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# EDITED TRANSCRIPT

SMG - Q2 2015 Scotts Miracle-Gro Co Earnings Call

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## OVERVIEW:

SMG reported 2Q15 Co.-wide sales growth of 2%, or 4% excluding FX rate impact. 2Q15 adjusted net income was \$128m or \$2.06 per share. Co. expects 2015 sales growth to be 4-5% and EPS to be \$3.40-3.60.



## CORPORATE PARTICIPANTS

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

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

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

**Mike Lukemire** *The Scotts Miracle-Gro Company - EVP and COO*

## CONFERENCE CALL PARTICIPANTS

**Bill Chappell** *SunTrust Robinson Humphrey - Analyst*

**Olivia Tong** *BofA Merrill Lynch - Analyst*

**Josh Borstein** *Longbow Research - Analyst*

**Jon Andersen** *William Blair - Analyst*

**Eric Bosshard** *Cleveland Research - Analyst*

**Jim Barrett** *CL King & Associates - Analyst*

## PRESENTATION

### Operator

Good day and welcome to the second-quarter earnings conference call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Jim King. Please go ahead.

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

Thank you, Shelley. Good morning, everyone, and welcome to The Scotts Miracle-Gro second-quarter conference call.

With me today in Marysville is Jim Hagedorn, our Chairman and CEO; Randy Coleman, our Chief Financial Officer; Mike Lukemire, our Chief Operating Officer, and several other members of the management team.

Jim will provide an overview of the current state of the business, and then Randy will walk through the financials and the implications of today's results and our full-year outlook.

I want to make sure you understand the context of their remarks before we begin. Jim's comments will focus on consumer purchases of our products on a true year-to-date basis through this past weekend. Randy's comments will focus on our second-quarter and first-half financial results for the period ended March 28.

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

One bit of housekeeping before we begin. Randy and I will be presenting on Thursday, March 21 at the BMO Farm to Market Conference in New York. We'll issue a press release the next week with the details, but I want to make sure you're aware of the event, which will be posted via webcast on our Investor Relations website.



Moving on to today's business, I want to remind everyone that our comments will contain forward-looking statements. As such, actual results may differ materially. Due to that risk, Scotts Miracle-Gro encourages investors to review the risk factors outlined in our Form 10-K, which is filed with the Securities and Exchange Commission or our most recent 10-Q.

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

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

Thanks, Jim. Good morning, everyone. Historically in our business, the second quarter is the most difficult to analyze, and that may be truer this year than in any I can remember for a long time.

So let's just cut to the chase. We feel really good about the state of the business now, and when I say right now, I'm talking on a real-time basis with real-time year-to-date results.

As you saw in the press release, consumer purchases on a fiscal year-to-date basis are up 5% coming out of this past weekend. In most categories, POS is either in line with last year or positive. In some cases, for example, mulch, Ortho and Roundup, we are seeing high single-digit to low double-digit increases in consumer purchase activity.

We are also seeing strong market share performance, especially in Ortho, which I'll spend more time explaining in a few minutes.

Also, whether it's Bonus S or Nature's Care or Scotts Outdoor Cleaner with OxiClean, our new product initiatives are meeting or exceeding expectations.

But the most encouraging thing about our current level of POS is that lawn and garden activity in the Northeast is still weeks behind schedule. Dandelions are just now starting to pop, and most consumers will probably still wait another week or two before putting in flowers and veggies into the ground.

Entering April, year-to-date POS in the Northeast was down almost 18%. After last weekend, the region is nearly flat, and we expect to start reporting positive year-to-date POS in the Northeast by the end of the week. In the Midwest, POS is up 15%. It's up 3% in the South, 3% in the Southwest, and 7% in the West. Those are year-to-date numbers, including last fall.

If you just focus on the results for the current season, the numbers are even better across the board.

It's important to remember that net pricing this year is almost 0, so all the gains we are seeing now are volume-driven.

So what's this all mean? That we are not really concerned by the fact that the harsh winter got us off to a slow start. Entering May, retail inventories were on target, POS is honking, and we are doing a great job of managing the stores.

We are also doing a good job of managing our costs, so net-net we are where we need to be. I don't want to be dismissive of the numbers we reported today because I know they are short of what you all expected. Randy will explain the gap between what we plan for and our actual results for the quarter. In a word, it's timing.

So I can confidently reaffirm our full-year guidance this morning, and I would encourage people not to overanalyze the Q2 results.

With that, let me give you more detailed breakdown of what we are seeing. I'll leave the details of the financials to Randy. I want to focus on five specific reasons I feel good about the state of our business.

First, consumer engagement is extremely strong in all major retail channels. It has been especially strong in mass retail where consumer purchases are up double digits on a year-to-date basis. While our retail partners have been supportive of the category and of our brands all along, consumer engagement was a challenge for the last several years. Clearly our products have a more discretionary element to them in this channel than in the

rest of the business. But as macroeconomic factors continue to improve and as these consumers continue to benefit from lower gas prices, they have reengaged with our business.

What's clear is that retailers in this channel anticipated the potential for that to happen. They were set early for the seasons, have more inventory in their stores, and stuck with their plans even when weather delayed the start of the season.

We are also seeing continued strong consumer engagement with the home center channel, which accounts for more than half of our sales. Low to mid-single-digit POS growth has been consistent throughout the season. Retailers in this space continue to see lawn and garden as a destination category and continue to use our brands to drive foot traffic.

Our listing support has been strong, and promotional activities have created a lot of momentum for the entire category.

Second, in all channels of retail, we've seen resurgence this year in our Ortho business. We've taken costs out of the manufacturing process, which allowed for lower prices to be passed on to the consumer. We've coupled that with smarter product claims and more aggressive advertising. As we prepare for the peak of the bug and weed control season, our Ortho products have already gained market share.

You'll remember that we tipped our hats to the competition last year and acknowledge that we were outperformed. So the starting point for my comments is about market share the season, not last fall. New programs, in-store placement and promotions this season started a few months ago, and every data point we have tells us our products are winning in the marketplace.

In fact, we believe we are in a great position to recapture most if not all of the share losses we saw last year.

Third, our business on the West Coast, including California, has been extremely strong this spring, up 7%, even in the face of historic drought conditions.

I know a lot of you have been calling and asking questions about California ever since Governor Brown issued mandatory water reductions for homeowners. And he has gone so far as to provide incentives for homeowners to reduce the size of their lawns. But while these headline sound scary in a vacuum, we actually see more opportunity for us in California than we do challenges. Our team has been actively engaged in working with officials in the state to provide solutions to help them manage the drought with consumers.

I have personally met with Governor Brown and Wade Crowfoot, the person charged with overseeing drought relief efforts in California. Our environmental stewardship, corporate affairs and marketing teams are working in concert on a series of programs we believe will not only help California, but also help us grow our business there.

No later than next spring, we expect to introduce a new product that when applied to lawns helps dramatically increase water efficiency. The product called Every Drop still needs regulatory approvals in a number of states, including California.

As soon as we get approvals there, we will immediately begin shipping the product and getting it in front of consumers.

Concerns over water conservation and water quality has been an area where we have a history of turning potential negative situations into positive ones. Many of you remember the drought issues we faced in Texas just three seasons ago. There, just like in California, we got actively engaged in a way that actually helped our business more than it hurt it.

The fourth reason I feel good about the business is because of our success in completing acquisitions that are consistent with the strategy we outlined nearly 18 months ago.

Since that time, we've completed a series of acquisitions that will add about \$200 million of sales on an annualized basis. The largest and most recent of those acquisitions was of General Hydroponics and Vermicrop, two California-based manufacturers of liquid nutrients and growing media products. These are the transactions we talked about in veiled terms at our Analyst Day event in February.

These deals give us immediate scale and credibility in the fast-growing hydroponic category, which we consider essential to our plans for continued success in the urban and indoor gardening market.

During the quarter, we also bought two more growing media operations, one in New York and the other in Australia. We purchased an organic product line called EcoScraps that will be part of our Hawthorne Gardening group portfolio, along with General Hydroponics, Vermicrop and AeroGrow. EcoScraps is an organic line that is derived from food waste. It's a small company, but it's exactly the kind of niche opportunity that makes sense as we look forward.

As you all know, early in the year we purchased Fafard in Canada, which has given us a better understanding of the strategic importance of peat for our supply chain, and we purchased Solus in the United Kingdom.

As we said in our last call, this deal is a small one, and it had a few complications as we work through the integration. But overall, our M&A activity has been on mark. As we look ahead, we need to continue whether weighing -- we need to continue weighing whether shareholders are better served with a conservative approach to M&A that's sends more cash back to them or whether they are served by funding more unique opportunities for growth or something in the middle.

As you know, our goal has been a 50-50 split through the last 12 months, though the last 12 months have been weighted more toward deals.

The current pipeline is mostly filled with transactions in line with what we've already done. And at the end of the quarter, our leverage was 2.6 times. But there are strategic opportunities within the industry that support our long-term growth strategy and that may cause us to take leverage a bit higher in the short run.

This is not new news. It's a point Randy made during our Analyst Day meeting in Florida. I'm not going to elaborate right now, but I will tell you that we will not stray for an inning as a lawn and garden company.

So everything we are looking at right now is focused on either growing or protecting our existing franchise.

The fifth reason I am feeling good about the state of things is because of the current state of our team. As you all know, we've reduced our executive ranks by half. This time a year ago, Randy was preparing for his first conference call as CFO. Mike Lukemire's role at the time was confined to North America. We had two leaders at SLS and a top-heavy leadership structure in Europe. We've seen a lot of change in the past year, but I can look anybody in the eye with a straight face and say that every move we made related to our team was the right decision.

We've streamlined our decision-making and improved the efficiency of the business. Most of all, we've coalesced as a team, and that has created a positive vibe throughout the Company.

Before I turn things over to Randy, I want to conclude by telling our shareholders that we have taken great pride in how we are executing right now. Our consumers are engaged, our retailers are engaged, and the team is engaged. New products are working, new advertising messages are working, new promotional programs at the retailers are working, and our acquisitions are working.

I want to thank the thousands of Scotts Miracle-Gro Associates who are doing a great job again this season, and I want to thank our retail partners for their continued support of the lawn and garden category and of our brands.

I can't tell you what POS will look like for the balance of the season, but I can tell you that our comps for the balance of the year are not particularly difficult. And I can tell you that I continue to feel good about our ability to manage issues that are within our control. And that leaves me extremely optimistic about our ability to drive value for our shareholders in both the near- and long-term.

With that, let me turn things over to Randy.



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

Thank you, Jim, and good morning, everyone. Today marks a year to the day since I communicated to all of you for the first time as CFO. I told you last May that I felt good about the business and our plans to drive shareholder value, and I'm glad to say that my confidence in the business has only increased since then.

I'm going to run through the numbers, but before I do, I want to make sure I am clear. When Jim was talking about performance from a consumer POS perspective, he was citing real-time information that includes results from this past weekend. I'm not doing that in my remarks. Unless otherwise stated, my remarks are going to be confined to the reporting period, either Q2 which ended March 28 or the first half.

Before I do, I want to make one comment. As a habit, we typically do not speak to the First Call numbers, but I will this time. If March had come together as we originally planned, the consensus numbers would have been fine. But, as Jim said, and as I want to reemphasize for anyone joining late, the fact that we missed the Q2 EPS consensus by \$0.20 was largely because of timing, and it does not impact our full-year outlook. In a nutshell, the math under those \$0.20 is this. \$0.10 from volume shortfall due to shipping delays. As Jim said, that's now behind us. \$0.05 from mark-to-market adjustments in Q1.

As we explained last quarter, that will also be behind us at the end of Q3. And the remaining \$0.05 is from FX. That number unfortunately won't go away, but we believe strength in the US will cover that issue for the full year.

So let's jump into the results, and then we'll take your questions. Let's start with the topline.

On a Company-wide basis, Q2 sales were up 2% or 4% when excluding the impact of foreign exchange rates. Growth in the quarter came primarily from acquisitions and was aided by modest volume growth in the US. Sales were driven by a 2% increase in the Global Consumer segment and 5% from Scotts LawnService.

Within the Global Consumer segment, North America sales increased 3%, and international sales increased 5% on an operating basis that decreased 10%, including foreign exchange. Consumer POS was up 4% year-to-date through the end of March. But with such a bad start in densely populated areas of the country, especially the Northeast, our shipments in the quarter were behind plan. However, early in the third quarter, our shipments began tracking closely to POS, and this has continued throughout the month of April, giving us continued confidence in our original outlook.

Moving on to Scotts LawnService, most of the growth in the quarter is from the acquisition of Action Past. But that fact masked what is a particularly encouraging story because SLS continues to benefit from higher year-over-year customer accounts and new sales. Those metrics remain at record levels as does customer retention.

However, due to weather challenges in the Northeast, actual production at SLS is lagging our plan. In fact, homeowners in Boston and points north have only recently started to mow their lawns.

Given the delays in the season, SLS will probably find itself in the same position as it did last year: working hard for the next five months to get on plan. But unless other major events get in the way over the course of the season, we believe we can still hit our original target. If SLS falls short for the year and revenue is pushed out a few weeks, it should give us a nice tailwind in the first quarter of fiscal 2016.

Let's move on to the gross margin line. I will tell you that it's easy to misinterpret the first-half results, so let me explain. In the quarter, the adjusted gross margin rate declined 80 basis points to 39.3%. That decline was primarily attributable to acquisitions and higher product costs, especially around peat.

For the first six months, the gross margin rate was down 170 basis points to 35.1%. In addition to the issues that impacted Q2, remember that we had significant negative mark-to-market adjustments on fuel hedges in Q1. As I said earlier, that issue is still worth about \$0.05 a share on a year-to-date basis, but the good news is that we've started to see the tide turn.

Beginning late in Q2, we started to enjoy the benefit of lower year-over-year diesel prices. As that trend continues through the rest of the season, the negative mark-to-market impact will be offset, and we expect this to occur by the end of Q3.

I still see the gross margin rate being flat for the year, but there is not much room for error at this point. In fact, if there is one place where I think we might have some risk from a guidance perspective, it is here.

Margin was still be negative on a year-to-date basis through Q3, and we expect to make up the gap in Q4. We got a lot of volume scheduled to move through the system over the next two months. As long as we continue to meet our volume projections, we should be okay from a margin rate perspective.

SG&A continues to be a pretty boring story for us, and we like that. SG&A was up 4% in the quarter and 2% year-to-date. We are benefiting from some of the expenses we took out of the business last year, helping to keep our apples-to-apples, year-over-year operating SG&A at about half the rate of sales. We are introducing some new expenses associated with the acquisitions we made along with some related upfront deal costs.

However, we are also benefiting from FX changes as a partial offset to the the acquisition-related SG&A.

So I see no issues here for the full year, and we expect second-half earnings from our March 30 acquisitions to offset related acquisition costs that have already been recorded in our year-to-date results.

Company-wide reported operating income in the quarter was \$209 million compared with \$217 million a year ago. Year-to-date we are at \$103 million versus \$127 million versus a year ago. By segment, Global Consumer operating income was up 1% in the quarter to \$272 million and down 2% year-to-date to \$198 million.

For SLS, the operating loss increased \$2 million in the quarter to \$22 million and increased \$4 million to \$21 million on a year-to-date basis.

Remember that all the profits from Scotts LawnService come in the second half with most of them coming in the fourth quarter.

As expected, interest expense increased \$3 million in the quarter to \$15 million and is essentially flat on a year-to-date basis.

You'll remember we called some high interest bonds a year ago and still benefited from that in Q1. The increase in Q2 is due to higher borrowings, mostly attributed to acquisitions and also cash returned to shareholders in the prior year. And on the bottom line, adjusted net income was \$128 million or \$2.06 per share compared with \$137 million or \$2.17 per share a year ago.

Year-to-date adjusted net income was \$59 million or \$0.96 per share compared with \$71 million or \$1.13 per share a year ago. During the first half, FX has cost us about \$0.05, which is largely the amount expected for the full year.

Speaking of the full year, let me reiterate for everyone the guidance we have provided. On the sales line, we guided to growth of 4% to 5%.

Originally 3% was planned for acquisitions and 1% to 2% from volume. Our FX exposure is not large from an earnings perspective, but it will create downward pressure of about 2 points from our topline guidance. But we will make that up for newly acquired growth from a slightly improved outlook from volume growth in the US. In other words, the 4% to 5% sales growth still holds for the full year.

As mentioned earlier, we still see the gross margin rate as flat, and we expect 3% to 4% growth in SG&A, primarily from acquisitions which more than offset the impacts of FX.

And so we are maintaining our earnings guidance of \$3.40 to \$3.60 per share. As you think about your current models, FX again is probably worth \$0.05 more than we anticipated entering the year, but our EPS range is wide enough to accommodate this issue.



Before we take your questions, let me anticipate a couple of them. We have been following our normal glidepath for locking our urea costs for next year, a path we plan to continue following. That means we will probably have two-thirds of our urea costs locked by the end of the fiscal year and a similar amount of fuel locked by the end of the year.

So yes, we expect to see some benefit from these commodities. But I want to stress that we continue to see pressure on growing media inputs, especially bark and peat. In fact, the harsh winter is likely to meet a third straight year of challenging peat harvest.

Also, we continue to move forward with our plans to take pricing next year, although less than we would've expected just a few months ago given the commodity environment. On a net dollar basis, we expect to realize the same amount of gross margin dollar improvement regardless of commodity fluctuations and continue to expect sustainable growth in our gross margin rate in 2016. We won't be any more specific than that until we get to the end of the calendar year when we typically provide our guidance.

This brings me full circle from where I started this morning. I feel good about where we are right now. The acquisitions we've made are performing as we expected, the business operators continue to be extremely effective at managing the existing portfolio, our discipline around cost controls remain firmly in place, and as Jim said, we see even more attractive opportunities on the horizon.

Jim King and I will be on the road a bit in the weeks ahead and then try to conduct as many one-on-one visits as we can throughout the summer. I hope to see many of you as possible in the months ahead.

And with that, let me turn back to the operator so we can take your questions. Thanks.

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#### **Operator**

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

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#### **Olivia Tong - BofA Merrill Lynch - Analyst**

Great. Thanks. Good morning. I first want to just try to understand a little bit of the bridge to get back to your full-year outlook. You said kind of the \$0.20 is already back. You expect US to accelerate and commodities are better, but are you expecting US to accelerate, or are communities better in Q4 than you had previously anticipated, or are you just pacing to a lower end of the range relative to where you thought before? Thanks.

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

So within the range of \$3.40 to \$3.60, we still believe we will be, call it, in the mid-range of that area. Related to commodities, we are seeing some benefit in certain areas like you would expect. Urea, a little bit of resin, but we are also seeing some headwinds in areas more so related to our growing media business. And commodities, they typically want to recognize like bark vines, peat, even pallets are up a little bit. So we will see a little bit more benefit on gross margin from commodities on a net net basis, but not as much as you might think just thinking about the rest of fiscal 2015.

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#### **Olivia Tong - BofA Merrill Lynch - Analyst**

Is that a function of your hedges and we'll see it in fiscal 2016, or it's just some are up, some are down?

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

Thinking about diesel and gasoline, we are hedged. So we are 70% hedged on fuel going into the year. So when we've seen the price of oil drop in half, we haven't seen really hardly any benefit of that year-to-date. In fact, it's been negative because of the mark-to-market impact. We will see a little bit of benefit in Q4, but again it's been very much muted because of the hedges we had in place.

Looking ahead to 2016, we are about 40% hedged on fuel for next year, and we'll expect to be about two-thirds hedged by the time we get to the end of the year. So looking at commodities more broadly, we do expect to be more favorable in 2016 and 2015. But again, there are some headwinds that are probably not as obvious to the investment community, and there is a growing media.

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

But I'd like to just add we are not coming off our numbers. So we are not -- there's no secret warning that we are like nervous within the range. And so I think what Randy said is right. I do think that all our unhedged commodities are positive for us, and that will be positive. But the biggest thing at Scotts we got going for us right now is sales and consumer take away.

So the season is pretty much going crazy in the Northeast, and that's a happy thing for us. So it's just a matter of I think that's the biggest single factor we got right now is probably a little positiveness on our hedged commodities and depends on where sales go. But the comps are not particularly difficult. I think we are feeling pretty good.

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**Olivia Tong** - *BofA Merrill Lynch - Analyst*

Got it. And then on the acquisitions, can you actually give us the sales contribution from acquisitions in dollars this quarter, and then also you mentioned in the press release additional benefit to sales. But any additional benefit to EPS from some of the more recent acquisitions since the close of the December quarter? Thanks.

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

Our acquisitions for the quarter, from the topline perspective, have added a couple points. A little bit more than that on a year-to-date basis, and again with the closing of the General Hydroponics and Vermicrop deals on March 30, it should be a little bit better. So our original guidance on topline benefit from acquisitions was about 3%, and it should be a little better than that now with the recent deals we done.

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

But I would add, Olivia, that we also had sort of higher deal costs than we had originally budgeted. So that's going to eat up a little bit of positives that we would have -- which we didn't budget, but we would have seen. So it's kind of good news for next year, and I think it probably says something about some of the deals we're doing with smaller companies is that we are probably doing more sort of remedial kind of work trying to get stuff up to a standard that we find acceptable. And I think we have been talking about that internally as we sort of budget deal costs. But those deal costs hit the P&L in the year.

So I think we are balanced from where we said, probably not seeing sort of more upside because of deal costs. And I think we will probably try to remember that as we go forward.

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

The other thing to keep in mind on the topline as well, we are seeing a lot of growth from acquisitions. FX is muting some of that to the tune of 2% to 3% for the year.

**Olivia Tong** - *BofA Merrill Lynch - Analyst*

Understood. Thanks very much. Appreciate the help.

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**Operator**

Josh Borstein, Longbow Research.

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**Josh Borstein** - *Longbow Research - Analyst*

Good morning, everyone. Thanks for taking my questions here. You had mentioned that the mass retail channel rebounded. What would you think accounts for that? Is it the value-oriented consumer coming back to the category due to better macros, or is it more the result of your engagement with your retail partners to promote the category better?

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

Well, I would say all of the above. I think -- on top of that, I would say the retailers are getting back in the business, and that's a big deal is that I think we are ready. I think our programs are I think right for the accounts. I think Mike and his team are working very closely with the mass accounts in a positive way. But I think a lot of it is the retailers recognize that lawn and garden is important, and they want to succeed there, and they are doing sort of the kind of stuff that you view as very rational.

So I think it's both what you said plus the retailers I think themselves are doing a pretty good job.

Mike, would you add anything to that?

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**Mike Lukemire** - *The Scotts Miracle-Gro Company - EVP and COO*

I think they are just committed to stay into the season and putting inventory in the stores. So I think that's a big change for them.

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**Josh Borstein** - *Longbow Research - Analyst*

And just one follow-up related to that based on your assessment of retail shelf space. How does it compare to last year, and where does that lead you to believe your market share might shake out here in 2015? Thanks.

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

I think in DIY, in mass -- in big-box DIY call it hardware, I think that you are seeing probably a similar kind of shelf space. I know we are taking share because we have the data.

So I know we are taking share, and so that feels like a pretty good story for us. Go ahead, Mike.

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**Mike Lukemire** - *The Scotts Miracle-Gro Company - EVP and COO*

Our share of shelf was up about 5% across all retailers, and we are seeing that show up in POS and market share.

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

I would say in mass a little differently. I think you are seeing more shelf space in the departments dedicated to lawn and garden. So I think that's a positive for us, too, because I think we are getting at least our fair share of that.

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**Josh Borstein** - *Longbow Research - Analyst*

Great. Thanks for the color.

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**Operator**

Bill Chappell, SunTrust.

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**Bill Chappell** - *SunTrust Robinson Humphrey - Analyst*

Good morning. Just as you look at the POS year-to-day and you've touched on it a little bit, but 5% at this stage is probably the best thing we've had in years. So is it market share? Is it retailers? Is the category really coming back, and if that's the case, what do you attribute that to? Are you seeing just a better consumer reception to the category, or is it just pocketbooks are back open again? If you can maybe characterize --

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

You guys probably are way smarter than we are. I would say it's all of the above. I think that the results from my point of view, for the Northeast to be like as bad as it was, just really a few weeks ago, where the season was -- it looked like winter a couple weeks ago in the Northeast. And Boston is still -- there's a lot of places where there's no leaves on the trees yet. That's really just starting to happen in the Northeast at least in New York.

So if you look at those numbers and the numbers get even better if you look January 1 until now and say, let's just focus on this seasonal year, what it says is the rest of the country has had a really good year. And I think it's just good weather. I think the consumer is a little bit healthier. I think the retailer programs have been powerful. I think our execution teams have worked well.

We've got -- I think the retailers, particularly the DIY folks, have had like a couple of really good Black Friday events already. So I think just a lot of good things happening. And then if you say the Northeast has been -- within that has been -- is now today flat, call it, we had a great weekend last weekend, and the weather looks warm and dry this coming weekend.

It's just -- I don't know. I would say that things are coming together, but it's healthy. I'm not sure we can totally explain it, except I think it basically says that America seems to be doing a little better. I don't think it's great because I can look at places like Florida and say I think we continue to see -- remember, we do a lot of the opening price point products as well. I think you see us continue to be people who aren't maybe losing their jobs and worried about losing their homes, but they continue to be value-driven.

And I think if you look at the Midwest where you see plus 15, that's -- there is a market where I would say the Midwest is a couple weeks ahead of the Northeast. And so that's -- the Midwest, plus 15 on POS, that is a fabulous number. I think it's just America is a little bit healthier, and the programs and weather have been -- it's been a great spring here so far.

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**Unidentified Company Representative**

The other thing I would add is I think it's encouraging we look at both ends of the spectrum because our mass consumer is doing better, which we think is tied back to consumer confidence and prices at the pump. And they have more disposable income. But when you look at the other end



with the service consumer, our customer account has never been this high going into, call it, middle of the spring, and I think that really encouraging, too.

So both ends we are seeing a lot of positives, and our core consumer at the home centers is continuing to perform as we expected. So far, so good on May 5th.

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**Bill Chappell** - *SunTrust Robinson Humphrey - Analyst*

No, that's great. Obviously no complaints. Just follow up to that, any -- I know it's early on Europe and it's smaller, but do you expect a little bit tougher comparisons over there. Do you expect a good or at least a decent season, the current season adjusted for this year?

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

We knew that our European business are going to have really difficult comps because we had fantastic weather last year in the UK and France. But they are right on track with our (inaudible) plans right now, and that's why there's really nothing that we've spoken to in the scripts about Europe. Everything is on track, and we are in good shape.

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**Unidentified Company Representative**

I would that's the business now that's being led from an executive team here in Marysville is part of how we've restructured that. And I would say we have great leadership in the countries, and the team here in Marysville that's working it is a very experienced kind of European executive team that have been in Ohio for a while.

And I think they have some really good plans going forward. So I don't think -- the problem is I think with Europe is you don't see this major sort of efficiency of the amount of how powerful we are in the United States where if you get really good weather for a few weekends, you get this giant crush of business.

It's weird in Europe. You get good weather, and it's a little bit better. But so I don't know that there's massive sort of upside to it, but I think the business is performing well, and I'm really confident in the leadership team. And as we guys interact with you all more in person, I think you will be impressed as well with the team that's operating the business.

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**Bill Chappell** - *SunTrust Robinson Humphrey - Analyst*

That helps. And just last one from me, just wanted to make sure I understand on the guidance of 24% top line and flat gross margin for the full year, does that include the most recent Hydroponics acquisition, or how does that affect it?

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

Yes, it does include the General Hydroponics and Vermicrop acquisition. That should add about \$25 million of sales for the back half of the year. On a full-year 12-month basis, it would be around [15].

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**Bill Chappell** - *SunTrust Robinson Humphrey - Analyst*

Perfect. Thanks so much.



**Operator**

Jon Andersen, William Blair.

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**Jon Andersen** - *William Blair - Analyst*

Good morning, everybody. What should we make of, I guess, the West Coast being up 7% this spring, given -- despite the drought, I guess, and noise around the drought? Is this just a matter of being too early to affect the business, or Jim, given your commentary, do you think this is an opportunity to really work through it through some new solutions that you bring to market over time?

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

Look, I think the business tends to actually do better when the weather is a little dry within reason, which I think is part of what we're seeing in the Northeast, is it's been really dry from a rain point of view.

I've been in Santa Rosa and Sacramento quite a bit this year. First, I think if you look at sort of just -- and I would say Sacramento is probably in the center of sort of the drought universe. But a lot of their December weather was pretty wet. And so a lot of the sort of -- if you just go to an environment and you look around, it's pretty green there. It has been. Not as brown as it was last year. So I think that's positive. The weather has been good. I think our competitive programs against other people who play in the space has been really good, and our in-store people, I think, are doing a fabulous job there.

So I think it's good weather. Dry is probably good for us within reason. Remember, lawns represent -- if we don't have the numbers right, we will correct it. But lawns is only about 15% of our California business. So it's not a huge part of our business.

Growing media is the biggest business we have out there, and that business is doing really well.

So I think we are a little less vulnerable. The interaction with state I thought was very positive with sort of the drought czar and the governor. And the products we have coming on, I think they were pretty happy with. And so I think if we are not kind of hobos in the space of operating a drought, even when it's severe. Texas had a pretty severe drought going back a few years ago as did Australia, both of which we know how to do, and this technology we are talking about is a business -- or is a, I think, a very accepted professional technique on when it comes to turf management of active ingredients you can apply that allow the 40% less water to be used to have the same kind of lawn.

So I think the state was really happy with that. Hopefully that will give us our registration quickly, and we'll get it out there.

But I think overall it's just been a really nice season. And I think you're probably right to say that a lot of the restrictions, which are I think happening like maybe this week are kind of beyond the peak of our season. So I think that was probably helpful for us.

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**Jon Andersen** - *William Blair - Analyst*

Okay. The other question I had is on the allocation of capital. You talked about the fact that you are kind weighing M&A versus returning cash. I guess a little over a year ago, it was more oriented towards returning cash to shareholders over the last 12 months and clearly skewed more towards acquisitions. Can you talk a little bit more about your decision-making process, what's driven that shift, what specifically you are seeing in the market in terms of wanting to establish a footprint or protect existing territory?

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

I think to start with, as Hagedorn and as the family that's the largest shareholder in the Company, if we don't have something better to use the money for, our view is that the money belongs to shareholders. And so we've come out of a period that I thought actually was pretty difficult where

we've really get our business processes down, it didn't seem like there were sort of a lot of fair-priced opportunities, and in the sort of absence of something better to do with the money, we made the decision to send it home. And I think that was the right decision, and I think it's really worked well for us.

I do think we are sort of at a time where for some reason, and maybe it's serendipity, I wouldn't even say it's that positive. I'm not saying it's negative either, but I think that whatever is occurring, there does seem to be opportunities presented to us that I think says you have choices now. And so this idea of there's nothing better to use the money for so send it home, it belongs to the shareholders, now is a little more competitive saying that there actually are opportunities to grow the business within lawn and garden.

I must say at things that we say we think are fairly priced.

So this is -- we just had a board meeting last week, I've spent quite a bit of time with my older sister Susan. I assume she's on the call. And I think there is generally relief at the board level and relief at the family level that at least there's opportunities for growth and that that ought to be something then that there is sort of a definite and sort of rigid intellectual discussion amongst the board and the management team and some of our larger shareholders.

And that's -- it says, remember, my family are insiders, how do we feel about that, and what are the opportunities, and it's a good place for us to be? It's better than the alternative where there is just we don't see the opportunities and better to send the money home.

So I think we are actually being pretty careful about it and selective. And it's -- I would say it's a good time to be in lawn and garden, that's what I would say.

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**Jon Andersen** - *William Blair - Analyst*

Thanks. I'll pass it on.

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**Operator**

(Operator Instructions). Eric Bosshard, Cleveland Research.

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

Hey, dude.

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**Eric Bosshard** - *Cleveland Research - Analyst*

Good morning. Two questions for you. First of all, the sales story sounds very positive. You've made a couple acquisitions, yet you are affirming the full-year sales guide. And I'm curious if there's something moving against you within the business that's limiting upside to sales, and otherwise what feels like it should be a better than what you thought coming into the year sales performance. What are your thoughts there?

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

The rule about downside we're seeing in the sales line is really just FX. So operationally everything is very much on track. We are feeling very confident, but FX will be at least 2%. It could be even a little more than that as a drag on our full-year sales growth. So that's really what's dragging it down. And we expect some of that earlier in the year, but the FX currency changes have been more than what we planned. And that's really the one --



**Unidentified Company Representative**

I would throw in there, Eric, was not happy with where we took the two with the quality of our growing media products. I think we have been pretty open about that. We are putting quite a bit more peat and composted bark depending on where in the country you are. That's going to cost us money. And I think as we said, fuel costs that in the GH deal were probably higher than we thought as well. And that probably is a lesson just as we sort of -- to acquire possibly like small family businesses. As we look at a lot of the stuff, we just -- it just means more work, not less.

And so I think these are some of the things that I would say are a little bit headwinds, but I think we've got quite a bit of tailwinds as well. And at the end of the day, all we're trying to say is where we started the year with you guys, we're sticking. The sales side -- I would say everything is sales right now.

So that's -- I'm not sure -- I think that FX, so the cost of our inputs on growing media, which is a quality issue and deal expenses on GH a little higher than budget, sort of eating in a little bit into sort of upside.

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**Eric Bosshard - Cleveland Research - Analyst**

And I appreciate it from an EPS standpoint, but from a sales perspective, I guess it's just the two points of FX. It feels like all the good things that are going on in April and the in May and engagement in retailers, it feels like there would be upside on the sales line. Are you being conservative? Is there something that I'm not thinking about, or is this just what it adds up to?

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

Look, I'll take that. Because I think if Luke had his way, he would probably push it up, and I think if Randy had his way, he would probably stick hard. And I would say for this call, Randy won. We will wait to see if Mike and his sort of execution team can outperform.

Remember, I said the comps are pretty easy, like real easy. So it sort of depends on the next -- I'm going to say four weeks or so. But it's pretty much all sales at this point.

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**Eric Bosshard - Cleveland Research - Analyst**

And then the second question, strategically I appreciate your transparency of seeing attractive acquisition opportunities in kind of the newer business you are growing. My question is that kind of when the smoke clears a year or two from now, as you build out this Hawthorne business, what is the growth and profitability profile of that business look like, and how does it compare to the quarter?

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

Well, I would say higher. So I think this is the -- the historical performance is higher growth rate than our core and higher margin. We believe that we can at least help the growth rate be higher, and I think we would like to not screw the margin up.

So I think that's -- I think if we looked at kind of what we would hope it to be in a few years, I think that that's kind of coming together with us. We have reserved money for continued consolidation in that space, and it's our plan to do that.

But right now we are pretty solid in the integration of GH, and that's what we are working on right now. But I think we intend to continue in consolidating Hydro.

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**Eric Bosshard** - *Cleveland Research - Analyst*

Okay. Thank you.

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**Operator**

Jim Barrett, CL King & Associates.

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**Jim Barrett** - *CL King & Associates - Analyst*

Good morning, everyone. Randy, I think this may be a question for you. You mentioned you envision the Company leveraging up in the near term. Could you discuss what would be the maximum leverage you would be comfortable with, and then on a related point, can you talk about your capital spending outlook for the next year or two?

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

Sure. So over the last couple of years, we've said we would like to stay in a range of 2 to 2.5 times leverage. When we spoke at the Analyst Day in Boca Raton a few months ago, we said given the operational soundness of our business and the predictability, we are comfortable going 2 to 3 times on, call it, an everyday basis normal run rate.

We also said depending on the deal, if it's the right strategic fit at the right price, we would be willing to go well above that on a temporary basis, knowing that over time we would want to be back to that 2 to 3 times range.

So from conversations with our banks, we feel like if we need to, there's more money out there at a good price right now. So that's not a concern. And we even just have enough capacity given our existing capital structure with our credit facility that we can borrow quite a bit more money without even having to go back to the credit markets or banks.

So that's not necessarily a concern, but again we prefer to be in the 2 to 3 times range over time. But right deal, right price, right fit, we would go above that and not be concerned in the short-term.

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

I would just add to that that, again, we just had our board meeting. We basically played a little bit of chess with the board, showing them various opportunities that we believe are out there, and none of the leverage numbers look particularly scary, that if you said like maybe one turn on top of three on a temporary basis, and a commitment to management to work its way down.

And that's if everything we wanted to happen happened.

So the numbers did not look scary, and it's a management team that has operated with leverage before. We have a nice consistent cash flow. So we feel that it's really -- the question is how important are the strategic opportunities that are placed in front of us and how did the sort of board and the management team feel about it.

So I don't think that we felt that this was irresponsible. So just sort of talking -- we're talking like an additional turn, that's all.

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**Jim Barrett** - *CL King & Associates - Analyst*

And then finally, the deals that you have, you have visibility on, are you seeing competition for these deals, or does it appear as if you are the only game in town?

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

I don't know. If you listen to the sellers, it's a zillion people. Private equity, they're going public. I don't know. I would say who knows the truth. I think that a lot of times we feel like we are the strategic out there.

So I think we are realistic about it, but if you listen to the sellers, it's a super competitive world out there. I do think -- multiples are still like kind of crazy, I think. But some of these are pretty strategic for us, but whether it's sort of -- if you just look at historic deals, Hydro sort of rodenticides, we are paying pretty fair money for the stuff.

So it is not like the stuff is super cheap, and I think that does get back a little bit to the competition is that I don't think they would begin these kind of multiples if there was no competition.

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**Jim Barrett** - *CL King & Associates - Analyst*

Right. That's very helpful, Jim. Thank you both very much.

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**Operator**

Joe Altobello, Raymond James.

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**Unidentified Participant**

This is [Christina] on for Joe. I was just wondering if you guys are seeing any mix impact on gross margins from strong growth in the mass channel versus home centers?

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

So from a customer point of view, there's really not a mix component. From a product mix component, we have seen a little bit of a headwind in the quarter. If you recall back to last year, we ended our fiscal year with higher inventories than we have in the past.

So we've been doing a build of mulch and growing media products this year more aggressively than in the past. And we shipped that in earlier in March than we would have typically done in the past to avoid any kind of distribution hiccups that we had a year ago. But that's going really well for us, but it did provide a little bit of a mix headwind for us in the quarter on a year-to-date basis but not remarkably so.

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**Unidentified Participant**

Thank you.

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**Operator**

There are no further questions in a queue at this time. I'd now like to turn the call over to Jim King for any closing remarks.

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

Thank you, Shelley. One point of clarification. I apparently misspoke at the beginning of the call. Randy and I will be at the BMO conference on May 21, and we will put a press release out related to that next week. If there are follow-up questions for anybody, feel free to call me directly today. I am at 937-578-5622.

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

**Operator**

This does conclude today's presentation. We thank you all for your participation.

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