S&P Global Market Intelligence

# The Scotts Miracle-Gro Company NYSE:SMG

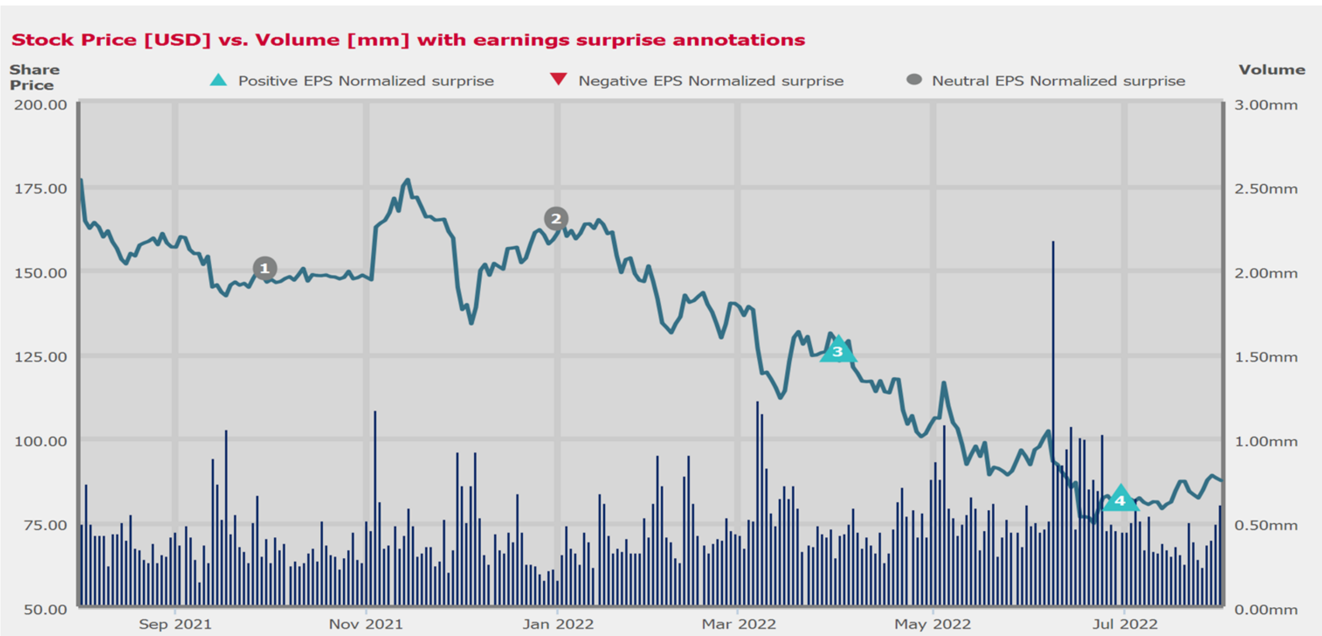
# FQ3 2022 Earnings Call Transcripts

## Wednesday, August 03, 2022 1:00 PM GMT

## S&P Global Market Intelligence Estimates

| | -FQ3 2022- | | | -FQ4 2022- | -FY 2022- | -FY 2023- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 1.72 | 1.98 | ▲15.12 | (1.31) | 4.61 | 5.85 |
| **Revenue (mm)** | 1228.24 | 1186.10 | ▼(3.43 %) | 647.96 | 4122.01 | 4362.24 |

Currency: USD
Consensus as of Aug-03-2022 1:45 PM GMT




| - EPS NORMALIZED - | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ4 2021** | (0.86) | (0.82) | NM |
| **FQ1 2022** | (0.73) | (0.88) | NM |
| **FQ2 2022** | 4.81 | 5.03 | ▲4.57 % |
| **FQ3 2022** | 1.72 | 1.98 | ▲15.12 % |

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# Call Participants

## EXECUTIVES

**Christopher J. Hagedorn**
*Division President*

**Cory J. Miller**
*Executive VP & CFO*

**James S. Hagedorn**
*CEO & Chairman of the Board*

**Kelly Berry**
*VP of Consumer Finance*

**Michael C. Lukemire**
*President & COO*

## ANALYSTS

**Carla Casella**
*JPMorgan Chase & Co, Research Division*

**Christopher Michael Carey**
*Wells Fargo Securities, LLC, Research Division*

**Eric Bosshard**
*Cleveland Research Company LLC*

**Gaurav Jain**
*Barclays Bank PLC, Research Division*

**Jon Robert Andersen**
*William Blair & Company L.L.C., Research Division*

**Joseph Nicholas Altobello**
*Raymond James & Associates, Inc., Research Division*

**Peter K. Grom**
*UBS Investment Bank, Research Division*

**William Andrew Carter**
*Stifel, Nicolaus & Company, Incorporated, Research Division*

**William Bates Chappell**
*Truist Securities, Inc., Research Division*

**William Michael Reuter**
*BofA Securities, Research Division*

# Presentation

**Operator**

Good day, and welcome to the Scotts Miracle-Gro Company's Third Quarter Earnings Conference Call. As a reminder, today's call is being recorded. At this time, I would like to turn the conference over to Kelly Berry, Vice President of Investor Relations. Please go ahead.

**Kelly Berry**
*VP of Consumer Finance*

Good morning, everyone. I'm Kelly Berry, and I'd like to welcome you to the Scotts Miracle-Gro Third Quarter Earnings Conference Call. I've stepped in to lead Investor Relations after a long career in finance at the company. I'm proud to succeed Jim King, Executive Vice President and Chief Communications Officer, who has retired from Scotts Miracle-Gro after a 21-year career at the company. Jim has agreed to stay around over the next few months to help transition as needed. I've had the pleasure of meeting many of you already, and I look forward to meeting all of you over the coming months.

Today's remarks from Jim and Cory have been prerecorded. Once we conclude the prepared remarks, we'll open the call to live Q&A. After the Q&A, an archived version of the call will be published on our website. Joining me for the Q&A this morning is Chairman and CEO, Jim Hagedorn; Chief Financial Officer, Cory Miller; as well as our President and Chief Operating Officer, Mike Lukemire; Chris Hagedorn, Group President of Hawthorne and several other members of the management team.

Before we begin the remarks, I want to let everyone know that the management team will be attending the Barclays Global Consumer Staples Conference in early September. We'll publish more details related to the date and time of the event, a couple of weeks in advance. With that, let's move on to today's call.

As always, we want to make you aware that we will be discussing forward-looking statements on the call today. I want to caution everyone that our actual results could differ materially from what we say. Investors should familiarize themselves with the full range of risk factors that could impact our results, and those are filed in our Form 10-K.

I'll now turn the call over to Jim Hagedorn. Jim

**James S. Hagedorn**
*CEO & Chairman of the Board*

Thanks, Kelly, and good morning, everyone. There's a lot to cover on the call today. The current performance of both major business segments, the implications of that performance in our fiscal '22 results and the steps we're taking to manage the higher-than-expected leverage we will carry into next year.

I will say at the outset, we are not providing guidance today for fiscal '23, we plan to do that in November as we normally do. While some of the finer points of our operating plan for next year are still being finalized, there are some tailwinds and headwinds already coming into focus. So we'll share some of those details today where we can.

In terms of my comments around our current performance, I'll spend more of my time on the U.S. consumer business. Obviously, it's the biggest driver of shareholder value. But I also believe it's easy to misread what's happened over the past few months, and I want to make sure you understand why we remain optimistic.

Before I address these topics, I want to clear the air. I told you on previous calls that I was focused on our long-term strategy and would not manage on a quarter-to-quarter basis. I also said I try to ignore the stock price and market fluctuations but there are times and circumstances that require an exception, and this is 1 of them.

As you know, my family and I are the largest shareholders in this company. None of us are pleased with our current performance or the equity value. I understand the rest of our shareholders aren't either. You shouldn't be, especially those who supported the shares at much higher levels than we're seeing today. There were some challenges that emerged this year, several of them actually that we could not have anticipated. In other cases, especially with Hawthorne, we misread the market, which drove investment decisions that I'd reverse if I could, but I can't. What I can do and will do is focus on the proactive steps we can take to get this business back to an acceptable level of profitability. So to our more recent shareholders are those still doing research, we appreciate your interest and share the belief of many of you that there is an opportunity for significant upside from today's levels. I'm not just the largest shareholder, I'm the CEO. So I'm accountable to all shareholders, and I accept that. Whether our results this year are due to factors beyond our control or missteps that we made, it doesn't matter. What matters and what you'll hear from me today are the steps we're taking to get back on track.

There are 3 things I hope you take away from this call. First, is confidence that we understand the challenges in front of us and are moving with urgency. And while we've been forced to make dozens of tough decisions in a compressed time frame, including a headcount reduction of hundreds of people, we're also protecting our competitive advantages and securing the leadership pipeline we need for the future.

Second is a belief in the underlying and undeniable strength of our U.S. consumer franchise. It is critical for shareholders to look beyond the financial performance of this business in the second half of the year. The fundamentals are still there. The consumers remain engaged and the future remains bright.

And third is an understanding of why we're confident we can restore the business to our historical margins, generate significant cash flow and recapture the financial flexibility we need to drive growth and enhance value.

Much of the improvement is within our control, and we are working quickly to make it happen through an effort we are calling Project Springboard. The first phase has been largely reactive and is designed to adjust to our near-term reality. The next phase is about returning the business to a proper level of financial performance and ensuring we are well positioned to take advantage of the opportunities we believe still lie ahead.

On this call 90 days ago, I could not have predicted that we would be where we are right now. We outlined the impact of lousy weather in April and said we would claw back some of the consumer engagement we lost in the early weeks of the season. We were mostly right in that assumption. In any other year, we would have seen replenishment orders keep up with the surge in consumer POS that occurred throughout May and June. But by late May, it became clear those orders were not coming.

The single biggest change since May is the way retailers are managing their inventory. I'll elaborate on this point later in my remarks. That shift translates directly into lower sales of our U.S. Consumer segment, negative fixed cost leverage in our P&L and higher levels of our inventory than we expected. And that combination is driving our leverage beyond where we want it and is prompting us to focus on debt reduction as our primary use of cash over the next year. We are aggressively managing those issues in real time. And I'll return to this discussion again shortly.

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First, though, I want to update you on the performance of both business segments. I'll keep my comments at a high level and leave the details around the numbers to Cory. Despite the unexpected challenges in our U.S. Consumer segment, I remain confident in the strength and stability of this business.

Household penetration for our products this year is on par with 2020. That's the year 20 million new customers enter the category. More importantly, our total consumer base got younger again this year due to the continued influx of millennial and Gen Z consumers who are buying homes and entering the category. And finally, we kept a higher percentage of those younger consumers this year than we did in either of the previous 2 years. The demographics of this business continue to get better. That gives us and our retail partners a great deal of enthusiasm as we look forward. While total POS units are down 8% year-to-date, that performance is in line with the guidance we provided going into the year.

Given our aggressive pricing actions, we initially expected POS dollars to be flat on that volume. However, POS dollars are down 5%, but still in line with 2020 levels. The recent POS dollars are lower is twofold. First, retailers were more aggressive promoting low ticket categories like mulch and soil. Meanwhile, units of higher-priced and lesser promoted categories, specifically lawn fertilizer and grass seed are down nearly 20%.

I want to elaborate on those 2 categories because there's a lot to understand and it's easy to misinterpret the data this year. Let's start with the fact that we included a volume decline in our initial guidance. If you normalize for that, POS units in these categories are still down about 12% more than expected. It is possible that some of that decline is related to elasticity, although that appears to be minimal. If elasticity was the primary issue, we would have expected to see a significant decline in market share. We didn't. We lost about 2 points of share but the gap between our products and opening price point products was well above normal this year. Let me explain. You'll recall we implemented 4 price increases this year in our branded products. It doesn't work that way in private label. Prices are set once a year, and that contract holds all season. That price gap will normalize next year with higher price increases in private label. So while we currently believe the share decline is not a big issue, we're watching it closely.

There are 2 major factors we believe drove the other 10 points of decline. The most impactful was weather, which impacts fertilizer and grass seed more than anything else we sell. In March and April, it was cold and rainy and nearly the entire eastern half of the country, including critical early season markets like Texas. And in the Western United States, drought conditions also created a headwind.

Weather created 2 challenges. First, it kept consumers out of the store in April, our most important month for fertilizer sales. Second, the wet and cool conditions meant lawns look great in May. In our research, more consumers than normal told us they didn't see the need for fertilizer or grass seed this year.

The other major issue was a lack of promotional activity. Instead of using highly visible promotions to drive traffic, as they've done in previous years, some key retailers adopted an everyday low price strategy in those 2 categories. Experience tells us that EDLP has not worked in the past and it didn't work this year either.

As we look ahead, we expect the return of early and well-timed promotion in these categories next year. Fertilizer and grass seed are the earliest breaking products for us and we need to be working with our retailers to get consumers off the couch and into the backyard. Right now, the scorching summer heat is having a negative impact on consumer loans. That should benefit this category in the fall months and we're hoping to get our first clean read on both fertilizer and grass seed in September and October.

When you look at POS and you look at our sales to the retailer, there is clearly a greater gap than we planned. Some of you have suggested that, that means retailers are less enthusiastic about this category. That is not the case. Planning for the '23 season is well underway, and there is continued enthusiasm. Retailers know what we know, in times of macroeconomic distress, consumable lawn and garden products remain 1 of their strongest categories.

So let me explain what is happening. If you walked into stores in late May and June, you would have seen an unusually high amount of seasonable durable products like grills and outdoor furniture. Those categories just weren't selling. What was moving? Our stuff. POS of our products in May and June was the second highest on record. So it was easy for retailers to reduce their seasonal inventory by carrying less safety stock of our products and reduce their replenishment orders. Sitting here today, retail inventory of our products measured in units is down 12% from last year, and we expect it to drop a few more points further by the end of the year. The opportunity is that retail inventory will be significantly lower going into the spring.

So based on our ongoing conversations with our retail partners, we expect a strong and predictable sell-in at the start of the season. We expect retailers to be more aggressive next year using consumable lawn and garden categories to drive foot traffic and therefore, are more likely to be aggressive at the start of the season in early breaking products like lawn fertilizer.

Moving on to Hawthorne. The story has not changed much. Cannabis prices remain significantly lower due to excess inventory produced by cultivators. As the challenges continue, it is increasingly clear the role public policy has played in fueling the problem. Some states licensed far greater levels of cannabis production than their citizens could consume. The combination of loose regulation and limited enforcement has fueled the illicit market and created a hurdle the legal market is struggling to overcome. We believe we are seeing a reset in the industry right now with some cultivators simply walking away because of the tough business climate. While new East Coast markets continue to grow, it is not enough to offset the declines in the established ones.

There are a few good things to take away as we plan for next year. We will begin to lap some low numbers within a few months, and we're hopeful to start posting modest growth in fiscal '23. We also remain confident our competitive position has remained strong. Even in the face of aggressive cost controls, we've stayed focused on maintaining our advantages in areas like innovation and technical sales. Others in the industry have not.

The translation is that we remain committed to this industry and our vision. While it's been a tough year, we'll be there when the dust settles. So we'll continue hitting the pavement and staying in front of our retail customers, cultivators and our vendors, and we will collaborate with them to meet their needs and ensure they are in the best position possible when the market does return. This will translate into everything from our sales programs to our R&D pipeline. Already, the market is evolving to 1 which large-scale innovative growers are most likely to succeed. We've expected that from day 1, and it plays to Hawthorne strength. The most pressing task in hand, though is restoring Hawthorne profitability. While industry performance has been obviously a headwind, some of our previous investment decisions have been as well. We clearly overbuilt the infrastructure of this business, and I'm not going to sugarcoat it. The difference in cost of what we have versus what we need is roughly $65 million a year. While we are moving aggressively to reduce Hawthorne's supply chain footprint, it won't happen overnight.

The goal is to return Hawthorne to its previous margin structure within 2 years. Beyond that, we remain focused on achieving an operating margin of 15%. The final Hawthorne item I want to discuss relates to its future as a stand-alone business. Ideally, we would separate the business today for a variety of reasons. Not the least of which is the impact of volatility the cannabis industry has on the equity value of SMG in total. But our analysis tells that now is not the right time for this move. This is not the kind of market in which a full or partial IPO makes sense. And we're not going to sell the business when its earnings are at a multiyear low, and we have a clear and achievable plan for improvement. We explore the notion of combining the business with someone else, but that means sharing the synergies with another investor base after paying bankers, consultants, lawyers and others.

In a best-case scenario, we end up as good, if not better, by controlling our own destiny and allowing 100% of the upside of our restructuring efforts to accrue to SMG shareholders. The best course of action is to fix the business and wait for the industry to recover. So for now, that's the end of the discussion.

I want to spend the rest of my time coming back to some of the themes I discussed earlier. While my team and I remain resolute in our vision, we realize our current focus needs to be on taking the right short-term actions to enable it. That means we must get the business back to an acceptable level of profitability. It means we must be laser-focused on sustainable free cash flow, and it means we must strengthen our balance sheet and reduce leverage.

So we will hit the pause button on M&A and share repurchases. We remain committed to using the strength of our brands to help offset inflation, and we will reduce as much expense as possible without impacting the health of those brands. Regarding our leverage ratio, which stood at 5.1x at the end of Q3 and is almost certain to go higher.

Remember, our leverage is calculated in our rolling 4-quarter basis. As we look ahead, we would expect leverage to peak in the March quarter at approximately 6x. From that point, we would expect it to decline quickly I'm not sure if we can get back to 4.5x at the end of fiscal '23, but that's the goal. It's likely to be fiscal '24, however, before leverage is below our preferred long-term target of 3.5x.

Given the recent amendments to our credit facility, we are comfortable we have the room to navigate. And while I'm on the subject, I want to thank our syndicate banks for their support and flexibility. The challenges in the business emerged so suddenly this year, we were forced to reopen discussions with our lenders only a few weeks after finalizing a new facility. They recognize the unusual circumstances and encouraged us to seek even more flexibility given the uncertainty in the broader economy. I will tell you what I told them. We know what this business can accomplish, and we are committed to getting it back where we belong. Our U.S. Consumer business should have operating margins in the mid-20s, not the high teens.

We still have conviction that Hawthorne can achieve a mid-teens margin, and we should also be able to deliver free cash flow productivity consistently near 100%, though next year, that performance should be significantly better. In fact, over the next 2 years, our goal is to generate at least $1 billion of free cash flow, the vast majority of which should be generated in fiscal '23.

I'm confident we can get back to the level of performance that we and our shareholders expect and deserve. And rest assured, we will hold ourselves accountable. No one on the management team is receiving a bonus this year, and the equity grants we've made in recent years have taken a significant hit as well. Earning a bonus next year will require dramatic improvements in targeted areas, especially cash flow and leverage.

The goals we set will be focused on driving value for our shareholders and not merely delivering modest improvements off an unacceptably low base. We know what needs to be done, and we're focused and committed to getting it done. Each of us on this team knows the power of this business and our brands. We know the resilience of this category and mostly, we know the dedication of our associates. On that note, I want to take a moment to recognize our people and thank them for their efforts this year. We've encountered challenges we never expected, and we're forced to make changes that call many of them off guard, especially only part of the company with so many of our former colleagues. It's important that all our stakeholders know that my team and I remain optimistic about the future. We know our collective strengths and competitive advantages will get us back on track. And that gives us confidence that we'll once again deliver for our shareholders the results and value creation that they deserve.

With that, let's shift gears. Let me turn things over to Cory.

**Cory J. Miller**
*Executive VP & CFO*

Thanks, Jim, and good morning, everyone. Jim gave you a high-level overview of the trends we saw during the quarter in this commentary. I'll use my time to take a deeper dive into the P&L and balance sheet results to give you some additional insights.

I'll start by saying that overall, our results for the quarter were mostly in line with the revised outlook we gave you in early June. There was 1 area where results were unfavorable to our expectations. U.S. Consumer top line sales. Jim mentioned the shift in retailer focus to inventory reductions that we've been experiencing since May. We had adjusted our full year outlook for the U.S. Consumer sales to account for this, but the trend has continued and accelerated. In the third quarter, POS units were down 6%, while our shipment units into retail were down 18%. Our third quarter sales were down 14%, and we expect a similar or deeper decline in the fourth quarter. This means our full year sales outlook is now down 8% to 9%. While there is clearly noise in the numbers this year from retail inventory actions, I want to remind you that POS results are generally in line with what we guided at the beginning of the year. POS units were up 6% and in 2021. So our performance this year means that we are just slightly behind 2020 results in well above 2019 levels.

Hawthorne sales were down 63% for the quarter. The run rate for that business did decline slightly in the quarter, in line with the revised guidance we provided in early June. The decline was driven by less outdoor growing in the third quarter than we originally had expected and further delays in capital projects for indoor growers, both driven by the oversupply in the cannabis industry. It's also important to note that we were comparing against record results. The third quarter of 2021 was the highest quarter of sales in Hawthorne's history. We expect the run rate for Hawthorne to improve in the fourth quarter, driven by innovation in our horticulture lighting business in Europe and Canada. We recently launched the WEGA, a new LED product developed specifically for the greenhouse applications in the vegetable and flower markets. Just like our previous LED innovations, it uses less power and delivers optimal light output. The return on investment proposition has been clear to the growers in the space, who appreciate the energy cost savings combined with superior results. Early orders for the product have exceeded our expectations.

Moving on to gross margin rate. The adjusted gross margin rate in the quarter was 530 basis points below last year, which brings the year-to-date decline to 300 basis points behind prior year. The principal driver of the decline in the quarter was fixed cost deleverage stemming from the volume miss in both segments. Warehousing and manufacturing costs are largely fixed in the short term, and these fixed costs were spread over fewer units in the quarter. The fixed cost deleverage impact was included in our latest guidance on gross margin rate for the full year.

The gross margin rate decline in the fourth quarter will be higher than what we saw in the third quarter. This is primarily due to an aggressive pullback in production that will result in more costs falling through to the bottom line in the fourth quarter. As expected, commodities also weighed heavily on the gross margin rate for the quarter. Almost all of our commodities experienced new highs after the Ukraine invasion. Urea has recovered recently after experiencing extreme spikes in the spring. This recovery helped lessen the pressure in the quarter, but will not provide much relief in the balance of the year. Commodity changes from this point on will primarily impact us in next fiscal year as we are 95% locked on our commodities for fiscal 2022. The extreme pressures of deleverage and commodities were partially offset by pricing and favorable segment mix due to lower sales in the Hawthorne segment.

SG&A was significantly lower for the quarter, down 30% from prior year. Three key items drove these results. The first was variable compensation. As Jim mentioned, no one on the management team is getting a bonus this year. The full year impact of variable compensation is worth approximately $60 million. The second driver of SG&A savings was the restructuring effort that we announced last quarter. We told you that we had set a target to reduce our overhead structure by 10%. This restructuring effort became the first initiative for Project Springboard. The targeted reductions were achieved and some of that favorability was realized during the quarter.

Finally, spending reductions across the company drove further SG&A savings in the quarter. Every cost center was evaluated for potential reductions and we identified opportunities to cut or delay spending in each of them. We were aggressive with these actions, but we also maintain a strong point of view on the activities that contribute to our competitive advantages. For example, we took care to preserve research and development in both businesses and our U.S. Consumer field sales team. The favorability we experienced in the third quarter will carry through to the fourth quarter. Prompting us to adjust our outlook for SG&A from down 13% for the full year to down 15%. With these factors now baked into our expectations for full year adjusted EPS, a we now expect to finish at $4 to $4.20 per share.

Shifting gears now, I'll cover the impairment and restructuring charges we recognized during the quarter. Jim covered the challenges we have been facing in the Hawthorne segment related to oversupply in the cannabis industry. Those challenges, combined with the overinvestment in the Hawthorne supply chain, led to a noncash impairment charge of $633 million, related to goodwill and intangible assets.

Additionally, we recognized a $46 million inventory write-down associated with the discontinuation and retirement of our Sun Systems brand. Lastly, the restructuring efforts that we discussed above resulted in charges of $41 million, related to employee termination benefits and fixed asset impairments.

Below the operating line, interest expense was $9 million higher in the quarter and $26 million higher year-to-date. The change is driven by higher borrowing levels. Those higher borrowing levels, combined with lower earnings in the business, resulted in a leverage ratio of 5.1x at quarter end. Jim gave a good amount of detail on this topic in his comments, so I won't elaborate further.

We expect our full year adjusted effective tax rate to be approximately 22% this year. The favorable rate is due to a benefit of discrete items related to the vesting of long-term share-based compensation awards, though we aren't giving guidance yet on 2023, I want to call your attention to some headwinds we will be facing next year below the operating line. Tax rate will likely be a headwind as we expect to return to a more normalized rate closer to the 24% we've seen in the prior few years. Interest rates will be a headwind due to higher variable interest rates as well as higher spreads from the recent amendment to the credit facility.

EPS could also face pressure due to share count. Since we aren't planning on share repurchases in 2023, we will see some dilution from equity awards. On the bottom line, we had a GAAP loss per share of $8.01 compared with earnings of $3.94 last year. This number includes the impairment and restructuring charges that I described earlier. Non-GAAP adjusted earnings per share, which excludes impairment, restructuring and other nonrecurring charges was $1.98 in the quarter compared with $3.98 a year ago.

I'll switch gears now to the balance sheet and cash flow. We've made some progress on our inventory reduction goals, even considering the further decline in U.S. Consumer replenishment orders. Inventory at quarter end was $445 million higher than this time last year. This was an $84 million improvement from where we ended the second quarter if we exclude the Sun System's write-down. We have pulled back on production in all of our manufacturing facilities and will continue to limit production and dramatically reduce our inventory levels throughout 2023. This decision will put pressure on our gross margin rate in the short term, but aggressive inventory reductions will allow us to act quickly on rightsizing our distribution network and get our long-term margins back to an acceptable level.

We've also lowered our expectations for CapEx. We are now planning to spend about $135 million, down from an original target of $200 million. We will lower our CapEx spending further in 2023 as part of our plan to decrease leverage. The changes that I just covered on the balance sheet and CapEx were already built into the revised cash flow guidance of flat that we communicated in early June. However, the additional decline in U.S. Consumer sales will put further pressure on our free cash flow. We are now expecting negative free cash flow of $150 million for the year.

Jim mentioned his confidence in cash flow going forward, and I certainly agree. Reductions in working capital will provide a strong tailwind next year, improved performance and reductions in CapEx will likely bring the full year number close to $700 million, if not higher. As we look at capital allocation, no changes are planned for the normal quarterly dividend. And as Jim mentioned, all other uses of capital are on pause, including M&A and share repurchases. Project Springboard is working to establish detailed targets for leverage and capital allocation that we will share with all of you next quarter.

Without question, reducing our leverage and getting the business back to acceptable levels of profitability is our most important goal. There's no doubt that this has been a difficult year. It would be easy to lament the factors that impacted us. Instead, we are squarely focused on the things that we can control in forging a path forward. I'm confident that our plan has been designed with the shareholder value creation in mind as our guiding principle. Rest assured, we understand that the true proof of our strategy will be seen in the results that we deliver, and we will hold ourselves accountable for those results.
Now I'll turn the call over to the operator for your questions.

# Question and Answer

**Operator**

[Operator Instructions] And we'll go to our first question from Chris Carey with Wells Fargo.

**Christopher Michael Carey**
*Wells Fargo Securities, LLC, Research Division*

Can we maybe review the cash flow expectations a bit more? I appreciate you gave a lot of detail with -- especially the significant cash generation expected for next year. But I suppose the 4.5x leverage target, if that cash flow outcome is achieved specifically in fiscal '23 does imply a pretty notable profit recovery as well. So clearly, there's confidence in the business.

And so I guess just #1, can you maybe help us understand the success you expect from carrying the inventory from this year into next year, which I think is a key assumption around your working capital? And then secondly, maybe just dimensionalize, you mentioned some gross margin pressure from carrying that inventory over. Is that the only real impact you would expect? Or would you have to do anything else to make that inventory more current? Or should it be more or less good to go for the fiscal '23 season? Then I have a quick follow-up.

**Cory J. Miller**
*Executive VP & CFO*

Chris, it's Cory. So a couple of things there. When we look at free cash flow for next year, we see 2 factors that will kind of drive us to get to a number that is around $700 million. One will be the normal rate of cash flow that we see on a kind of year-on-year out basis of about $300 million. So we think that the earnings we'll generate next year will allow us to kind of normally generate that level of cash flow.

The second item that will increase the cash flow that we'll see next year above what we'll see kind of going forward after that will be the reduction in inventory that we're going to experience by the end of '23, which should be around $400 million. So combining those 2 things together, you get to the $700 million.

And then on a go-forward basis after that, we won't repeat the benefit that we get from reducing inventory, but we should still be able to be at that roughly $300 million, normal run rate. So I think in Jim's comments, he said $1 billion for 2 years, that's kind of how you get there. And I gave $700 million is the number for next year.

Second part of the question is on gross margin pressure. If you look at the pressure we've experienced this year, you kind of have 3 things that net out to -- net down to the pressure that we felt of 300 basis points year-to-date and expectation for about down 400 basis points for the year. First would be the cost of our inputs going into that -- into the products. So pressure related to that. We also had pressure related to volume coming down. That affects us because our fixed cost leverage across our distribution network, our manufacturing footprint and just on the normal cost that run the business, all are on fewer units. So those 2 things are the biggest pressure, offsetting that pressure is the pricing that we've taken this year, which about offsets the dollars we incurred on our input costs going up.

So we took enough pricing to cover the dollars. That alone has decreased effect on the rate and then the fixed cost leverage makes the rate a little worse yet. So those are the 2 things -- are 3 things that kind of net down to this year's gross margin rate pressure. As we go into next year, we're taking more pricing. We're also expecting to see more cost increases, even though the costs have come down recently, our average cost for next year are still planned to be above the cost that we've experienced this year because of the timing of when we bought inputs and when those inputs get sold out. So that's the rate pressure that we're looking at for next year. And we haven't forecasted the entire year yet. We're obviously not giving guidance on it, but we're just pointing it out that there will be a pressure point.

**Christopher Michael Carey**
*Wells Fargo Securities, LLC, Research Division*

Okay. Quick clarification just on that, how much of that inventory reduction is related to U.S. Consumer versus your sales expectation in Hawthorne. And then just a second question here, and then I'll jump back in as SG&A is going to be down pretty substantially this year. How much of that reduction do you think comes back in fiscal '23 like comp versus what might be sustainable cost savings going forward?

**Cory J. Miller**
*Executive VP & CFO*

If you look at the reduction, the way we have it modeled out now is about 2/3 in U.S. Consumer, 1/3 in Hawthorne. And if you look at the inventory levels that we're expecting to end next year at, it still assumes the higher level of cost inputs driving that inventory higher. So if you look at total inventory increase, a good portion of the increase that we've had versus last year is due to every unit just costing more with cost increases. So right now, we're looking at 2/3 U.S. Consumer, 1/3 Hawthorne, if costs come down in the Hawthorne -- I'm sorry, in the consumable market, we could have additional decreases in inventory that will mainly be on the U.S. Consumer side, but that's dependent on cost coming down as we're producing it related to the inventory that we hold at year-end.

**Christopher Michael Carey**
*Wells Fargo Securities, LLC, Research Division*

And then just on SG&A?

**Cory J. Miller**
*Executive VP & CFO*

SG&A cost, obviously, this year are lower than in the past. We talked in the comments about $60 million of this is due to incentive compensation. We are looking to add incentive comp back into the plan for next year. So there will be a cost headwind related to that. If you look at other costs related to people, we don't have any drastic changes in our initial plans now related to people, but incentive is a pretty significant one that we will add back.

**James S. Hagedorn**
*CEO & Chairman of the Board*

Chris, Hagedorn here. I just want to sort of throw out this Springboard project and kind of where we're at with that. The -- we are sort of talking internally kind of Phase 1, Phase 2 of Springboard. And Phase 1 is kind of the reactionary holy ship order we got to do to stay good, especially through our peak borrowing period next March. And I'd say that what we've accomplished, which is a lot, I would say, probably is in excess of 1 turn of leverage. And so the team has been -- when I say the team, the whole company has been working really hard on this.

And my focus when I talk to Cory and the team is not really on sort of EPS in 2 months. It's making sure our leverage is -- and you heard me talking about 6 is -- call it, 6 or less next March. And so there's a lot of work, as you heard just -- I just said, that's already gone into that. And I think that if you just look at the business, those are more than you asked for, probably. But we exceeded our July numbers. That's the first time we've exceeded numbers in probably 4 months. So that felt pretty good. I think we have pretty much a handle on the last couple of months of the year that Mike is comfortable with. And then our sell-in numbers, again, I'm not throwing forecast out for next year. But I think in Springboard, what we're doing is we're looking for, I'm not going to say completely achievable, but a very achievable number that everybody has a lot of confidence in. And -- so I think that there is probably room there if Mike makes his numbers to sort of do better than that. So I think we're becoming more comfortable. This has been a challenging period. I'm going to say its sort of since Memorial Day, roughly here. But I think we feel like we're regaining control of what's going on based on sort of the last part was just while consumer sales were okay, reorders were not and sort of we've been through that.

But back to sort of this question of G&A., and I'm really speaking for myself, but as the leader of the business. It was pretty blunt what we did. We went in to kind of emergency mode, we made the sort of -- I think we've probably overachieved on SG&A reductions. And just to be clear, we'll do whatever we have to do through March. At that point, leverage based on our assumptions goes down pretty quick, okay? Probably more than 4.5x. But I think that's the number that sort of ended up in the script. But the Springboard target is better than that, more like 4x or something like that or just a hair over, I think, is kind of where the numbers that I've seen recently. And those numbers are updated all the time.

But once we have confidence in sort of peak leverage at that point, which will be pretty soon, I think, we're going to move into Phase 2, which is basically how do we want to structure the company and how do we get the value of the equity back up. And I don't think this is like cosmic math. People are using '19 as kind of a proxy, I think, at this point. I mean I hear this in the sort of analyst community, we don't see sales going back there. And we've used '19 levels as we've sort of, I think, planned through Phase 1 of Springboard as far as org goes.

I think going forward, we're going to be looking. And to be complementary of the folks at Hawthorne, Hawthorne has hardcore bought into things are different, and there've been tough days. If you like people, they've been tough days at Hawthorne.

I think we're going to look at the whole organization and sort of look at a pretty significant redesign of how we do it. Remember, we went in from this period of like, you and what army, unconstrained words that Luke and I were using to feeling a lot more constrained. And that's okay, but I think we're going to take a look at what we got to do to build value.

And so I think you going to see more of a sort of redesign in the organ. I think SG&A will reflect that. But that -- we haven't really gotten into that yet. Now we've been pretty blunt and not as fine as I would like to be, but it was what was necessary for where we were. But we'll move into Phase 2. And I think more to follow with you guys on where that goes. But it's not going to be bad, but it's going to be much more thoughtful about where do we add value in this business? What do we think the growth rates are going to be, how do we support that. And I think it will be focused on our brands. It'll be focused on our in-store presence and our ability to sell our ability to fulfill orders and our ability to innovate in the marketplace. And I think those are where we are going to invest. And -- but I think it's a good process. We just haven't really gotten to it because we're just now sort of regaining a handle on confidence, we kind of know where we're at.

**Cory J. Miller**
*Executive VP & CFO*

Yes. And Chris, I just want to clarify my point on $60 million coming out of the plan or out of this year's results versus last year related to variable comp. That's not what will go in next year. So a couple reasons why we paid out above target a year ago. We have fewer people because of the actions Jim just talked about going into next year. So the number that came out with $60 million. The number that we're looking to add back in is closer to $35 million.

**Operator**

And our next question will come from Peter Grom with UBS.

**Peter K. Grom**
*UBS Investment Bank, Research Division*

Good morning, everyone. I hope you're doing well. So I kind of just wanted to just follow up on that last question. And I know you don't really want to provide fiscal '23 guidance. So I may be reaching here, but kind of taking a step back and putting together all the different pieces on what you said today, it doesn't really sound like you'd expect EPS growth, I guess, to some degree. So it sounds like the U.S. Consumer business should be okay, Hawthorne moderate growth. And I guess, in your response to Chris' question, it doesn't sound like you expect a lot of margin improvement. And then Cory, you called out a bunch of unfavorable things below the line. So am I thinking about that right, based on where things stand today? Or is there something I'm kind of missing in kind of that broader assumption?

**James S. Hagedorn**
*CEO & Chairman of the Board*

I'm interested in what Cory is going to say now.

**Cory J. Miller**
*Executive VP & CFO*

Well, I was going to stress your first point that we're not giving guidance today. So the range that we would give you would be very broad. I think where we're looking to call this year at $4 to $4.20, you look at next year in we don't expect significant decline or significant growth, we'd be in a range that is kind of around where we're at this year. It would be my early read on it. A lot of things to come together. But again, I don't expect drastic deviation from where the finish is expected to be this year.

**Peter K. Grom**
*UBS Investment Bank, Research Division*

Okay. No, that's really helpful. And then I guess just -- there's a lot of commentary in the prepared remarks, Jim, you discussed the importance of margin recovery. So can you maybe help us understand or think about the time line here? Like you mentioned looking back to 2019, and you're still sitting on a revenue basis, roughly 30% above that, right, EPS is below.

So how should we think about what a normalized earnings number could be? And kind of any sort of time line around getting back to that because it clearly doesn't sound like it's next year.

**James S. Hagedorn**
*CEO & Chairman of the Board*

Cory is like making face that [ me too ]. Come on.

**Cory J. Miller**
*Executive VP & CFO*

Well, if you look at the market today, I'd say there's...

**James S. Hagedorn**
*CEO & Chairman of the Board*

Take a breath for a second. Here's what I would say. We inputed, I think, and so if I say mistakes that I will take responsibility for, we built out a footprint on, call it, a $1 billion Hawthorne business that would have supported a business at least $1.5 billion, maybe more than that. I said that the cost of that, I think legit, is like $65 million a year. That includes the cost of the inventory, et cetera, but warehousing all the stuff that goes with it. Part of getting their margins back is going to be getting rid of that basically overhang of -- and that's nearly half the profitability of that business is that. And we got to sell lights, where that's our prime category. That's a good margin business for us. And that should come back over time. And indoor growing is still the most significant part of the Hawthorne business. But wholesale prices got to get to the part where people can sort of justify the capital expenditure to upgrade and add cultivation space.

On the consumer side, we went through a period of a couple of years where we would just hand them out in inventory. And Mike and I made the decision to like get that over with and build sufficient inventory, which you could look at now and say, but at the time we made the decisions, it seemed like a reasonable idea. I mean we've taken the inventory down probably $150 million since -- we hit our peak, but we were probably sitting on like $600 million of excess inventory which is not that many weeks ago.

And so getting that down, the negative impact of just we shut the valves off, I mean, we're hardly making anything, which has a pretty significant negative on margin. And we've just had some pricing that just took effect that's nearly 10%. And so I think all those things, when they normalize, meaning the pricing is in, we're back in normal manufacturing mode, our inventory is back where it needs to be. All these things should be positive. And I don't know, Cory, where you take it from there. But I think that's -- I think -- I don't think it's very cosmic. It's not a lot of actions on our side.

**Cory J. Miller**
*Executive VP & CFO*

Yes. And the timing of when all those things can show us benefit in the P&L will be important. And the other factor that wasn't mentioned are cost increases. While costs have come down recently, our average cost for inputs next year still looks to be higher than what we've experienced this year. So the pricing that we just put in place this week will help to offset those increases, but we're still seeing increases.

So as we get further into the year, we hopefully can turn that around. We hopefully can get costs that are more in line with kind of historical levels and that what we've seen in the last 6 months here. So I think it comes down to timing. We're making all the moves to get our gross margin rate back to where we want it to be, but it takes time for all this stuff to flow through the P&L and show in increased margins. So that would be my biggest question, Peter.

**Operator**

And our next question will come from William Reuter with Bank of America.

**William Michael Reuter**
*BofA Securities, Research Division*

The first question on the comment you just made about the recent 10% increase in prices. I thought on the previous call, you guys had through the 4 rounds of pricing increases by an aggregate of 10%. So are we now at 20% year-over-year? Or where are we sitting on a year-over-year basis at this point?

**James S. Hagedorn**
*CEO & Chairman of the Board*

Luke, you can take this gain?

**Michael C. Lukemire**
*President & COO*

I don't know what the aggregate. I think it's 18%. Based on how it runs through by month, you get into an average for the year.

**James S. Hagedorn**
*CEO & Chairman of the Board*

And that's Michael Lukemire talking just by the way.

**Michael C. Lukemire**
*President & COO*

Yes. So -- but the 10% is definitely incremental.

**Cory J. Miller**
*Executive VP & CFO*

Yes, you're going back over more pricing actions. So you're going to last August and rolling forward those pricing averages across different categories that are getting different levels of pricing, but the average is 10% right there around 18%.

**Michael C. Lukemire**
*President & COO*

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Right.

**William Michael Reuter**
*BofA Securities, Research Division*

Okay. And then there were a couple of different comments about leverage. At 1 point in the prepared remarks, you've talked about potentially there being a challenge to get to 4.5x next year, but then Jim seemed to express enthusiasm that you guys could actually get to 4x. I guess what are the things which are going to dictate that number how much of your costs are you locked in for 2023 at this point? And I guess, is it basically thinking about elasticity, which, Jim, in the prepared remarks, you mentioned you felt was relatively low at least this year.

**James S. Hagedorn**
*CEO & Chairman of the Board*

Well, just let me -- I'll leave some of this to Cory and Luke, if he wants to. But remember, our peak leverage period is really kind of before we start selling stuff to the consumer. It's all retailer load. So based on current inventory levels and where we think and what retailers think they're going to need, I think we have a pretty good idea of what that is. And it doesn't really -- elasticity is not really an issue at that point when we hit our peak leverage point.

So it's mostly sell-in related, and I would say risk there would be based on selling. That would be -- volume would be probably the biggest single driver in that. I think our own costs we understand pretty well. And like I said, we are 100% on top of that.

I remember Luke's number is based on a high confidence level. And we think there's probably upside to that. But that at the end of the day, a lot of the sort of anxiety we've had here over the last month, 1.5 months, I don't know, whatever it is, since the beginning of June has really been consumer performance, not Hawthorne. It's been -- I mean Hawthorne is just bobbing along, not really seen a recovery yet. We don't need to talk about that very much. I don't think that's news.

But I think that consumer -- disregard, retailer inventories have really driven merchants to be very careful in how they order. And it's not that they're not supporting the business, and it's not that they're not ordering. But there's 0 excess [ out ] of inventory, I'd say it's very minimal. That is an opportunity for next year, in our opinion. But a lot of the struggle over the last couple of months has been performance in the consumer side, and that's just reorders.

**Michael C. Lukemire**
*President & COO*

Yes. And they're just following their -- this is Mike again. They're following the replenishment, the turn replenishment systems back on, and that's what's really driving the reorder versus doing activities to push certain things to driving activity, though we are going to do some things.

**William Michael Reuter**
*BofA Securities, Research Division*

Okay. And then just 1 last question on that. It sounds like you have been given no indications that the retailers are any less excited about the season for next year. And given that, I think you mentioned inventories are lower by 12% on a unit basis year-over-year at this point. We should expect that next year, the sell-in would be very strong. Is that your expectation from your conversations?

**Michael C. Lukemire**
*President & COO*

That is definitely our expectation. I mean we're being conservative to say what that's going to be. But the -- remember, there's -- really, it's not POS driven. It's ready for the season, and we're going to be even hitting the season earlier on fert and seed, more back to traditional levels and you'll see promotion in those activities. So we're going to be a lot more aggressive to get started sooner. And so -- but the load end is pretty standard. And even if you think about this year, we were totally on our plan after the first half. That's a retailer lean in. What happens afterwards is based on POS and what the consumer does in those months.

**James S. Hagedorn**
*CEO & Chairman of the Board*

Yes. And just another sort of point on that. I think we're seeing sort of continuing reduction of the retail inventory occurring between now and fiscal year-end for us that's probably, I don't know, like of course, [indiscernible]. I think, call it, 3-ish percent. I mean, that's again, this is a number that people have said is they think it will be down like roughly 15% by year-end. So we're -- and that's in our plan is we're continuing to see retailers look to kind of end the season pretty clean.

**Operator**

And moving on, we'll hear from Bill Chappell with Truist Securities.

**William Bates Chappell**
*Truist Securities, Inc., Research Division*

Jim, on that same line, I mean, I guess I'm still kind of confused about your comments on what happened at retail for U.S. Consumer and why you're so encouraged that retailers are just as excited about the category going to next year? I mean in that -- from at least what you said, they destocked in the middle of the season for the first time in 20 years because they had poor retail management of consumables versus durables and that's -- I'm just trying to get my arms around that.

And then I didn't hear exactly other than you're going to have a strong December quarter in terms of sell-in, what gets you excited that they don't? Are -- as excited about the category as they were in 2020 and 2021 when the category was surging and where they don't kind of move their efforts elsewhere. So can you just kind of quantify it or give us some more detail of [indiscernible]

**James S. Hagedorn**
*CEO & Chairman of the Board*

Let me start with some qualitative stuff. And then like people want to quantitate it, they can do that. I start with just a couple of points, Bill, which is, #1, we are very advanced in our discussions for fiscal '23 season with our retailers.

And so it's not like we kind of hope that they are enthusiastic about it. We know they're enthusiastic about it. We know decisions they've made on the shelves. They favor us, by the way. And we understand, I think, pretty well the promotional plans that are going into next year. That gives us some confidence.

I don't think we're reinventing the wheel here in -- as people on Wall Street talk about. So I'll say this, I doubt if I was a merchant at a retailer, I would be saying to myself, "Oh, we're going to sell a boatload of patio furniture and outdoor grills next year." We have a deep understanding of I think, challenging financial times within the economy on how it affects our business.

And I think a lot of you on the call, Bill, I mean, you've known us a long time, I think what you saw kind of in, call it, [ 10 ] was as consumers became challenged, lawn and garden consumable products and paint were kind of the big items that we're selling for quite a while as the consumer was stressed.

So I think -- I don't think, I know lawn and garden is a significant category for retailers. They need for it to be successful. They are not going to be successful, in my opinion, selling durable products. They're going to be successful by selling consumable products, and that is us. Okay? So we feel confident not only because of discussions but because of our understanding of history.

And the other thing that -- there's a bunch of things that are going to be different next year for us. Some of them is sort of back to the future. Bill, I think you're likely to see earlier promotion. During COVID, we advocated hard, I think, and the retailers agreed to sort of promote and activate the consumer in season, not sort of ahead of the season. And we talked a lot about that, which is we thought there was a lot of risk from weather. Those promotions tended to be I think, marginally effective.

I think our learning this year, a couple of things is we want to get ahead and sort of the retailer on lawn fertilizer and grass seed. It's an important category. It's a high-margin category for both them and us. And the plan is to get out against that early, and our brand teams are working that and our relationship people with our big accounts are working that, and there's enthusiasm behind that. And we're going to be investing pretty heavily, higher to do that.

So in spite of a lot of the challenges around here, we are not skimping on activation for those early high-margin products and we -- so we're going to work really hard to get those going. I don't know. I think that's, Mike and [indiscernible], do you want to add?

**Michael C. Lukemire**
*President & COO*

I would just say they're not destocking. They're not -- the replenishment systems are [ low ]. They're in stock. I got Josh Meihls sitting over here, head of sales. What we're seeing is because the box has got so much other inventory on durables, they're discounting that stuff. So they lean in and do more, they got enough discounting going on, so they're going into a little bit of margin protection.

But we had one of the best July we've had in a while. We made our numbers, and that was all off of replenishment. So if you were just turning the [indiscernible], Bonnie had the best July ever. It was up over $25 million, which was unprecedented for Bonnie. So it's just in that without leaning in with more promotion on that activity, and they're using their replenishment system. So that gives us confidence in the category.

We want to tie that into doing a fall program to get started, especially with fert and grass seed and also get earlier started because we're also battling time with consumers as well. And so if we don't get early start while...

**James S. Hagedorn**
*CEO & Chairman of the Board*

Yes. There's 1 thing I wanted to add is this issue of kind of elasticity. And I know as we prepared for this call, I had the lawns folks in and we were talking. And the consumer does appear to be more interested in sort of promotion. So for like our July business, when we were promoting, business was better than when retailers were not on promotion. And so I think that's also driving us next year, which is a feeling that if consumers are stressed, they want a bargain and we need to sort of build our business into that.

We mentioned this issue of elasticity, not because we really know. We use that 2% number of share loss. That is Nielsen diary data. I mean I'm not sure Mike is a big believer in that, where we see the data at some of our largest retailers, we're not seeing any share loss at all. But remember, we didn't intend either when we took all that pricing, we took pricing the whole category decline.

So I think Scott's products kind of lead that. And so we're definitely going into next spring thinking promotion matters, retailers need to see bargains. We want to watch carefully, I think not just us, but the merchant teams are also -- lawn fertilizer products are starting to get pretty expensive. And we -- so we haven't seen a share loss, but we've seen this category reduction.

We think it's almost all weather. But this fall will be a really good indicator. We've had a hot in some areas [indiscernible], kind of difficult for lawns. So this would be a really good to watch and see sort of when we report out at year-end, how that lawns and seed promotions did when lawns are stressed.

**Michael C. Lukemire**
*President & COO*

Well, we even saw even on grass seed at some of our higher priced items are actually up. So Jim reminded me that we promote some of that, and we do. So -- but there was a good consumer takeaway on those activities. And there was a lot of less promotion in grass seed and fert this year than it has been in the past. So we'll be leaning in harder starting earlier, and we believe we will recover.

**William Bates Chappell**
*Truist Securities, Inc., Research Division*

Okay. Just I guess a follow-up there. One of the things Scotts, historically, and believe it or not, the 20 years I've covered the company, been good at is if the weather was bad, you were able to intra-season kind of tweak the spend behind the -- so you can still come to a similar bottom line number.

I'm just trying to understand why -- I mean, with the weather really starting bad early in the season, where you just -- your hands tied because of the cost increases and the inventory management where you couldn't mitigate this, the weather impact? Because it seems like it was a much bigger impact on the bottom line than I normally see a little on the top line.

**James S. Hagedorn**
*CEO & Chairman of the Board*

Definitely. I have felt and I'm not asking anybody to feel sorry for us or me. But like when you're sitting around a campfire or a barbecue and the smoke just follows you no matter where you go, it has felt like that here this year is that we had cost of goods issues. Hawthorne was driving that, which not just -- but it just seemed like we got to a point where -- and look, I'm not trying to defend it.

But I think you get into sort of early May, where all of a sudden, there's a lot of things going against you and you sort of need a good season. And I think if any 1 of the things, whether it was cost of goods [indiscernible], the sort of last quarter of consumer. If any of those have not gone against us, we wouldn't be having this sort of -- kind of conversation. It was just -- we get to that point, like early May where you're sort of you're either hopeful you can pull the year together or it's like capitulation. And that's what May seems like.

We had a 1 of 2 Board meetings we're having this week, which is typical for us. We break forward meeting up and to kind of get all the bunch of -- all the stuff we have to do out of the way, committee reports, all that stuff. And then we talk about, which will be Friday, what's happening in the business and where are we going. But there was like 4 Board meeting minutes that going back to April that had to be approved. So I was going through the preparation for the Board meeting, and I was reading through all those minutes from April. So like late July. Oh my God, it gave me like PTSD just reading it the whole journey is in there.

And yes, Bill, it got to the point where there was just capitulation. It was just everything was kind of going against us. And I don't think it's that unusual. I think a lot of the companies you probably follow or get to the point where they just can't cover it all. I think we have a really good history of adapting through the year, it just -- it got to the point where -- and I'll give credit to Cory. It felt a little ugly here, but there was a point where we -- everybody threw the bulls*** flag up and said, "yo, it's starting to get serious." And that's where we've been living kind of since Memorial Day, sir.

**Operator**

And next, we'll move on to Joe Altobello with Raymond James.

**Joseph Nicholas Altobello**
*Raymond James & Associates, Inc., Research Division*

I guess first question on Hawthorne. You mentioned that July was a really strong month. I think you were speaking U.S. Consumer. So maybe clarify, did Hawthorne have a good month as well? Or are you starting to see some early signs of a turn there at all?

**Christopher J. Hagedorn**
*Division President*

Bill -- Joe, this is Chris. Yes. So no, that comment was directed at U.S. Consumer. Hawthorne did not had a strong month in July, I wouldn't say that the trends we've been experiencing for sort of the beginning of this fiscal year continued through July. We're taking a lot of action, obviously, it has been discussed to control the cost that we can, as Jim talked about, wind down the inventory and infrastructure investments that we made, but we haven't seen much recovery in the industry. We continue to look for sort of bright spots and signs that the recovery may be on the way. But we're on plan for July for our revised plan. And right now, we feel confident in, again, our revised plan for the rest of the year, but that does not include material recovery in the marketplace.

**James S. Hagedorn**
*CEO & Chairman of the Board*

Look, Joe, I want to throw out just my own comments. I know king has given me that I'd like to watch sign, which is like go faster. Ever there was a call worth talking I think, in getting a feel for what's happening here, this would be it. I think that -- I don't know, I think it was Forbes of Fortune or [indiscernible] it's going to be a blood bath, how right they were. But this is pretty much a war of attrition at this point, and we aren't caving.

We're on the beach and the landing craft have left, and we're going to fight our way off the beach. We know the strategic advantages we have relative to other people. We know the relationship we've always talked about, which is building it with cultivation partners.

Retail sales of cannabis products are not down. It's the wholesale price. And the more we look at this, the more outrageous. This idea of bringing a public policy. There are states like Michigan and Oklahoma that are producing and licensed producers so much cannabis that it is -- that cannot be sold because there's no -- I don't know what the numbers are, but let's just say that Oklahoma requires 0.5 million pounds. I think the number is like 11 million pounds or something like that, that they've licensed or if everybody grew to what the license would allow.

So that product can't be used in the state. It has to be illegally shipped out of the state. And it is -- if you look at the volume of it, it's depressing the entire like American market and then throw banking and taxation on top of that. And if someone wants to know what's your other mistakes, Jim, it was assuming the Feds would actually get around to solving the problems of banking and taxation on a product that's legal to like 75% of consumers in this country.

We based our investment thesis on this concept of prohibition will end in this space, whatever exactly that meant. But where I think we largely would say, banking is solved and listing of top equities on the U.S. exchanges would be allowed. That was kind of our view that, that would be accomplished in sort of 3 to 5 years. You heard me, Joe, talk about that.

Those things didn't happen. And I think our footprint size and the sort of assumption that while the states we're making improvements, the Feds would actually do their job, I'm talking to Leader Schumer this afternoon to encourage some action before this Congress changes because there are things that they could do that there are majority support and probably filibuster prove support if the Senate would like act on some of this stuff.

But that's kind of the market we're living in. But strategically, we had an R&D field day here in Marysville, I don't know, a week or so ago. And we looked at all the stuff we're doing in R&D. Chris talked about -- I don't -- somebody, Cory, I guess, talked about this new light that's being sold into Canada and Europe for greenhouse. This would be like veggie garden. You're talking $100 million in sales in its first year. That -- I mean this is a really high end, a lot of IP in that light and $100 million in its first year. No one else is doing research. What you trying to say? I'm giving the people? Anyway, Sorry, Joe. People are like reading notes to me that I don't really want to see.

**Joseph Nicholas Altobello**
*Raymond James & Associates, Inc., Research Division*

No, I appreciate that. It sounds like it boils down to the fact that we have too many growers and allow them not to go out of business, that's happening, but too slowly?

**James S. Hagedorn**
*CEO & Chairman of the Board*

Yes, absolutely true.

**Joseph Nicholas Altobello**
*Raymond James & Associates, Inc., Research Division*

Okay. And just one last one, if I could squeeze on inventory. You mentioned you're looking for a $400 million reduction next year. If I look at your sales this quarter, they're nearly similar to your sales in the June quarter of 2019 and your inventories are higher by $900 million versus June of '19. So I guess that the $400 million enough?

**Cory J. Miller**
*Executive VP & CFO*

Well, we think that's the level of inventory that we need to support our sales going forward after that point. We're going to continue looking at the demands of the retailers and we're going to tighten our inventory as much as we can. We think that the decrease that we have planned is at the right level. Obviously, if we get to that point, and we're able to take more out, we will.

**Operator**

And our next question will come from Jon Andersen with William Blair.

**Jon Robert Andersen**
*William Blair & Company L.L.C., Research Division*

Two quick ones, I hope. One on Hawthorne with the discussion around rightsizing the infrastructure. I'm just wondering if you're kind of planning now for a different kind of long-term growth rate for that business. I think historically, you've talked about maybe 10% to 15%. But does all of the discussion here around rightsizing imply a different kind of structural growth rate for that business?

And then the second question, I'll just lump it on top of that is I know you're not guiding for 2023, but you did call out some puts and takes. And I'm wondering if you could -- I think you're taking more price in 2023. How much?

You mentioned share creep. Could you talk about a typical year of share creep without repurchases? That would be super helpful.

**James S. Hagedorn**
*CEO & Chairman of the Board*

You want to?

**Christopher J. Hagedorn**
*Division President*

Yes. Jon, I can take the Hawthorne question in terms of the long-term growth rate. If you -- even with the noise we've had both in this disruption and then looking back at 2018, went through that, if you look at our I think 5- or 6-year CAGR, it's about 6%. That's roughly where we look at the business is kind of mid- to high single-digit growth sort of into the long term, obviously, with margin recovery through '23, but really getting to where we want to be from a margin perspective in '24.

**Cory J. Miller**
*Executive VP & CFO*

Yes. On your question around pricing, with our most recent action that took place this week, we're 18%, 19% above where we were kind of 12, 13 months ago. So as we look at cost increases that we expect going into next year, we're hoping that this price increase gets us able to cover those. We continue to look at costs as they come in. And we'll make a decision between now and kind of January time period if we have to take any more. We're hoping that we're able to get by with what we've taken, but we continue to look at it as cost change.

**Jon Robert Andersen**
*William Blair & Company L.L.C., Research Division*

And a typical share creep without repurchases?

**Cory J. Miller**
*Executive VP & CFO*

Share creek will probably be close to 1 million shares if you get to the end of next year. So I think that's kind of a good number to use. It could deviate a little bit from that, but about $1 million.

**Operator**

Next, we'll hear from Gaurav Jain with Barclays.

**Gaurav Jain**
*Barclays Bank PLC, Research Division*

A couple of questions from me. So in the press release, you have mentioned that consumer POS dollars are down 6%, while units are down 8%, and you have also mentioned that pricing is up almost 18%. So should I -- does that mean that the mix has shifted towards lower-priced products in what you sell?

**James S. Hagedorn**
*CEO & Chairman of the Board*

Definitely. So I think lawns being down, which is a mix issue that we think is mostly weather-related. And more significant promotion on sort of our dirt and mulch products, I think drove that.

**Gaurav Jain**
*Barclays Bank PLC, Research Division*

Okay, sure. And second is on some of these balance sheet items like the accounts receivable inventory, is there any risk of write-downs here, like especially on the Hawthorne side where it's consumer -- its customers itself, the retailers might be struggling right now, the hydroponic retailers. So do we have any risk of write-downs in account receivables and also in inventory?

**Christopher J. Hagedorn**
*Division President*

Yes. If you look at AR and inventory. Those would be the 2 that I'd point out as well. Today, what we sold into retail, retailers are struggling a little bit on the hydro side. We do have some retailers out there that are slow paying us. We think we have it properly reserved and stated in the balance sheet. So we don't see drastic risk on top of what we've booked to date. But we still continue to watch AR pretty closely.

On inventory, we look at our inventory, we did eliminate a brand going forward, our Sun Systems brand. So we took an inventory reserve this quarter around the inventory that we hold with that brand. We think that everything we have and the rest of the business is properly stated. We continue to look at it.

We're not selling below cost at this point. We have a lot of inventory. So as we look at the network, there may be inventory that could potentially go away because we're looking to rightsize that network and reduce the square footage that is available to hold product. But the product that we have as of now, it feels like it's a good product, and we don't have any unusual reserves against it today.

**Operator**

And next, we'll take a question from Eric Bosshard with Cleveland Research.

**Eric Bosshard**
*Cleveland Research Company LLC*

Two things. I hear your comments about conviction and retailers ordering heavy to start next year. The question I have on the other side of that is your confidence on consumer engagement next year. I think you said that you've retained all the customers that you've gained from 2020. And the units are down 8% this year. You're taking more price next year and the consumer is under incremental pressure and incrementally less confident. And so I'm curious in your outlook for what the consumer will be engaged in this category in 2023?

**James S. Hagedorn**
*CEO & Chairman of the Board*

What was that, Mike?

**Michael C. Lukemire**

*President & COO*

Yes. I think you're going to see that there is a movement towards value and from the areas where I think it's where you're going to see promotion be more value, Eric. And so we're going to start that earlier. And so in some ways, you might say it's a return to the past. But where we've seen value, we've seen it like in club categories and stuff, consumers have gone to value.

And so we're going to offer values to consumers and bring them in with the retailers and keep them engaged. We expected -- I'll use Bonnie as an example, I guess, I think it was a little exuberant about saying, $25 million. It was $16 million, 25%. But -- so hopefully, I corrected that for the and/or [indiscernible]. But we didn't think people would buy at $5 -- over $5, and yet we've seen good consumer takeaway. And so -- and the indications on our higher-value items, when we offer some value that the consumers have bought in, so.

**James S. Hagedorn**
*CEO & Chairman of the Board*

But Mike, you don't see crazy -- you're not depending on a crazy [ debt ] prebuys for next year?

**Michael C. Lukemire**
*President & COO*

I mean, I'll read Eric's stuff and say, if I incorporated part of that into our plan, yes, I have, Eric. So you have good thoughts on where it is, but I don't think -- I don't see consumers running away from that. We're going to need footstep -- we're going to need footsteps in the store, our products are the ones that help lead footsteps to the store, especially in the second quarter. And we just got to be able to do that and work with the retailers to get that to happen.

**James S. Hagedorn**
*CEO & Chairman of the Board*

But do we need excessively heavy orders?

**Michael C. Lukemire**
*President & COO*

No, it's not -- no, it's not excessive. Its -- you just got to be ready and you got to get out of the gate early.

**James S. Hagedorn**
*CEO & Chairman of the Board*

One of the messages I think we've had is that a little bit my concern is that what happens if retailers are heavy on durables on just inventory in the box in general, they push toward their end of January, their fiscal year-end. Mike, its like they do that, we can't fulfill. I just can't get the trucks.

So I think if there's a message to retailers, what we're planning on is just what they need to stock the stores based on our view and I think their view and our sales people's view of what they need. And that can out weight until the end of January. We just won't be able to get the trucks in time. So I think we feel okay about it. I -- we all read your reports, sir. I think this is an area where we would disagree.

**Eric Bosshard**
*Cleveland Research Company LLC*

The question to circle back, Mike that what seems that contrast is consumers want more value, value will be more important and you're raising prices 10%. [ They're ] still seem to be conflicting. Am I missing something?

**Michael C. Lukemire**
*President & COO*

No, you're not missing anything. I think it's the fact that, do you remember what you paid for fertilizer last year? And if you offer a value and you need to do it and the activity, are you walking away from it because it's a once-a-year purchase.

And so when we've seen that historically with pricing all the way back to 2010, where we took a tremendous amount of pricing. But they're looking for those value. And we're seeing it with clubs and stuff. I mean people asked about Walmart and say, well, I look at Sam's. Sam's was actually up, and there's cases where we're taking. So people are looking for value equation there. And I think promotion was historically how we did it. In bad times, we think they will return to that activity, not that they will escape.

**Christopher J. Hagedorn**
*Division President*

Eric, I think the answer is it is in conflict, our cost of goods is driving pricing. It is not -- we're not trying to drive up margin. We're trying to maintain margins and not doing that well at it. So it is one of those things that sort of have to happen. But I think we believe in sort of the retailers, we have a good plan going forward into the spring.

**Eric Bosshard**
*Cleveland Research Company LLC*

Okay. And then just 1 for Chris. The write-offs in Hawthorne sound like they are in total around $700 million, if you include it all, the vintage of the investments that you're writing off, can you just help dimensionalize that a little bit. And what I'm trying to figure out is this Sunlight from 4 years ago? Or is this Luxx from 6 months ago?

**Christopher J. Hagedorn**
*Division President*

It's a combination. Look, it's pretty much all goodwill from the business, including brands that were relatively recently purchased. There's some lighting technology that has sort of become obsolete as we've been able to launch innovation. There's a -- as we mentioned, the Sun systems brand is one that we're moving away from. So it's, like I said, all the goodwill pretty much -- I mean, I think for every single penny we put away in the business Yes. And what amount does that total of $700 million?

**Cory J. Miller**
*Executive VP & CFO*

Over $600 million.

**Christopher J. Hagedorn**
*Division President*

Yes. And then the balances in some inventory that we're rationalized out of the system, primarily Lighting.

**James S. Hagedorn**
*CEO & Chairman of the Board*

We have external people come in, Eric, help us with those calculations. There is a benefit, I don't know exactly what the EPS benefit is from sort of taking this noncash charge now, and there's also a long-term tax benefit to do it. So we just basically grabbed the bull by the horns and just wrote down all goodwill in that business. And I think -- we think from an accounting point of view, it is right. But I think it also freeze the business a bit to move forward. .

**Cory J. Miller**
*Executive VP & CFO*

Yes. If you look at the impairment calculation, it's pretty heavily weighted to the results that you're seeing today and the results that you expect to see in the short term. So with our growth rates kind of being midsingle digits for the foreseeable future, the results that we're posting this year, the results that competitors in the space are posting as well.

All that gets factored into the calculation. And this is kind of where it landed. It was a pretty mechanical calculation. And given our level of goodwill, we just decided to take all of it down to 0, even though some of the acquisitions were pretty recent.

**Operator**

Up next, we'll take the question from Carla Casella with JPMorgan.

**Carla Casella**
*JPMorgan Chase & Co, Research Division*

Just 1 follow-up on the restructuring. How much of the restructuring was cash? I'm assuming just the $41 million portion. And do you expect much more cash restructuring in the back half? And then I have 1 other follow-up question.

**Cory J. Miller**
*Executive VP & CFO*

You're correct. So the restructuring portions that were related to headcount reductions were the cash portions. As we look at Q4 and likely into Q1, our rightsizing of the Hawthorne footprint will have an impact on the facilities that we have out there. There's likely some more restructuring to hit there as well. How much of that is cash and kind of people-related restructuring versus noncash, still to be determined at this point.

But likely, there's going to be a mix. I don't have a firm number right now. But if you think about getting our footprint right and the DCs associated with that, you're going to have a mix of inventory, discontinuation costs of that footprint and some people will go along with that most likely.

**Carla Casella**
*JPMorgan Chase & Co, Research Division*

That's all included in the cash flow guide?

**Cory J. Miller**
*Executive VP & CFO*

I'm sorry, can you repeat that?

**Carla Casella**
*JPMorgan Chase & Co, Research Division*

That's all included in the free cash flow guidance that you've given for next year?

**Cory J. Miller**
*Executive VP & CFO*

Yes.

**Carla Casella**
*JPMorgan Chase & Co, Research Division*

And then on Hawthorne, have you ever disclosed how much of that business is sold into cannabis versus other indoor growing? And maybe what that looks like today versus in the past or where you see that longer term?

**Cory J. Miller**
*Executive VP & CFO*

If you look at the business, the international business that we operate really has very little cannabis. It's mainly lighting into greenhouses that are growing fruits, vegetables and flowers. So let's call it

$100 million to $125 million. And of the remainder of the business, mostly in the U.S., although some in Canada, it's a mix, but it's -- it all goes into retail or resellers.

So we don't sell to the end consumer. So we lose a little bit of visibility, but it's a high percentage that goes into cannabis. I don't have an exact percentage for you.

**Operator**

All right. And our last question will come from Andrew Carter with Stifel.

**William Andrew Carter**
*Stifel, Nicolaus & Company, Incorporated, Research Division*

Sorry, I was on mute. What I were to ask, so just looking at Hawthorne, I know independent -- spend off the table, you did say also selling it is something you don't want to consider. But why not evaluate that more thoroughly. I mean a lot of mistakes were made with seemingly unconstrained resources, and now you're kind of executing with finite resources.

Where do you see the risk of not being able to invest against all opportunities? And I guess there's another risk, what if some of your competitors or customers consolidate could be a risk or someone well resourced, not dissimilar to yourself when you enter the space comes in, [ buys ] of these assets kind of broken down, thus putting you a disadvantage? Just how do you think through that?

**James S. Hagedorn**
*CEO & Chairman of the Board*

All right. I don't even know where to start, dude. I'd start by saying I think we made some mistakes, but you go around this table and say, do we like this business? Do we think this business recovers? Do we strategically think this is a good place for us to be? The answer to that is yes. So you're not going to find us uncommitted to this space.

To the extent that people combine. I'm not exactly sure who that is. We've talked here about putting kind of a leper colony together of every kind of public equity in the space. And to be honest, I think as we look at our strategic advantages, what we have been building, I think we feel like we are, without a doubt, the best house in the neighborhood.

And am I interested in sort of setting that house on fire? Not really. We I'll start with the sort of basic, which is -- and we -- I caught to this mistake, this is -- which is if you look at our distribution footprint, that's about $65 million a year. We probably can't make it go away completely in '23, but largely, it will be done in '23. And that takes a business that I don't know exactly where, but call it breakeven today, a little less than that actually, but call it, near breakeven today to sort of more than plus $50 million, okay?

We think the business does recover. We think that the business is going to be better for us. And why do I say that? Because I think if you look and say who is succeeding here, in our view is the more commercial folks are the people that's going to succeed. We know this business, whether it was our pro turf business, our pro horticulture business, call it a pro cannabis business. This is a business that we understand, we understand how we add value and we are making those investments.

One of the issues that we've had as we've looked at various ways to do this is our spend in innovation. We've told you guys this as we've been down the track that the work that's happening in R&D on this sort of very immature category of cannabis cultivation is really impressive, the work that's been happening here.

Our view is that, that's an important part of the future and that any deal we do with anybody, would they be willing to make the investment we're willing to make in cultivation practices and improving productivity, improving the quality of products, just all the work that we've been doing. And I think our answer is we don't think other people would be willing to -- in this market, be willing to make the investment required to strategically build a business for the future.

We are not, look, we are disappointed, but start by saying half the profitability of business, we screwed up by basically saying we're going to build a footprint for $1.5 billion, and we're sitting at, I don't know, $800 million or something like that. And we're eating that. And we're going to have to fix that. And that's on us, okay? The overproduction issues will get solved because people will die, okay? And that's what has to happen here.

I mean, Joe, I think, said it earlier, is that there is going to be non-survivors here. That will not be us. So to the extent that we could be interested in any sort of deal going forward as this -- to consolidate for the better. It has to make us better, okay? And that is a bit of an order, okay?

So I don't know. I don't want to sort of argue the point except to say, why not sell it? Because we're on the beach and the landing crafts have left, okay? And nobody around here is interested in putting their hands up and basically either go into a prison or war camp or getting shot on the beach. And we're going to fight through this, and that's a promise to sort of anybody who thinks they're going to compete with us is we got the means to get through this. We have the tools to get through it, and we have been building a vision of the future which I don't think you're going to see any place else.

So we aren't going to be victimized in any sort of consolidation. And that's -- this is not to impune anybody else. I think in discussions we've had with other folks, they have been super great people, everybody is struggling right now. It's just that we've got to look to this and say it's got to be better for us.

**Operator**

And that concludes the Q&A session. I'll turn the call back over to Kelly Berry for closing remarks.

**Kelly Berry**
*VP of Consumer Finance*

Okay. Thanks, everyone. So again, a quick reminder that the management team will be attending the Barclays Global Consumer Staples Conference on September 8, and we'll communicate the details as we get closer to that event. In the meantime, feel free to reach out to me if you have any questions. Thanks for joining us today. Have a great day.

**Operator**
And this does conclude today's call. We thank you again for your participation. You may now disconnect.