, we're just is not in a position really to talk about, and we're not -- there's no serious discussions occurring on anything beyond that.

William Reuter - *BofA Merrill Lynch - Analyst*

Okay. And then earlier, you also referenced getting rid of the bonds, which the 6 5/8 are not callable until December of 2015. Do you guys have any plans with regard to that at this point?

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

I'd like to get rid of them as soon as we could. How's that?

William Reuter - *BofA Merrill Lynch - Analyst*

Okay. And I guess just one last one on those bonds (multiple speakers) --

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

(multiple speakers)

William Reuter - *BofA Merrill Lynch - Analyst*

That's true. Do you know what the RP basket is in those bonds right now?

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

Restricted payment basket?

William Reuter - *BofA Merrill Lynch - Analyst*

Yes.

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

Yes. We'll give you a call back afterward and get back to you.

William Reuter - *BofA Merrill Lynch - Analyst*

Okay.

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

That is the constraint, though. It's much more limiting with the bonds than it is with our credit facility overall. I know there is a basket as you move past our pro forma leverage around three times (multiple speakers) --

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

You know, I always get through with high yields. I mean, I think that if we looked at our total credit sources and sort of 2008, and said, oh, my God, we're like 100% bank debt, and we don't think -- at the time we didn't believe it was -- you could probably replace that 100% bank debt. And we wanted some more diversity of our credit sources. And this is right when these markets were reopening that we -- the tranche we just took out last year, and then this tranche of bonds. And I think they are modestly expensive. But I think it's the restrictions on them that felt fine at the time, but I think today, we'd look at and say, oh, I wish we didn't have them. So I think we just are kind of running the clock out, to be honest, on these things.

William Reuter - *BofA Merrill Lynch - Analyst*

Right. Okay. That's it for me. Thank you.

Operator

Jon Andersen, William Blair.

Jon Andersen - *William Blair & Company - Analyst*

Thanks for the question. Jim, I think it was you -- you mentioned earlier that you'd use the word kind of disappointment in relation to margins. And I just want to make sure I understood that was in the context of maybe near-term or transitory pressures, and it hasn't affected your long-term outlook or ability to get the kind of mid-teen operating margin?

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

Well, Barry is nodding his head, no, no. I would say that the disappointments to me are that it's a rough world out there. And this is not me crying in my beer. I think we've produced a reasonable result. But I think it's -- for all consumer companies, anybody I talked to, in my level, I don't think anybody is like overjoyed. I think that the world is enough of kind of a headwind. I really didn't need any more sort of like noise.

And I think the conflict that we are going to induce in Ortho is probably not going to accrete our margins. That's my view. I do believe that we have capacity on the manufacturing side that, from an absorption point of view, will be interesting to us, but it's probably just -- any time we are doing more private label, it's going to be margin dilutive, even though it's profit-accretive to us. And from a absorption point of view, it's extremely healthy for us.

So, I see that. And I see some areas where I think we need to put -- you know, improve the efficacy of our products. You know, we are coming out of a period where if I was to be -- like I'm just going to be honest with you all -- where the world since 2008 has been one of those things where Barry and his team have done a great job, I think, on the margin side. And really being focused on the business.

I think that the effect of some of that stuff is that I believe that the value equation we need to address some of that area. And I think Mike talked about that with Ortho. But I don't think it's alone. I think -- we are significantly improving the quality of the product of our lawn fertilizer products. Remember that when urea pricing went up, we took like -- I don't know, more than a 50% increase in one year. We have not given that back.

I think that it limits our ability to sort of make the price even higher on it. And so that my view is that we have an obligation to improve the consumer experience and we're going to do that. And this is not like huge margin change. I think that what it does, it just takes a little bit of the shine off where my head was that we would be sort of positive every year, and our gross margins would be going up. And to being a little more of a sort of dull finish on that, which is just another one of these things where it's just it's part of what we do.

But in the mix of how I view the future, I just think a little more pressure on gross margins than I wish existed. And I think some of it is self-induced and some of it is the market on commodities.

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

John, this is Randy again. You know as -- when we last talked to you at the end of last quarter, we saw a lot of the freight pressure that was happening in April. And we didn't really expect that to persist into May and June. So that was really a lot of the surprise.

Now as we look ahead to next year, we think, with our eyes wide open planning ahead better, we can have tighter logistics planning next year. We can do a lot of operational enhancements on the front part of the year getting ready for the spring. That will diminish a lot of our concerns as we head into May and June next year.

So I think we'll be much tighter operationally, which will be a help. And we still will have continued supply chain savings projects last year that's going to help, but we also have some investments to make, as Jim pointed out, in certain lines of businesses, targeted price reductions that makes sense. You know, we think we can grow sales and have a competitive edge by doing that. So there's still a lot of things that are in the mix right now. We haven't finalized our plans for next year, but I think things that we're doing operationally make a lot of good sense.

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

John, this is Barry Sanders as well. This is not guidance going forward next year, but I think it's the way you can think about how we think about this from an operating side is, historically, the peak of our gross margins was in the 38% range. And I think we are getting pretty close back to that. So we are at a historical range. And like Jim says, we've been very focused on getting back to where our margins were around 10.

We've said, over time, we think we can get this business into the 40% margin range. So I think what you're seeing is you're not going to see 100 or 150 basis point improvement in gross margins on an ongoing term. But it will be an extreme focus of us to continue to improve that margin. And we think we can get it to about the 40% range over time.

But I would also say your question was implications for operating margins. A large part of the work we've been doing over the last 12 to 18 months is getting our overhead structure in line with where we think we need to be operating, given the environment. So I think we will get as much operating leverage on the discipline we've had on our SG&A structure as we will on our gross margin going forward.

So I would say continued improvement on the operating margin. And we think we can get that and to the 15% range, same thing over time. And so I think it will be now a combination of hard work on the gross margin side and being disciplined on the SG&A side to maintain and improve that operating margin structure.

Jon Andersen - *William Blair & Company - Analyst*

Thanks for the candor on that. One quick follow-up as you look to 2015, and I know you're not providing guidance. But if you were to point to two or three new product opportunities, or I guess, further rollouts of products you've tested this year, what holds the most potential in your mind?

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

We are really excited about our new Bonus S product in the South. We saw some big uptick in that. And then this national launch of Nature Care line. We are launching a brand-new product for us in the cleaners category that will be branded Scotts. I think we've got some good learnings on the TOMCAT business. I think we are going to see good acceleration of growth there. And then, some of the things we're doing around gardens, when we took all of you guys out to look and one of the products we had was Gro-ables, the Miracle-Gro Gro-ables. I think that's going to be a great product for us over time.

And so overall, I would say new products plus I think people are reasonably optimistic going into next year. So I think you'll see some margin expansion on growth this year rather than trying to scramble to cover the misses that we've had.

Jon Andersen - *William Blair & Company - Analyst*

Thanks. I'll pass it on.

Operator

Jim Barrett, CL King & Associates.

Jim Barrett - *CL King & Associates - Analyst*

Jim, could you comment a bit on your -- I know the mix is changing, but could you comment on your total advertising spend? How does it compare versus last year? What do you see next year? And then could you just elaborate on SLS? You know, your major competitor is having operating difficulties. Is that proving to be an opportunity for Scotts? Is it an opportunity to more aggressively grow that business? Just wanted to get your thoughts on that.

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

Well, I mean, let me start with the last ones, so I can remember it. I think our team is probably on the non-mom-and-pop -- you know, so on a sort of multi-branch lawncare operation. I think we are probably the best operators out there right now. And so I think that means there's opportunity, because we're not having those issues ourselves.

What was the other question? Oh, advertising. Look, on the advertising, I think we are up. The -- a lot of the work that we've done -- and we've kind of talked about this, but the challenges that Randy and I have sort of pushed down to Barry -- and now willingly -- on sort of overheads and officer count, and sort of embrace the reality of a low-growth world, is that we've got to treat our brands and our consumers. This is actually critical to our future properly.

The brands -- not talking about 50% increases in advertising like 12 -- but remember 12 was about saying, if we do that, can we get the growth? And I think we did, just not at a cost that we could deal with. But we've talked about A to S ratios sort of 5 or north that we believe are consistent with other consumer goods companies, that -- which is where I think ultimately, I don't think this business does well if we're not spending money that's appropriate -- and not some number I pull out of the air, but numbers based on other sort of peer companies that sell consumer products.

So the cuts we're making are in part to get our advertising on the brands where it's not there; certain ones are -- and Ortho is one we've talked about -- to a level which we believe are consistent with other consumer goods companies. And that we then tell the consumer, especially where we have products -- Barry talked about Bonus S right now -- we have a Bonus S product, which is the only product, it's proprietary to us, that controls the most important weeds in the Florida and Gulf market. We have that exclusively.

And where we tested it in -- with a higher level of advertising spend, by the way -- in, I think, Fort Myers and Jacksonville, it really, really performed well. And that's a product that will be launched throughout the entire South next year.

So, I think that what you're seeing is without affecting the bottom line, we are reprioritizing to the things that we think we need to do. And those things are largely brand-support activities that are consistent with other companies like us, and products that meet the sort of value equation when people are buying sort of the premium brands. And that's really what we are focused on. And our view is, if we do this things right, can we, in a world of kind of 0% to 2%, get an extra 100, 200 basis points of growth? And our view is, the answer is -- I mean, it's not even a hard sell here -- the answer is yes.

And Randy and I are not even asking any more than that. So I think we are hopeful we can get more. But I think we are just -- we are kind of forcing people to do more of the right things and less of the things that we say, oh, we really don't need to do. And to have an overhead structure and an officer sort of group cadre that is consistent with our sort of growth expectations.

Jim Barrett - *CL King & Associates - Analyst*

Well, thank you very much. That was helpful. Thanks.

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

Okay.

Operator

Josh Borstein, Longbow Research.

Andy Brown - *Longbow Research - Analyst*

This is actually Andy Brown on the line for Josh. I was wondering if you could just walk us through your domestic consumer business, and let us know what kind of variability you saw by region? And specifically, what kind of impact the drought in California and Texas had on your results? Thanks.

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

Yes. So, I'm going to break it down into three regions that we have. And Mike, help me with this, if I'm quoting numbers right. Probably the most positive we saw is the North region, which is the combination of the Northeast plus the Midwest. Actually, I think they are going to get pretty close back to plan. And so we saw late-season resurgence. They've done pretty well.

I'll tell you the drought in -- on the West Coast and in Texas, and I was out there and it's pretty severe -- it impacted our business actually a little bit more than I thought it would this year. And the West Coast was down the most. And I would attribute that to the drought. And then the South was kind of in the middle, and I would say a combination of a little bit of weather, a late start to the season and so forth. And it performed the best. So, call it North up a percent, South down a percent, and the West down a couple of percent, kind of the mix overall.

Andy Brown - *Longbow Research - Analyst*

Okay, thanks. And then as, you know, the drought conditions start to get better, what kind of bounce-back would you expect to see?

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

You know, the West had been the best performing region for us up until this year. And so it was out in front plus a couple of percent. So I would -- if the drought alleviates, I would expect that to bounce back and turn around 200, 300 basis points.

Andy Brown - *Longbow Research - Analyst*

Okay, great. I appreciate it.

Operator

We'll have our final question from Bill Chappell, SunTrust.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

First on the dividend, I just wanted to make sure I understood. Jim, did you say kind of a 40% increase? So if I'm looking at the regular dividend, would that go to $0.60? And then maybe you have a one-time payout of $1.50? Is that the way I get to a -- the kind of this quarter payout?

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP of EVP of North American Business Unit*

Bill, so, over the last couple of years, we've had big increases in our annual dividend. So that's what Jim is talking about on a cumulative basis. It's somewhere in that 40% range over time. So, not something we plan to do in a short-term here. And he wasn't necessarily referring to this special one-time distribution that we are still contemplating.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

So you're not changing your regular dividend? It's just -- it's all going to be a special in terms of, what, this quarter?

Mike Lukemire - *The Scotts Miracle-Gro Company - EVP of EVP of North American Business Unit*

Well, we still need to talk to the Board about our annual dividend this week. And I guess until we make a change, I really can't (multiple speakers) --

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

What we're talking about, the sort of -- I think it would be fair to say the dollar volume is set unless we had like a basically off-the-rail conversation with the Board. So the dollar amount, I think we pretty much agreed with our finance committee on. It's just a matter of how we executed. But if you look into say, kind of call it, 60 million-ish shares outstanding, $125 million, it's -- and that would be a special or a repurchase, one of the two. And that would be in addition to the normal dividend.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay. And then just a little more color on kind of the fourth quarter guidance or topline guidance, if you will. I'm just trying to understand -- I mean, with the season largely over -- and I mean, some of the mass channels kind of already switching garden over to back-to-school or even Halloween, I mean, how do you make it up over the next two months? Or is it just July was that strong, you can get to those numbers?

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

Year-to-date through June, companywide, we're up about 2%, and our guidance is 1% to 2%. So we've put a little bit of conservatism potentially into that. But until we finish out the year, it's too early to call. I would say August/September are largely load months where POS isn't necessarily as important as what we saw in June and July. And hopefully, then we have a little better control over how we finish the game here at the end of the year.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

But you do have a tougher comparison over the next couple of months versus last year?

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

Well, actually, June last year was up 14% and July was up 19%. August was up 6% and September was just about flat last year.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay. okay. That helps. Thanks so much.

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

Thank you.

Operator

That concludes the question-and-answer session. I'll turn the conference back over to Mr. King for any additional or closing remarks.

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

Okay, thanks. And thanks to everybody for joining us today. If you've got follow-up calls or questions that we have not taken, just call me directly. That's 937-578-5622. Otherwise, recall our year-end earnings we typically report around the first week of November, so we'll get that communication out about a couple of weeks before. And then one housekeeping note for anybody in Europe who's listening or reading the transcript, Randy Coleman and I are going to be participating in a BofA conference there, I believe September 16th. So, look for us there and we'll be glad to meet with you.

Other than that, thanks for joining us today and have a great day.

Operator

That concludes today's conference. Thank you for your participation.