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The Scotts Miracle-Gro Company
NYSE:SMG
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Call Participants

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Presentation

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

All right. Good morning, everybody. Thank you for joining us for our next presentation of the day from Scotts Miracle-Gro. Scotts is the unquestioned leader in the U.S. consumer lawn and garden industry with brands that include Scotts and Miracle-Gro, obviously, as well as Ortho and Roundup, just to name a few. In addition, it's Hawthorne hydroponics segment is the leading supplier to cannabis cultivators, both in North America as well as in Europe and across nearly every product category.

Over the past 2 years, the U.S. consumer segment has clearly benefited from a surge in demand throughout the COVID-19 pandemic as millions of households have entered the category, including the key millennial demographic. Thus far, demand has held up well, though it's unclear exactly how the consumer will respond to multiple price increases to offset heightened cost pressures. At the same time, demand on the hydroponics side has suffered from an oversupply of cannabis that has weighed on pricing and discourage growers. With that in mind, we are very pleased to have with us today to help us better understand all of this the company's CFO, Cory Miller; and Chief Communications Officer, Jim King. So let me hand things over to Cory to walk us through the story Thanks.

Cory J. Miller
Executive VP & CFO

Great. Thank you, Joe. Good morning, everybody. Thanks for joining us. I appreciate the opportunity to be here and present about SMG. For me, this is actually my first in-person investor event. So I've met a lot of investors and analysts going back virtually over the last year, but it's nice to have an opportunity to be face-to-face and look forward to meeting several of you later today as we have our breakout sessions. While I've only been a CFO of Scotts Miracle-Gro for about a year, I have been at the company for about 2 decades in various finance roles in corporate and operating finance, including CFO of our Hawthorne business that Joe spoke of since 2015 when that business started with the acquisition of General Hydroponics.

I can tell you with a lot of confidence, we have significant opportunities still ahead of us, both within the U.S. consumer business, our traditional business in lawn and garden as well as in Hawthorne, which focuses on inputs used in the quickly evolving cannabis industry. We've identified 5 strategic growth pillars between the 2 segments that will be our focus over the last -- over the coming years. And I'll spend the majority of my time talking about these this morning and moving into some detail on each of those.

The takeaway, though, is that if we have reasonable organic growth over the next 5 years and look at our M&A, both future and current opportunities ahead of us, we are looking to double the size of the business in 5 years. So I'm not going to lay that out there as a target because I don't want to go after growth just to go after sales growth. We want to go after profitable growth. But I emphasize this, just to share how long the runway is that we see in front of us.

Before I dive into the details of our business, I do want to give an update to our current outlook for fiscal '22, and we'll also have a release that goes out this morning. The headline is that the progress we had hoped to see in Hawthorne in January and February fell a little short of what we expected, so we are lowering our outlook for that business as well as the impact that could have on us achieving our full year guidance on EPS. If you follow SMG, now that we've seen a sudden and fairly dramatic decline in sales in recent months due to the oversupply of cannabis in the United States. That oversupply has pulled cannabis prices down, which led to a temporary reduction in cultivation. Since our products are used in cultivating and building cultivation sites, we've been impacted by this.

Our Hawthorne portfolio, unlike some of our competitors is significantly comprised of durable products, especially lighting and air handling. We've seen -- so we've seen a sharper decline in sales than others. In the last public earnings release, we said that we had found bottom, but had not yet bounced off of that bottom. That remains to be the case today. But by now, we would have expected to see a little bit of seasonal increase on our sales dollars that we look out on a daily basis. That seasonal increase has not happened, but the sales dollars have remained consistent. So when you look at our sales versus a year ago, our percentage gap has increased. So the year-over-year percentage gap in sales that we are guiding to for the full year is a 15% to 25% decline on a full year basis.

We're clearly disappointed in the results this year for Hawthorne, but it does not change our long-term view of the business. The cannabis market is still going to grow. We continue that -- we continue to believe that we will have high single to low double-digit growth into the foreseeable future. But there's obviously going to be a resetting of the base this year.

We continue to say that we'll start seeing growth at the end of this year that will set us up next year for full year growth. In our U.S. consumer business, we remain extremely encouraged by what we are seeing. I'll point out that the midpoint of our guidance range suggests an 8-point decline in unit sales from last year, offset entirely by pricing. While it's far too early in the season to change our guidance, what we're seeing real time with data is much different than this. Through 5 to 6 months into the year, POS is a very different story. POS in units is about flat compared to last year, up about 7% in dollars.

After reporting 24% growth in 2020 and another 11% last year, logic would suggest we'd see a pullback in consumer activity this year. Instead, we've been consistently seeing an increase in consumer takeaway, and our consumer research suggests gardening activity will be sticky again this year. I'll remind you that we're less than 20% through the year. So we have a lot of tough comps ahead of us for the next 5 or 6 weeks, and then comps start to ease as we get into the back half of the year. So we're hoping that these trends stick.

The other update is related to M&A. On our Q1 conference call, our CEO told investors that we are close to announcing a significant opportunity in our Live Goods strategy. That deal would have likely been accretive to earnings this year. However, as negotiations dragged on, we finally put the pencils down and decided to revisit the opportunity later in the year. The seasonal nature of both our business and the Live Goods business that we are looking at would have put us in risk if the discussions would have kept dragging on. We're not going to chase a deal that was beginning to feel like a red deal as negotiations kept going. So we decided to step away for now.

Calling down Hawthorne and leaving our outlook for the U.S. consumer unchanged leads us to a place that makes our existing POS range -- I'm sorry, existing EPS range of $8.50 to $8.90 per share, really tough to hit. We think that the current consensus of about $8.40 is likely on the high end of where we can finish as well, but very possible. While I'm not going to provide a new range today, I will say that we are shooting for EPS of above $8 per share.

Our top line sales have been an area that have been a great story for us the last few years. We've expected this growth pace to slow, and we're starting to see that a little bit this year. Our U.S. consumer business will have a record sales year in 2022, an 11% CAGR over this period for a business that has historically been 0% to 2% growth. We remain confident in the 2% to 4% annual growth that we've talked about over the last year. While Hawthorne will likely not end at record levels, it will have a second best year in that company's short business history, showing a 35% CAGR over this period. The chart here shows the segment breakdown of sales and profits as of the end of last year. As this year plays out, we will continue to see the sales from our U.S. consumer business, drive our total business and the related earnings will likely be even more pronounced than in the prior year.

The U.S. Consumer segment provides the dry powder for us to pursue continued growth opportunities and returns to shareholders that are expected. As we look deeper into the cash flow numbers each year, it's obvious that we need to improve to get back to what we saw in 2020, which was our record cash flow year. We deliberately removed our focus from cash flow last year because the business required it. The growth that we saw in '19 followed up by even greater growth in '20 caused our capacity levels to be tested more than they ever have been in the past. So we needed to build capacity to stay up with the consumer demand.

Increasing this capacity caused our CapEx to increase by about $100 million from 2020 to 2022. We've also built more inventory all year to be able to service the customer in the peak season. This building of inventory cost us about $450 million. And then as global supply chains began to feel the pinch and costs started to rise, the cost of our inventory went up as well. The cost of our inventory increasing cost us about $125 million. We plan for all of these increases to slow as we move into next year, which should allow our cash flow to catch up to the increases that we've seen in sales over the past few years. We are going to get better in this area. We're looking to get cash flow up to historical high levels.

Let's move on to talk about the business behind our longer-term strategy, and why we're confident in the outlook over the next several years. I'll spend a few minutes talking about the left side of the page, our U.S. consumer business, and we could pivot to talk about Hawthorne, which is on the right. Our core lawn and garden brands are the powerhouse of this industry. We enjoy an average market share of over 50%. Fertilizers and growing media have share closer to 65%. Last year, we invested further into a partnership that gives us a 50% ownership in Bonnie Plants. Bonnie is the largest seller of edible live goods in the United States. When you think of edible live goods, think of peppers, tomato, plants, basal, et cetera.

Bonnie's share of the market is even greater than our core brands, and there's a lot of overlap within the retailer's footprint for us to market together and present our products together in the store. Our e-commerce platforms are becoming increasingly important to us as well with about 10% of our sales in U.S. consumer involving e-com in some way, and we expect that number to continue increasing as we move forward. These 3 pillars should help us generate the 2% to 4% growth on an annual basis that we're planning. There's a lot of noise in this business right now related to input costs. But as costs stabilize, we are looking to get back to a range of 23% to 25% operating margins.

The largest benefit of this business is its ability to generate significant free cash flow. We have a few clear competitive advantages that are really undeniable. Our brands are anywhere from 70 to 150 years old and have been used by millions of consumers in all parts of the U.S. Lawn and garden is a clear destination category for our largest retail partners, and we play a huge role in this section of the store. We have focused on consumer-driven innovation for nearly 100 years. This allows us to have 15% to 20% of our annual sales coming from innovation that's been introduced in the last 3 years. Our in-store sales force of more than 2,000 associates during the peak season continues to be a huge advantage for us, and with the tight labor market is becoming even more valuable. This sales force develops relationships in the store, onloads trucks, merchandises at the shelf, and they also serve as counselors to consumers that are at the shelf making buying decisions.

Lastly, our supply chain continues to be a definite advantage. The peak of the selling season is violent and meeting this demand in time to get the shelf set for the next weekend puts a lot of stress on the network in the spring. We handle this better than anyone in the industry and continue to look for ways to improve.

Within the U.S. consumer business, there are 3 major segments that we participate in. The lawn care segment is where our Scotts brand is the clear leader in lawn fertz,, grass seed and durable products such as spreaders. The Controls business is a combination of weed and insect control products where the Roundup brand and our Ortho brand compete. Gardening products is the largest slice of this pie is made up of soils and plant foods sold under the Miracle-Gro brand name and mulch sold under the Scotts brand name. This is the area that continues to grow at the fastest rate among our products.

Demographic tailwinds continue to give us confidence about the future of this business as well. Millennials made up the largest segment of homebuyers in 2021. They participate in the lawn and garden category at higher rates than previous generations, and they continue to move to the suburbs, buy homes, buy products and demand that those products work. Our products will be perfect for them. This is a graph that shows how millennials are engaged in our categories as they come into the category and are replacing boomers as boomers are aging out. Again, this gives us confidence in the future growth that is out there for us to go get.

In addition to our core brands, we're also working to develop online native brands that can be more directed at millennials that want a different option. These brands allow us to go after consumers in a way that we have not in the past and do so with some differentiated products that should not cause conflict at retail -- sorry about that.

Barkyard is a line of lawn products aimed at the millennial homeowner and pet owner. Knock! Knock! is a subscription service that sells high-quality potted plants to your home on a quarterly basis. While these are not major businesses for us now, they are a pathway to develop a relationship with this group of customers that we want to keep for decades to come.

I want to pivot to talk about the other side of our business now and how we're working to take advantage of the fast-paced emerging cannabis industry. This year is proving what we've been saying ever since Hawthorne first year, this category is going to be volatile. We have seen significant growth, but with a couple of soft years mixed in, the growth pattern is a little sawtooth. There's overwhelming consensus that the overall cannabis market will continue to expand by billions of dollars, and we are focused on the long term.

We are committed to keeping -- keep leaning on our first-mover advantage in our existing categories and look to expand that to other areas where we can take advantage of there as well. We continue to balance the short-term goals in this area as well as the long-term goals. We know that we need to keep increasing our earnings rate in the Hawthorne business, and we'll continue to improve in this area.

Some may not realize that we actually don't participate in the actual cannabis market today. We've assembled many of the leading brands in the cannabis input supply market that allow us to sell products that are using cultivation. Hawthorne was created through a series of 11 acquisitions starting back in 2015 when we acquired General Hydroponics, the leading provider of nutrients in this space. We then continued to add additional brands in nutrients, horticulture lighting, air handling, odor mitigation and water filtration.

In 2018, we acquired Sunlight Supply. Our largest customer at the time and the largest distributor into the hydro retail channel. This allowed us to own the relationship with the retailers and no longer needed to sell through other distributors where we could self distribute our product into the retailers. The growth since this first acquisition in 2015 has been explosive. We have more than tripled the size of the business since we acquired Sunlight in 2018.

While the current year decline in sales has received a lot of attention and with good reason, I want to be sure that we are keeping in perspective with the historical rate of growth in this business. We continue to focus on the long-term nature of this category and continue to be confident that there is more growth ahead of us. The driving factor of all this growth is the social tailwind coming from the legalization movement. Today, 37 states allow cannabis cultivation of some sort. That means 75% of Americans are living in these states. Nearly half of them allow adult-use -- adult recreational use. The chart on the right shows that legal cannabis consumption is expected to double again over the next 6 to 7 years. Growth of 7% per year will get us to a $55 billion category in 2031. This growth will be from legal indoor commercial operators, and that's where our focus has been and will continue to be.

Today, more than 90% of cannabis is grown by commercial operators. We believe that larger operators will continue to consolidate more of the space over time. We will always have products that appeal to smaller growers, but our primary focus will be to service the larger commercial growers that continue expanding.

The commercial growers need suppliers that are capable of more than simply a product and a price. They need partners that can help them grow healthier and more consistent plants. That's why we're investing with the long term in mind. We've assembled a team of technical growing experts, after all, we've been growing plants for 150 years on the other side of the business. We have the only dedicated cannabis R&D operation in the world in Kelowna, British Columbia. We've invested heavily in IT systems and a supply chain network that can meet the future of this market. And we've integrated all our businesses into that supply chain network to distribute and ship to customers on a single truck.

We've used all of this to build a better sales team and can deliver these tools to the customers with confidence that they will be proven successful. The different aspects of how we're looking to operate our business results in what we call Hawthorne 360. This puts the grower at the center of everything we do. Service and support will be provided to the growers for everything from the design of a new grow room to the airflow management of an existing facility. We don't just sell lights, we work with the growers to design their grow rooms and outfit them with a lighting layout that makes sense for them. We also have a service that helps these growers with finding what local rebates they qualify for as they transition over to lights that we sell them and help them get those rebates.

We get a lot of questions about the long-term nature of this business. This will be a driving force that can be explained further on our IR website through a couple of videos that we have posted there. I'm very excited about the future of SMG. I'm very excited to be in the CFO role and help drive this company to doubling our growth, doubling our sales size in the next 5 years. We continue to drive the U.S. consumer business, and we will hit another new record this year. We expect Hawthorne to have a rebound in the coming months, and we will keep achieving long-term growth. Our balance sheet remains healthy, and we continue to be disciplined with our capital to support the 5 pillars of our growth as well as returning cash to shareholders.
Finally, we've taken a step to protect our near-term margins in our U.S. consumer business, as prices go up and we price to offset those cost increases. And we have opportunities in both segments to improve from where we sit today with margins and leveling out of cost that will get us back to the cash flow of a couple of years ago. I want to thank you for your time and attention today and look forward for conversations for the remainder of the day. I don't know if we want to open it up for any questions now. I'm not sure what time it is.

Question and Answer

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

Maybe if you can talk a little bit about the input costs? And I don't know how much or how effective it is from Russia or Ukraine, but I know there's some urea exposure. And I don't know, maybe you can give me some quantification around that, would be great? I guess that's mostly for consumer.

Cory J. Miller
Executive VP & CFO

Yes, For our consumer business, input costs have seen a lot of activity in the last 2 weeks, which if we have to buy everything today at the market price today, we have exposure. It's kind of $10-ish million of exposure. The vast majority of our costs are locked in. Probably 80% of our costs are locked in at this point.

Diesel, urea is where you're seeing the largest input -- largest increase right now in input costs. Again, a lot of that's locked in. If we had to buy everything today, kind of $10-ish million, but before that, everything that we incurred over the last several months has all been offset in pricing. So we've covered all the dollar increases with our dollar price increases. So that's put a little bit of pressure on our margin rates. But from a dollar perspective, we're covered.

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

I guess just to follow up on that. If commodity costs stay where they are right now, what kind of headwind do you foresee in fiscal '23 when those hedges roll off?

Cory J. Miller
Executive VP & CFO

Yes, we'll have definite headwinds should they stay where they are. I don't have a dollar amount for you. A lot of what we're building -- what we're buying today and what we're building today will go into inventory for next year. So we continue to hedge for forward buying for the rest of this year to produce a lot of that product will go into inventory. It's not going to be sold out this month or next month. So what we'd be buying today will have a headwind, should urea stayed that -- at those levels.

We'll continue to look at pricing if we have to and go back to the market should we need to. We're trying not to do that. We're trying to be consumer-friendly and take as little as pricing as possible, but knowing that it's a delicate balance to walk. Retailers are pushing back, obviously, but the consumer is feeling the pinch on everything that they buy let alone our product. So it's a balancing act.

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

Just to go back to Hawthorne for a second. This is the second time you've lowered the outlook. Obviously, we don't know what we don't know at the end of the day. But the down 15% to 25%, is that a conservative number? Is that a realistic number? How would you characterize that?

Cory J. Miller
Executive VP & CFO

I look at it today and say it's about an accurate number. I'm not putting a lot of conservatism in it. I'm not being overly aggressive. It's kind of a number we think we can hit. And a lot will determine on when the rebound actually happens. We thought that we'd see a little bit of an increase at the end of January. We started to see that increase kind of at the end of February. We pushed a little bit of that through promotions. So with promotional activity, we're getting our sales to where we want. It's just we're pushing harder promotions to get there.

So we have some insights that are saying that cannabis prices are starting to come up. Retailers are starting to feel a little bit more foot traffic in their stores. So we think that this is going to start turning into increased sales for us, but it kind of depends on when that turnaround happens. So I can't nail it down to the week. But we're looking at kind of May-ish time period for that turnaround to be significant enough to get on a new path for the rest of our year.

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

Anybody else? Thanks, guys.

Cory J. Miller
Executive VP & CFO
Wonderful. Thank you all.