S&P Global
Market Intelligence

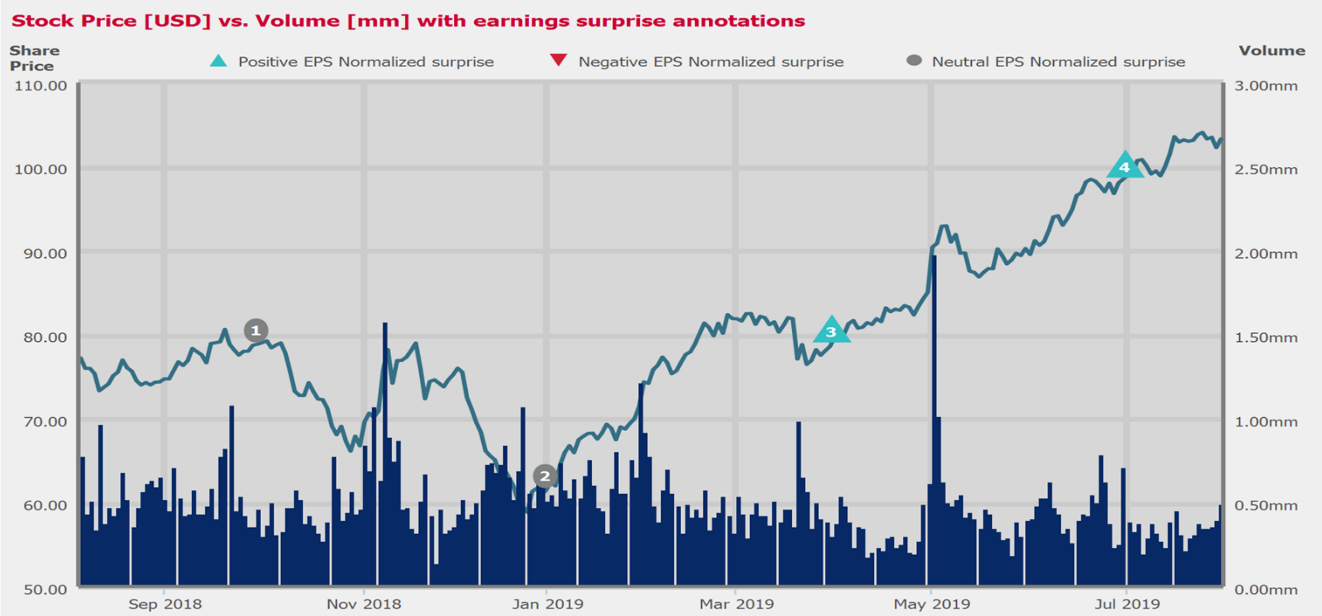
The Scotts Miracle-Gro Company
NYSE:SMG
FQ3 2019 Earnings Call Transcripts

Wednesday, July 31, 2019 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2019-			-FQ4 2019-	-FY 2019-	-FY 2020-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	2.74	3.11	▲13.50	(0.64)	4.37	4.81
Revenue (mm)	1069.26	1170.30	▲9.45	461.96	3023.81	3126.78

Currency: USD
Consensus as of Jul-31-2019 1:55 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2018	(0.66)	(0.75)	NM
FQ1 2019	(1.24)	(1.39)	NM
FQ2 2019	3.45	3.64	▲1 5.51 %
FQ3 2019	2.74	3.11	▲2 13.50 %

Table of Contents

Call Participants

EXECUTIVES

Christopher J. Hagedorn
GM & Senior VP

James S. Hagedorn
Chairman & CEO

Jim D. King
Chief Communications Officer and Senior VP of Investor Relations & Corporate Affairs

Michael C. Lukemire
President & COO

Thomas Randal Coleman
Executive VP & CFO

ANALYSTS

Carla Casella
JP Morgan Chase & Co, Research Division

Christopher Michael Carey
BofA Merrill Lynch, Research Division

Eric Bosshard
Cleveland Research Company

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

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

William Bates Chappell
SunTrust Robinson Humphrey, Inc., Research Division

Presentation

Operator

Good day, and welcome to the 2019 Q3 earnings conference call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Jim King. Please go ahead.

Jim D. King
Chief Communications Officer and Senior VP of Investor Relations & Corporate Affairs

Thanks, John. Good morning, everyone, and welcome to the Scotts Miracle-Gro third quarter conference call. With me this morning in Marysville, Ohio is our Chairman and CEO, Jim Hagedorn; and our CFO, Randy Coleman. Our President and Chief Operating Officer, Mike Lukemire; and Hawthorne General Manager, Chris Hagedorn, are also with us today and available to participate during the Q&A session. In a moment, Jim and Randy will share some brief prepared remarks. Afterwards, we'll open the call to your questions. [Operator Instructions]

With that, we've got a lot to cover, so let's move on with today's call.

As always, we expect to make forward-looking statements. So I want to caution that our actual results could differ materially from what we say today. Investors should familiarize themselves with the full range of risk factors that could impact our results, and those are filed in our Form 10-K, which is, of course, filed with the Securities and Exchange Commission.

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

With that, let's get started, and I'll turn things over to Jim Hagedorn.

James S. Hagedorn
Chairman & CEO

Thanks, Jim. Good morning, everyone. If you sensed a heightened level of enthusiasm in our voices today, I suspect you'll understand. We see today's result as a validation of the strategy we initially laid out in 2015, and it continues to bear fruit. And it's confirmation that the challenges that drove our conversation on this same call a year ago are now in the rearview mirror.

That strategy, Project Focus, was pretty straightforward. First, to fully leverage the power of our core business to drive both our earnings and cash flow. We know that our U.S. Consumer segment, while highly profitable, is also a low single-digit growth business. So the second part of our plan was to reconfigure our portfolio, divesting margin, talent, businesses and replace them with faster-growing ones like hydroponics and live goods that also offer higher margins. Part 3 of Project Focus was to make cash flow our #1 financial metric and the centerpiece of both our strategy and compensation plans. Improved cash flow performance has helped fund our reconfiguration. It also has allowed us to repurchase shares to further enhance shareholder value. As we quickly move closer to our long-term leverage target, we expect to return in fiscal 2020 to a more proactive approach to returning cash to shareholders.

This morning, you saw us increase our guidance for both our core business and for Hawthorne. We also increased our guidance for cash flow. This is the second time this year we've called up our numbers, so obviously, we're feeling pretty good about how the strategy is playing out. There's no doubt, it's been a good year. But with that said, we are not declaring victory. Both businesses had pretty easy comps, and I'm not going to pretend they didn't. But there's more to it than that. If you look at our history, you'll see a company that always nearly responds well to stress.

We were definitely stressed last year. Across the entire organization, people kept their heads down. They executed and they got the business back on track. In fact, 2019 has been one of the best years I can recall from an execution perspective since I've been CEO. There are a lot of people to acknowledge. I won't name them all, but I do want to call out Mike Lukemire and his entire U.S. leadership team. I also want to acknowledge Chris Hagedorn and his team at Hawthorne. And of course, I want to acknowledge the thousands of associates across the enterprise for their commitment, their loyalty and their ongoing support from what we are trying to build here.

I'll turn my attention first to our U.S. Consumer segment, which had a solid growth year in every channel of retail for the first time in 4 years. I told you earlier this year that I believe the relationship with our retail partners were as strong as they've been in years, maybe as good as they have ever been. Working together as partners, we addressed the opportunities in areas like organics, the challenges in areas like herbicides or new approaches to driving consumer engagement across the entire category. As a result, our retail partners didn't just support lawn and garden, but they specifically used our brands to drive foot traffic into their stores throughout this spring. And our ability to execute in-store helped them turn that foot traffic into sales.

That momentum is continuing. Whilst summer usually represents a lull for lawn and garden activity, we just finished the best July we've ever reported in terms of POS. Now we're seeing retailers switch gears and ramp up for the important fall season, which experienced homeowners know is actually the best time of year to feed your lawn. That means that retail inventory levels across the board, which we initially believe would decline, have increased on a year-over-year basis. It feels just like it did a couple of years ago and right where we believe it should be given their support for the category and the level of POS we continue to see.

The 4% growth we've seen in POS this year-to-date is not just because retailers are more engaged. Consumers are, too. And that's largely in response to our innovation efforts. Nearly 14% of our revenue in the U.S. Consumer segment this year and about 15% of the gross profit is from products we've introduced in the past 3 years. Entering August, consumer purchases of our lawn fertilizers are up 4%, the best growth rate we've seen since 2009.

As we've told you in the past, our new Triple Action products, which have multiple benefits from a single application, have led the way. Grass seed continues to have a great year too, up 18%, thanks to our Scotts Thick'R Lawn product. Our new Performance Organics product has helped drive soil purchases up nearly 6%. Miracle-Gro already is, by a wide margin, the market leader in branded soils, but that doesn't mean we sit back and rest. Innovation matters if our goal is to move beyond the status quo and expand the overall category while attracting the next generation of gardeners. Performance Organics and the science behind it is designed for that very purpose.

The same is true with our new Ortho GroundClear products. The support we've put behind that product line this year, more than a 75% advertising-to-sales ratio, has clearly paid off and it continues to exceed expectations. This product provided a great option for consumers looking for a different active ingredient and also helped us expand the category. Between Roundup and GroundClear, the nonselective weed category is up 9% from 2018 levels.

Our market share is either neutral or positive in nearly every category compared with last year. Those market share gains, we believe, were bolstered by retailers' support as well as increased investment in advertising and an overall improvement in our marketing efforts. Whether through social media or on TV, we were more creative and aggressive in our approach this year, and the data suggest that our messages resonated with consumers. A combination of these factors helps to explain the positive growth we saw in every region of the country this year.

And it's not like we had an easy time with weather. Heavy amounts of rain in key markets throughout the spring sometimes made it hard to maintain that momentum. Texas never gained any positive momentum. And even parts of the Northeast, which is up more than 6% for the year, were sluggish well into May. So when I look at our U.S. Consumer segment, it's hard not to be pleased. It's been our best year in quite a while, and our 2020 planning meetings with our retail partners gives us all a sense of continued optimism.

Turning now to Hawthorne. The bounce back from last year's decline remains in full swing. Led by lighting and nutrients, our 2 most important product lines, we saw 49% growth in the quarter on an apples-to-apples basis. And that trend is getting stronger every month. The recovery in California, our largest market for Hawthorne, continues to exceed our expectations. We are up more than 30% in the quarter and we're up 15% through the -- year-to-date through June. In Michigan, our largest market in the Eastern United States, we were of more than 70% in the quarter and nearly 35% year-to-date. And newer markets like Florida and Massachusetts are up 50% and 35% so far year-to-date.

From an operational perspective, by year-end, we will have achieved nearly 100% of our expected synergies from the acquisition of Sunlight. We are moving the Sunlight IT platform over to SAP this fall and giving that project all the attention it deserves. This will be our last step in moving all of Hawthorne onto a single IT platform, which we believe will enable even more cost savings as we look ahead.

I want to switch gears before I finish and highlight the other news item that we announced at this morning, the updates to our Roundup agency agreement and our long-standing relationship with Monsanto. I'll share only the highlights and leave the details to Randy, who, along with our General Counsel, Ivan Smith, shepherded this process from the outset.

But there are a few key areas I want to highlight: First, we restructured our profit-sharing agreement. Previously, Bayer, through its Monsanto subsidiary, earned 100% of the first $40 million of EBIT and we shared equally from that point forward. This puts Scotts disproportionately at risk if the business declined in any given year. Under the updated agreement, we will share the profit equally beginning with dollar 1 each year so both companies fully share in the benefit and risk of the ups and downs. Assuming a constant baseline, this improves our Roundup commission by $20 million annually into perpetuity beginning next year. There are important nuances here related to the P&L, and I'll let Randy cover those when he speaks in a few minutes.

Second, Monsanto will purchase for $112 million the brand extension rights that we purchased from them in 2015. Recall that we put the same value on those extensions at the time of that deal. The Monsanto subsidiary will now own those products. We will serve as agent, just as we do with the regular Roundup product line, and so we'll also share equally in the profits of those brand extensions going forward.

And third, one aspect of the previous agreement was that both parties had only limited ability to exit the relationship. Now both sides have at least some flexibility to do so, though that is not the current intent of either of us. If either party did choose to exit, the updates clarify the financial considerations paid to Scotts at that time.

It's no secret that the Roundup business is an important part of our earnings stream. While there has been plenty of headline noise this year, the brand has performed well and remains powerful with those consumers who have counted on its reliability for years. The combination of Roundup and the changes we've made to the overall nonselective product line has been a big win for us in 2019. Additionally, we found the new team in both Germany and St. Louis extremely responsive and good to work with, and I want to thank them for their engagement.

The Roundup business itself continues to perform well this year. POS is now slightly up from this time a year ago despite some downward pressure in the second half of the year against some extremely difficult comps.

I want to add one more point before I move on. We expect to receive the cash from the sale of the brand extensions in the early days of calendar 2020. We will use that money to further reduce our leverage.

Coming full circle to my original comments about Project Focus. I'm cautiously optimistic we will begin returning cash to shareholders this coming year. While figuring out what to do with our cash is a good problem to have, it doesn't mean we don't see plenty of opportunity to drive shareholder value by running the business better. We do. We've given up margin over the past 2 years, for example, and we need to get some of it back, especially at Hawthorne.

Margin doesn't have to come at the expense of growth. While we may not want to be as aggressive with our pricing or promotional strategies going forward, we'll still use those tools to drive the business. Better margins are available to us if we fully integrate Hawthorne into the overall corporation and take advantage wherever we can of the potential synergies from that approach.

Execution will be key to the U.S. Consumer business as well. We started to remake our marketing efforts this year, but we still have work to do and we need to do it quickly. Millennials are finally starting to do what some people feared that they wouldn't: buy homes. And that makes them the future of lawn and garden. While their sensitivities and buying patterns may be different than their parents, we know they love plants and the outdoors. They want to take care of their outdoor spaces, but they need help. We need to be there for them.

Among other things, that means our direct-to-consumer efforts and online strategies need to evolve, too. This year, we expect to top the $100 million mark in this area, and we know there's a lot more opportunity ahead of us. Some of those opportunities will be with our current products and brands. Some will be from new ventures that resonate with new consumers. What's critical is that we don't simply shift sales from one channel to another. I want these sales to be mostly incremental. So the way we communicate with those consumers that draw them to our category and to our brands will be a critical part of how we win.

So for as good as I feel about the business right now, I still see a lot of opportunity to do better. We have no doubt regained our momentum this year. It's up to us to keep it going and to continue executing our strategy in a way that drives shareholder value.

With that, let me turn the call over to Randy to run through some of the details.

Thomas Randal Coleman
Executive VP & CFO

Thank you, Jim, and hello, everyone. It's difficult to start this morning without first recognizing the obvious. We're having an absolutely tremendous year on both the top line and the bottom line. It's now clear that this year, we will see the highest level of sales growth in the U.S. Consumer segment since 2009, and the recovery at Hawthorne continues to gain momentum and exceed our expectations. I want to echo Jim's comments about our team and congratulate them for their efforts throughout 2019.

Calling up our guidance for the second time this year has put us back on track after our shortfall last year and has positioned us well as we put the final touches on our programs and budgets for 2020.

There's no need for my comments to be lengthy this morning. I won't go through everything line by line, but I will provide color where I believe it's helpful. I'm not going to provide many details related to our plans for next year, but I will sprinkle in a few comments as it relates to key areas like current commodity trends, our thoughts about the balance between volume and pricing and the implications of the amended Roundup agreement to our P&L going forward.

So let's jump in. On the top line, the story is good across the board. Sales in the U.S. Consumer segment were up 10% in the quarter to $889 million or now up 9% year-to-date. Earlier in the year, we told you that some of our key retail partners were moving shipments up earlier into the season. At that time, we expect that those retailers would slow down in the second half, and that has not happened. So as Jim said, retail inventory levels are higher than a year ago, but frankly, we believe retailers are much better positioned to support the category as a result.

The other piece of good news here is that we've seen strength across the entire portfolio in terms of consumer engagement. Jim touched on a few of the key categories so I won't delve further, but it's encouraging to see across-the-board momentum by retail channel, product category and geography.

We entered the year believing U.S. Consumer sales would increase 1% to 2%. The $20 million reimbursement from Monsanto and the incremental malls program at Lowes and the overall strength in the business allowed us to move that range to 3% to 4% in June. Based on what we know today, we're now expecting the U.S. Consumer business to grow 6% to 7% due to continued retailer engagement and consumer demand.

In Hawthorne, sales are up 138% in the quarter, thanks to the Sunlight deal. But when we break down the business on an apples-to-apples basis, we're up 49% in the quarter and 19% year-to-date. After last year's disappointment, we set out to be conservative in our planning and our guidance for this year, but the recovery we've seen this year is much stronger than we expected. Lighting is up 49% in the quarter and 25% year-to-date. Nutrients are up 43% and 26%, respectively. In total, the North America hydroponics business is up 40% in the quarter and up 15% year-to-date.

We've told you in the past that we've been intentionally more promotional within Hawthorne this year, so our full year operating margin will probably be around 8%. Our conscious decision to trade margin for volume in 2019 has helped drive the business this year and was definitely the right decision. We believe we can start to call back some of that margin next year, and we do not believe we'll have to sacrifice growth or market share to do so.

We now believe reported sales for Hawthorne in 2019 will be approximately $650 million, off of a base of $345 million last year. When we look at the business on an apples-to-apples basis, that puts the organic growth rate slightly north of 20%. When you put both pieces of the business together, we now believe company-wide sales will grow 16% to 17% for the year.

Let's move on to the gross margin line, where you'll see that Q3 adjusted rate is essentially in line with last year at 36.2%. On a year-to-date basis, we're 90 basis points below last year at 35.1%. The impact of the Sunlight deal and the promotional activities within Hawthorne are the primary drivers here. Note that commodity costs and tariffs will reduce gross margin dollars by about $30 million in 2019, and we're expecting another $20 million impact in 2020. I would expect us to close the rate gap a bit in Q4 and get back about half of the year-to-date decline. So our gross margin guidance versus last year of flat-to-down 50 basis points still seems to be the most likely outcome for the full year, although I expect to finish through the low end of that range.

Moving on to SG&A. The $166 million that we record in the quarter is 15% higher than last year and up 10% on a year-to-date basis. The percentage increase is obviously higher than our original expectations. We expected the impact from Sunlight and plan for higher marketing expense as well. The biggest unexpected increase actually speaks to the strength of the business this year. Our accrual for incentive compensation is significantly higher than a year ago.

Below the line, things are pretty much what we expected. So bringing all this down to earnings, we reported adjusted net income in the quarter of $176 million or $3.11 per share compared with $150 million last year or $2.67 per share. Year-to-date adjusted net income is $303 million or $5.39 per share compared with $253 million or $4.41 per share a year ago.

As you know, we raised our guidance back in June. I said publicly at that time, we were continuing to the err on the side of conservatism given that we still had 4 months left in the year. But we've done better than what I considered at that time to be a best-case scenario. We obviously have much better visibility now, so there's a high degree of confidence in the new range of $4.35 to $4.50 per share. Some of you may believe a $0.15 range still seems a bit broad with only 8 weeks to go, but our low share count makes it difficult to be more precise. For example, a $5 million swing in EBITDA is worth at $0.07. So the midpoint of our adjusted EPS guidance is actually tied to a pretty narrow range of earnings.

I know many of you are probably ready to turn the page or have a lot of questions about 2020. To be clear, we're not providing specific guidance today, but I will say that a stronger than U.S. Consumer segment has been, retailer engagement and not only consumer activity has driven the business this year. So the fundamentals of the business are largely unchanged. Additionally, it's our intent to increase pricing again next year, and we're planning for low single-digit growth.

As it relates to Hawthorne, it's important to remember that we're going up against negative comps this year. So be careful on how you think about growth going forward. We're still assuming a growth rate in the high single digits for 2020.

There are a couple of other things shareholders should understand about our 2020 P&L based on the changes Jim discussed in the Roundup agreement. First, while the nonselective Roundup profit-sharing agreement has permanently changed beginning in 2020, this is neutral to earnings next year as we booked a $20 million reimbursement from Monsanto in the third quarter. However, we will see a net EPS headwind of about $0.06 from our sale to Monsanto for the brand extensions, and this includes the benefit of interest expense. And we'll lose roughly $40 million of sales included in our 2019 P&L. We're not going to try to offset these pressures from an operating perspective. However, the proceeds from the sale of those brand extensions will help us delever. Right now, we're at 3.7x debt-to-EBITDA, and I would expect us to return to 3.5x leverage sometime around the midpoint of next year.

Related to leverage, I want to switch gears a bit and talk about cash flow. Again, we're seeing things come together better than we initially expected. Free cash flow, and that's operating cash flow net of CapEx, should now be approximately $185 million for the year. In June, we have set that range from $140 million to $160 million. Remember that we have about $140 million of outgoing cash this year for 2 unusual items: first, the tax billed for the sale of our TruGreen stake; and also the payment for legal matter that hit our P&L last year. So if you normalize for those 2 items, this may be our best year ever from a cash flow perspective.

We said when we entered this Project Focus that our cash flow would be our #1 performance metric. On a cumulative basis, over the past 2 years and also including expectations for 2019, we will have generated approximately $900 million of free cash flow. More importantly, by also tying it to our compensation plans, we have properly focused our associates and minimized the year-to-year volatility we had seen in the past. While our growth this year and the overall P&L performance will grab most of the headlines, I'd encourage you not to lose sight of our cash flow performance and our commitment to maintain our momentum going forward.

There's one nonoperating item I want to call to your attention. For nearly an entire year, our trading window has been closed to insiders due to our negotiations with Monsanto, related, first, to the reimbursement we received earlier this year; and also to the expected amendments to the agency agreement that we announced today. Later this week, we expect to once again allow associates, including myself, Jim and the other 4 named executive officers of the company to trade Scotts shares. We expect there will be insider selling occurring as some options are set to expire soon and other people may simply want to rebalance their portfolios. I want to remind you that we do have minimum ownership requirements, and every member of the executive team will continue to exceed those requirements. We all believe it's important for you to understand the dynamic here, and we want you to know our continued confidence in the business is unchanged.

I want to close by once again recognizing my colleagues for their efforts this year. And I'm not talking about the people sitting at the table with me. I'm talking about the folks who are in the trenches, those working on our sales force, our manufacturing plants and our distribution centers. The strength of the year has definitely stressed the system, but they never missed a beat. It was largely their efforts that helped drive such a positive outcome so far this year. Thank you for what you do.
And with that, let me turn the call back to the operator to take your questions. Thank you.

Question and Answer

Operator

[Operator Instructions] We will take our first question from Joe Altobello of Raymond James.

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

So a lot to chew on here. So I guess, first question is on the guidance for this year. And obviously, U.S. has been very strong. Shipments have been very strong. But it looks like the guide -- even the revised guide from this morning implies U.S. Consumer sales down in the fourth quarter. Was there any pull forward into the third quarter? Or does that just reflect retailer inventory rebalancing?

Thomas Randal Coleman
Executive VP & CFO

Joe, this is Randy. We do expect a little bit of slowdown in the fourth quarter, but it's on a relative sense. So I would expect retail inventories to be a little bit lower come the end of the year than where they are right now, but having said, still much higher than what we would have seen last year, when I think there was a reduction, especially in the home center channel that, I think, was one-time in nature. If you look at our retail inventory expectations, when you look at it now or looking from a couple of months from now, they're more or less consistent with what we would have seen 2 or 3 or 4 years ago. So I'd say things are more or less back to normal, and I think everybody is set up for a really good fall season as well.

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

Okay. That's helpful. And then secondly...

James S. Hagedorn
Chairman & CEO

Yes. And Joe, try not to create -- try not to connect all the dots, Joe. I think that we're -- as we sort of pulled everybody -- I'm also looking at Scott Haefke, who does a lot of our operating finance work, I think we're trying to be reasonable about the year-end expectations. And so I just -- what I wouldn't try to do is connect everything. I think we continue to be not wanting to get ahead of ourselves.

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

Okay. That's helpful. And secondly, on the $20 million from Bayer, you obviously got the payment in the third quarter this year. And you just have to spend that back. Next year, you're going to have a $20 million starting annually. How do we think about the $20 million next year? Does that get spent back as well? Or should that be considered incremental?

Thomas Randal Coleman
Executive VP & CFO

No. I think the way that you ought to look at it, Joe, is year-over-year, we'll have the $20 million. We're going to continue and invest in the business, so I wouldn't expect that to come away. With the sale of the brand extensions, we will lose a little bit of earnings there net of some interest expense, but if you add it all in versus our model without the -- these new agreement that we announced this morning, we should be about $0.20 -- approaching $0.20 better of EPS next year than what we planned. But year-over-year, it shouldn't be a whole lot different, if that helps.

Operator

We will take our next question from Chris Carey of Bank of America.

Christopher Michael Carey
BofA Merrill Lynch, Research Division

So just a question to start on Hawthorne, right? So a really good recovery on the top line this year, and obviously, you've been quite promotional in order to do that. And so as you go onto next year and you start to dial back the promotions a little bit, can you just talk to kind of how you're thinking about the risk of that impact sales so that you can continue to get the growth? Because obviously, you are still expecting high single digits.

And Chris, if you're on the line as well, can you maybe talk to how you're thinking about the introduction of track-and-trace in California next year? If you think that's a risk?

Thomas Randal Coleman
Executive VP & CFO

So Chris, let me start. This is Randy. I think right now, we're seeing high single-digit growth for next year. Really comfortable with that outlook right now. We may be a bit less promotional, but we'll still be aggressive. We'll still be driving the top line. We'll still be taking market share. So we're not going to change that as well, but I think we can find a balance where we can also be a bit more selective in the promotions we do run, make sure that we're thinking about margin a little bit better. And there's a lot of synergies still to be had. So we're going hit the $35 million number that we talked about when we announced this deal, but there is more to come and we'll be playing for some of that next year as well. And that will help not only our gross margin rate but our operating margin rate as well. So...

James S. Hagedorn
Chairman & CEO

Let me just take a little bit on this before Chris Hagedorn gets it just because we spent a little bit of time talking about this, Chris and myself, last week, which is how do we balance the margin need, sort of my compact with Randy and what we do here at corporate with, I think, a very competitive approach to the marketplace, which I think is bearing big-time fruit. And what we talked about was that there is a lot of benefit, and this is where -- whatever people feel about sort of big SMG here at [indiscernible], there is a lot of professionalism here as far as finding ways to integrate these businesses and get synergies out of them. And we have a lot of opportunity there. So I think just backing down a little bit on the sort of promotional level but still being very competitive brings something of value to the trade. Plus the synergies will get us a lot of the margin requirements that Randy and I have put on Mike and Chris.

So I don't know, Chris, where you'd go with that.

Christopher J. Hagedorn
GM & Senior VP

Yes. I'm not going to rehash everything that Jim and Randy said. This is Chris, by the way. How is it going? The one thing I would add to it is as we've seen the evolution of this category, it has gotten significantly more competitive, I think, than it had been. I think for me, the big thing that Randy and Jim haven't mentioned or focused on moving into '20 for us is we've got a significant amount of innovation coming out in some really key categories for us so this won't force us to take pricing on things that we promoted down this year. It'll allow us to launch new products with much healthier margins that are going to get us back to where we want to be. And then these are extensions of products we've launched over the last year or so that have already shown good traction, so we feel pretty confident in the market adoption there. So rolling into '20, obviously, we've got some steep earnings targets, but I feel pretty confident in our ability to hit them between operational efficiency, and the SAP one, that other things will unlock, and innovation that we've got coming. Quickly, on Track-and-Trace in California, we obviously saw the report you put out, read it, and coming out of reading that report, we reached out to some of our contacts in California just to get some perspective on how they see this rolling out from a government and law enforcement perspective. Now a Track-and-Trace is going to happen. It's going to be just the reality of the legal cannabis market in the U.S. in every state. The conversation we have with the folks in California, I don't think the impact will be quite as significant as we read about in the report. We are not expecting a massive negative impact in terms of -- in sort of making business more difficult to California. So we're optimistic there. Obviously, we are hedging as best as we can, and the growth we're seeing in other states I think is lowering the potential negative impact that California might have, still our most significant state by a good margin. But as other states in the East Coast come online, it really limits our exposure there.

Christopher Michael Carey
BofA Merrill Lynch, Research Division

I really appreciate the detail. And then just -- the second question is, you mentioned, right, best growth you've seen in U.S. consumer in 10 years. It was on easier comps, but nevertheless this is really strong top line performance and on profit. You did mention that your planning sessions on fiscal '20 give you some optimism, right? These are also really big numbers to overcome. So I wonder if you can just give a flavor of how you're thinking about market share, incremental distribution, those kinds of things as well. And maybe just that in the context of selling being a bit ahead of consumption, if you can maybe comment on that as well.

James S. Hagedorn
Chairman & CEO

I'll start. It's kind of unfair. Isn't he supposed to ask 1 question with a follow-up or something going? So this year has been a pretty interesting year. Maybe it's just Mike and I have worked together more, sort at the trade level, than we have in a while, but there had been some fabulous discussions with all of our retail partners. I'm talking across the board. Reengagement with people that sort of Mike and I haven't met with in a while. And what's clear is that we have a very unique ability to sort of drive business at the store level, and I think it is recognized, if it's ever been, that we are the prime vendor in this space and there's a lot of room to do that. We have spent quite a bit of time on our view of the strategy of promotion in season. These numbers are numbers I'm hearing, but I wouldn't say that they're going to be perfectly right. But we tend to operate on these big bets, called Black Fridays in the spring, that are planned out months in advance, sometimes more than half a year in advance, and a lot of our promotional work happens relative to those. We have been spending a lot of time. We partnered with IBM Watson, whatever they are, but they own the data behind The Weather Channel. And I think we're probably getting better weather data, and we always have weather vendor or partners, but I think we're getting sort of the best data combining it together with our historical sales. Our view of that is that we actually have a significantly less than 50% hit rate regarding weather on Black Friday events and that what we started to do is work with retailers to say we still want to do the events, but why do they have to be across the entire nation and why do they all have to be at the same time even if we know the weather is bad? I mean, can't we act using social media and sort of in-store activation in a much more responsive way? And the answer is we've tried that this year and it worked really well. And I think these are the kinds of discussions that go beyond the sort of day-to-day work that the sales group has with the merchant team. These are the kind of creative discussions that say, how do we drive volume better, how do we activate in the store, how does our sales force work together with marketing, with retailers, marketing folks? And as a part of that, I think we demonstrate, and it seems to me it's been a very powerful way, that we are a very unique vendor in a class of the trade that tend to carry lawn and garden products. So it's a pretty small universe, but I think Scotts is standing out as a pretty innovative player. And I think we have a lot of ideas and if we try those and they're working -- I feel very optimistic that we are recognized in a positive way for what we do and what we add to the marketplace. I think we've got some really good ideas. I think if you look at our innovation pipeline, it's really interesting and I think productive. And the discussions we're having with the retailers are consistent with what I just told you. So the original version of the scripts that we have -- so I don't know I was on, like version 6 or 7 -- had more optimism of 2020 sort of built into the early part of the script. We took it out just because we are trying to manage time, but it is real. Mike, I don't know, your view on next year?

Michael C. Lukemire
President & COO

Next year, there's a lot of opportunity because everybody is leaning in. We have the innovation. They want to work on the program. We're advertising. We're executing. I haven't seen it as complete as I've seen it in my 20-some years here. Whether you're talking on our traditional big 3 or outside of our 3, people are leaning into this category. And they like our innovation, and they like how we work with them.

Thomas Randal Coleman
Executive VP & CFO

Chris, this is Randy. Just to recap on the numbers and expectations for next year. Back to retail inventories, we think they are where they should be. They're consistent with where they were a few years ago. So I wouldn't expect to tell when, like we saw this year, in 2020 but I wouldn't expect it to be a headwind either. So I think back to our normal algorithm of U.S. consumer growth is what we're thinking. Like we've said, potentially, that could be conservative. On Hawthorne, right now, we're thinking high single-digit growth. Matching that with long-term consumer demand, as we've talked to people about it, we think that's the right way to think about it. We don't see any supply disruption issues like we had in California last year on the horizon. And again, you could argue with it being conservative. If you just took our Q3 run rate for our North America hydroponics business and run that across next year, you'd be dealing with a number that's low double digits into the teens. We're not going to guide to that number right now because there's still a lot of planning to do and a lot of time ahead of us, but that gives you at least some understanding of the way we think about it.

Operator

[Operator Instructions] We will now take our next question from Eric Bosshard of Cleveland Research Company.

Eric Bosshard
Cleveland Research Company

In the Hawthorne business, curious for your perspective as you think over the next 3 years in the areas of growth and competition and margin, how is your view of those different in the next 3 years than what you had thought previously? From a growth standpoint, it seems like the business is now growing faster than you thought. The competitive environment sounds like it's more difficult for promotion and [price's sake]. And margin which -- I think once upon a time this business was going to be 15%-plus. Just curious how you would frame our thinking for the next 3 years in those 3 areas for Hawthorne?

James S. Hagedorn
Chairman & CEO

Well, I'm just going to before -- I'll take -- what I enjoy was the competitive environment. I think the competitive environment is actually more benign. We head off after this call to Vermont for our summer Board meeting. My feelings -- this is a Board meeting where it's really just the principles of the business with the Board. We sit in our tent with no PowerPoint. We're just really talking about the strategy and where we're going. I think the discussion with Hawthorne, I'm always hopeful. Because it's less of a PowerPoint visit with the Board, you have to sort of count on people actually to carry the conversation. Is this you, Chris?

Christopher J. Hagedorn
GM & Senior VP

Yes.

James S. Hagedorn
Chairman & CEO

I think, Eric, where we're getting to in this business is just a general agreement on how -- what our place is in this industry and how we add value. And I think it's as good as I've wanted it, but I don't think the competitive environment is stiffer. I think that it's actually becoming more benign. What we are not trying to say is that, and this is just the issue for me, is that Randy's pushing hard for margin accretion in the business fair enough based on the acquisition cases that we did and our own strategies previous -- to sort of last year. We have an obligation, I think, financially to raise margins. The reason that I talked a little earlier about the conversation with Chris was to say, is this the right thing? If corporate puts pressure on getting margins up, is this going to screw up your approach and your competitiveness? And there's still some competition out there less, but there's still competition out there. And I think we ended up in a pretty good place where Chris, I think, is managing and balancing the need for some return of pricing but also that there's a lot of synergies out there. But I don't think the competitive environment is worse. I don't know, Chris?

Christopher J. Hagedorn
GM & Senior VP

I would agree. Hey! This is Chris, Eric. I think when you consider the pretty radical disruption we had in the marketplace last year -- so for me, it's a little hard to look at just sort of apples-to-apples growth considering how down things were. So I say, from our sort of place in the industry, I found it more useful to think about share instead of just pure kind of revenue growth. And for share perspective, we feel pretty good about what we've been able to accomplish, the share we were able to gain relative to other distributors out there in the pure hydroponic space. Our anticipation is that the competition is going to change and evolve. We'll see older players exit the space, which we've already begun to see. We'll see new competition out in the space that haven't traditionally served in this industry, and we'll take them on as well.

In terms of our 3-year outlook, I think we feel extremely bullish. For me, it's a combination of the innovation products that we have launching now and a little bit further out in our pipeline. Just the further integration of our business. We've mentioned SAP a couple of times. That's really going to unlock a lot of efficiency. We've been pushing the integration of Hawthorne departments and functions. Really pushing integration with SMG functions just to get as much professionalism, as much speed and agility as we possibly can out of the business. And that's starting to really work well and we're seeing really good performance both from the legacy Hawthorne teams and their SMG counterparts. And then I think it's us, and Jim mentioned understanding who we are and how we add value to the marketplace. Our services platform, which is focused on going and help people design facilities, help them make sure that all of our equipment is being used as well and as efficiently as it can be, that I think is where we're really starting to see ourselves differentiate. And that's something that again as we look at our competitive landscape, we feel like we're pretty far ahead. So we remain bullish. Obviously things evolve as we go, but we still feel pretty good.

Eric Bosshard
Cleveland Research Company

Just a follow-up within that. The margin path, I'm interested on everyone's answer, especially yours on this, Chris. Does all these support the competitive and growth environment? The path to 15% margin, does that exist or does that limit the growth? If the growth is fine and if it ends up being a lower margin than what was originally expected, like what's reasonable for the destination on margin in this business?

Thomas Randal Coleman
Executive VP & CFO

Eric, this is Randy. We're going to land around 8% margin for this year. Next year, we're expecting double digits. We're not going to get crazy with that, but a lot of the things that we're doing once we get on SAP, a lot of -- more consolidation we're doing, the innovation Chris talked about and just a bit more selective in our promotions. So we're not going to stop. We're going to be aggressive and just maybe a bit more selective. I'm confident we'll get to double digits. The 15% number is a 3-year number, so we get -- call it, 10-plus next year. A little bit more a year after that. The mid-teens the year after that. With more volume, more scale, everything that we have going the right way. I'm not concerned about that outlook right now.

James S. Hagedorn
Chairman & CEO

Yes. So I would agree with Randy. And I would say, some things that I won't get into detail in this call, but we've got some plans in terms of innovation, some new parts of the value chain, just the overall kind of commercial canvas value chain that we intend to participate in. I think it will add a lot of value both for us, our shareholders and for our customers, that we will be able to unveil over the next couple of years.

Operator

We will now take our next question from Jon Andersen from William Blair.

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

Two quick ones for me. Most of my questions have been answered. On new products, the pipeline obviously has been quite strong this year with Performance Organics and GroundClear and Thicker Seed (sic) [Thick'R Lawn] and the Triple Action network. Can you talk a little bit about the strength of the pipeline as you look out the 2020 and beyond? Just wanting to get a sense for the breadth and depth of the innovation because again I think it's been a key contributor, as you said, to the strong consumption growth this year. And then the second question, maybe more for Chris. You touched on this a little bit, but I'm wondering if you can talk a little bit more about how the go-to-market approach is evolving in hydroponics. In other words, how much time the organization is spending with retailers -- hydroponic retailers? How much this services element, that you direct connections with growers and helping design facilities, is playing a role and how that may shift or you see that shifting over time?

Michael C. Lukemire
President & COO

This is Mike. On the innovation, we target over $150 million a year in revenue opportunities and I would say 20 -- and actually 21 is probably closer to $200 million. This year -- next year, it will be about a strong -- we have to continue and support -- I mean one of the big questions is can we support all these innovations and get them out? It's important with advertising and media. That's where we're also trying to beat those up. But the activity on the pipeline is really -- I'm really bullish about it. And include Chris' stuff, it's an even greater number, so we're integrated. We had our first field day where we actually had a lot of the Hawthorne new products, and that's part of the integration -- that pipeline is just going to get continually stronger.

Thomas Randal Coleman
Executive VP & CFO

And, John, the only thing I'd add is one of the things I'm really encouraged about in 2019 is products that we just rolled out last year in '18, the Triple Action products, lawn fertilizers and then Thick'R. They're having such a phenomenal second year, and I think just keeping that momentum going next year with the GroundClear and Performance Organics that were launched in '19, we expect more growth again in 2020. And we'll be adding some new SKUs around Performance Organics. I think we just need to keep that momentum going behind these big launches.

James S. Hagedorn
Chairman & CEO

Whether it's the insecticidal part of the business, the herbicidal part of the business, the lawn fertilizer part of the business, I think really across all those prime categories for us, the Performance Organics both on nutrients and the soil, it really looks terrific. And when Mike talks about field day, that is where the R&D and marketing organization, and we do them here in Florida and in Oregon, bring together our Board of Directors and the leadership team to sort of go over what's happening and they get to show off their stuff. It's really impressive.

Christopher J. Hagedorn
GM & Senior VP

I'll jump in here. This is Chris. On the question on Hawthorne go-to-market. So again, our go-to-market strategy, it has evolved but I don't think in a way that we didn't expect or, frankly, talk about with you guys. I remember talking on last quarter's earnings call about the need for retailers to evolve the way they do business and the position that they play in occupying the space, and we've seen a lot of our more sophisticated retailers do exactly that. So if you look at certain markets -- the vast majority of our revenue still does go through retailers. Not all that go through retail shelves and warehouses. A lot of that is drop-shipped directly from Hawthorne distribution centers to our customers, with payment processed back to our retailer. I see that trend continuing to expand. It's just the most efficient way both for us, our customers and our retailers. But what we're looking at that gets us really excited is some of the more novel approaches we have in terms of going to market, helping consumers and cultivators. And one of the best examples I have of with that, which is pretty exciting I think both for us and our retail partners, is working specifically as a pilot program with a retailer in Michigan who is an extremely aggressive innovative retailer up there who has very close relationships with most of the large commercial operators. And again, just as a reminder, Michigan is our second biggest state. The growth up there that we are seeing is pretty astounding. And we're working with this retailer up there to lower a little bit of the upfront cost to allow cultivators who have not yet had their first harvest to get into our equipment, to build their facility out the way it should be and then start to pay that back on the back end. We're starting to see some pretty novel financing techniques that we can apply to this industry that are really unlocking some new opportunities and again working hand-in-hand with retail on that. So retail remains just an essential part of the go-to-market strategy here. Retail itself is evolving. I think we'll continue to see that.

Operator

We will take our next question from Bill Chappell of SunTrust.

William Bates Chappell
SunTrust Robinson Humphrey, Inc., Research Division

First question, there have been a couple of comments about easy comps this year. And so I was trying to understand what that means because from a weather standpoint, I certainly understand April was an easy comp, but it doesn't appear that May or even first part of June from the other companies that have reported in this space or that were weather related was that great. So just trying to understand, as you maybe look back over the past 3-ish months, was it a favorable comp on a weather basis, on a category basis? Or was it more just the category fundamentals got better? Hi, Bill. This is Randy. It's a big country so when you look across, state by state, there are different stories for different places. The best growth we've had this year is in the Northeast and then, after that, the Midwest. The West has done pretty well. I expect the South was still growing though less than the other regions, largely due to the floods in Texas and so on. So, in those areas, we didn't do as well. Like we've often said, big country, lots of different climates. By the time we get to the end of the year, things often work out, and we end up in a reasonable place and we hit our expectations. Hopefully, I answered your question. There's tons of different stories out there.

James S. Hagedorn
Chairman & CEO

We know [indiscernible] because they were suffering last year. I think it's one of those -- I'm just hoping I used the word properly when I put that part of the script together. This year seemed like challenging to me. We seem to have another year on the consumer side where the business came together mostly because I think the consumer was there, the retailer was there, we were able to activate, perform a delivery and get product in the stores. But you just look at, sort of, Bayer, I think, came out yesterday or the day before with their numbers and just having a hard time getting any kind of seed in the field. We saw that a lot. We were in New York with retailers in sort of third week of June, and we all sort of looked at each other and said, can we do something? This is where we got to this idea of can we activate in store when we know the weather is going to be better, but we all sort of looked at each other and said, this is like the first weekend in a month we've had where the weather in the East Coast has been good. I hope that was actually correct, that the consumer side was dealing with easy comps. This year, it didn't seem that easy compared to the year before. This is an issue where we're seeing, I think, the same kind of results now, I don't know, 5 years in a row. One of the reasons that we are focusing on this, Bill, is that I think weather patterns are changing, and I think it makes it harder to operate on these big national 6-month plus planned out Black Fridays and we've got to figure out how to activate. Part of how we're using this IBM data and these historical sales data is not trying to look at the year 6 months or a year in advance and say, we know what the weather is going to be because every time like this time of the year, I'm looking at the government long-term weather people forecast and they just don't seem to be right. This time of the year, everything will look like equal chance, which is weather talk first thing, it'll be a normal season. It just never has come out that way in the last bunch of years. So what we're trying to do is say, look, those forecast within 2 weeks are pretty good, and let's make sure that for the weather we know we're going to have, we've got the right product on the floor and sales is aware of what needs to happen based on what we think the weather is going to be this coming weekend or next weekend. And so this got us into this discussion of things, how well do these Black Friday events really do as far as hit the weather. And a less than 50% hit rate on weather is pretty phenomenally s*****. We know we have to do that. I think it got built into my script that it was an easy comp. It didn't seem so easy. I think, Chris' business was obvious. I don't know, was it an easy comp, Mike, compared to last year?

Michael C. Lukemire
President & COO

The season started about 4 weeks earlier this year, so we had this huge spike at the beginning and retailers leaned in. And then you always say, does it come back and so the comps got really hard, but, say, can you imagine that?

William Bates Chappell
SunTrust Robinson Humphrey, Inc., Research Division

Got it. So I'll assume -- it was normal this year is probably the best way to look at it. And then just the other question...

James S. Hagedorn
Chairman & CEO

Trying to get it all right. It was like we were minus 2% last year. So I think at the year-end, it probably was a relatively easy comp. I'll call it fairly normal, but fairly normal this time is I put that snafu term, situation normal, all kind of screwed up. But that's what it seems like the weather has been for us, and so we're trying to do better on that.

William Bates Chappell
SunTrust Robinson Humphrey, Inc., Research Division

That helps. And then my other question and maybe this -- you don't want to talk about this, but the Monsanto-Bayer agreement sounds fantastic from your standpoint. I'm trying to understand what Monsanto gets out of this because it seems very one-sided in terms of how it works out. So I'm trying to understanding what maybe you gave up as part of this agreement or why would they want to kind of go down this path?

James S. Hagedorn
Chairman & CEO

Actually, I don't agree with that at all. I think it's actually a pretty fair path forward -- for both companies. I think, clearly, we went into really -- post the Johnson verdict, pretty concerned. We've met several times with the Germans and with the sort of the American counterparts based in St. Louis. I think where I wanted to get to in the beginning was that we think the sale back of the brand extension rights was very fair, and we hope that business with -- those extension rights are kind of what the [Flourish] and Roundup brand goes forward. So I think there, we took a little bit off the table. But I think the rest of the deal clarifies indemnification issues in a way that it's super clear and we are very comfortable with. I think most of which we thought we already had and then gives us optionality if the business declines at certain points in time. But I think that that's probably not worth 100% of what we think the business is worth today. So what we have is I think the defense of kind of optionality that we didn't have, which we hope we don't have to sort of execute against because I think it's actually a pretty good deal for Bayer in that case, if we decide that we want to exercise that optionality. So I think, overall, it's a pretty fair deal. And I think compared to where this relationship, which is virtually 100% managed by us, were we turn into a bad family, I think that it was in everybody's interest to make sure that we are all pulling together and I think that's where we are. I don't know, Randy?

Thomas Randal Coleman
Executive VP & CFO

I'd say, Bill, this has been a long conversation that really started almost a year ago. We had lots and lots of meetings and conversations with the team. This is an agreement that's -- over 20 years, we worked together really well. It's been really helpful to both companies, and neither company wants to see that in. So we have optionality now that we don't intend to exercise, but it's available. We have more security in the agreement, so that's really an important for our shareholders. But our intent is to continue on. The business has done fairly well this year, and we're looking ahead to continuing to be partners with the team. So that's the way we are thinking about.

James S. Hagedorn
Chairman & CEO

I think we've said this before. I'm sure my lawyers would say, just shut up while the going is good. And he is nodding his head. But we've said this before. We wouldn't be selling this product if we didn't believe it wasn't safe. I'm still, to some extent, stunned by what's happening here as a result of that IR report and that Bayer 0 for 3 on their litigation. But remember, this is very early days. This is a really good product, a really great brand. And it's something that -- it shouldn't happen and maybe only in America could this kind of stuff happen where this is the sort of resulting core. But it's a really good product. We feel very comfortable with the efficacy and the safety of the product. I think it's our hope that this is a product line that continues on. I think that where we are is exactly where we should be. I think if -- I know I shouldn't agree with you it's one-sided. I think that this is something that Randy and I feel from -- if we have to look at our shareholders, that we've taken some risks off the table and we feel pretty good about that. And that's our job.

Operator

We will now take our next question from Carla Casella of JPMorgan.

Carla Casella
JP Morgan Chase & Co, Research Division

Most of my questions have been answered, but I'm just wondering if you consider refinancing some of your higher coupon bonds given where they're trading and in the process of lowering interest rates or reducing debt overall.

Thomas Randal Coleman
Executive VP & CFO

Yes. We're thinking about that all the time. We look at our capital structure frequently. We look at different ways to fix some of our variable rate interest as well. At this point, we're 60%, 65% fixed looking ahead to next year. A little bit less a year after. So that's always an active conversation. Nothing imminent right now but something we'll continue to look at.

Operator

We have no further questions at this time.

Jim D. King
Chief Communications Officer and Senior VP of Investor Relations & Corporate Affairs

All right, John. Thank you, and thanks, everybody, for joining this morning. Again, if there are follow-ups that people need help on, call me directly at (937) 578-5622. Otherwise, we will talk to you on our next scheduled conference call at year-end, which will be in early November. Thanks, everybody. Have a great day.

Operator
This concludes today's call. Thank you for your participation. You may now disconnect.