The Scotts Miracle-Gro Company

NYSE:SMG

Company Conference Presentation

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Presentation

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

Okay, good morning, everybody, and thank you for joining us for the 40th Annual Raymond James Institutional Investors Conference. I'm Joe Altobello, Senior Equity Research Analyst here at Raymond James, covering the household, personal care and leisure space. And we're very pleased to kick off the conference with our first presentation of the day, ScottsMiracle-Gro.

Scotts is an unquestioned leader in the U.S. consumer lawn and garden space, with brands that include not only Scotts and Miracle-Gro, but also Ortho and Roundup on the controls side. In recent years, the company has expanded to hydroponics in order to capitalize on the growing legalization of cannabis. To be clear, Scotts does not sell cannabis, but it does sell everything necessary to grow it from soils to nutrients, to lighting, to HVAC equipment and everything in between.

Here to tell us about is the company's CFO, Randy Coleman. Also in attendance is the Head of Investor Relations, Corporate Affairs and Communications, Jim King.

And with that, I'll hand it off to Randy.

Thomas Randal Coleman
Executive VP & CFO

Thank you, Joe. Good morning, everyone, and thanks for joining us bright and early on Monday morning. It's nice to be in Florida, even if it's just for a morning. When Jim King and I left Ohio yesterday, it was snowing, so we're really looking forward to spring this year.

Let me start with just a broad overview for why we believe Scotts is a compelling investment idea for investors, both current investors and perhaps new investors as well.

As you probably know, Scotts is a clear leader in the North American consumer products lawn and garden industry. We've been that way for going back to 1868 when the company was formed by O.M. Scott coming back from the Civil War. You'd have to fast forward to 1951 when Horace Hagedorn and a partner created Miracle-Gro on Long Island. Fast forward a bit more to the mid-90s when Scotts and Miracle-Gro formed a partnership. And then in the late 90s, when we added Ortho and Roundup to our portfolio as well.

If you think about the brands that we sell across our portfolio, they're largely synonymous with the products that we sell. For example, people shop at their favorite hardware store, their favorite home center, their favorite mass store, perhaps they're looking for Scotts. Instead of fertilizers, they're looking for Miracle-Gro, they're not looking for plant food. So very similar to Coca-Cola, very similar to Kleenex in that the brands are synonymous to the products that we sell.

In addition, I think there is sometimes a misperception that we're not as predictable and consistent as we actually are. There's a belief that we're very sensitive to weather. And while that's true from day-to-day, week-to-week and even month-to-month, when you get into the early spring, when you look at our sales over a 12-month period, year after year after year, there's a lot of predictably given all the climates and then the broad continent of North America, and we estimate plus or minus 2% on a given year. So I think a lot more predictable than people believe. And consumer engagement comes back every year. Especially people in the Midwest, Northeast right now that are just -- can't hardly wait to get outside.

The other aspect of our business that's new and emerging is Hawthorne. So it now represents about 20% of our top line and very fast-growing business, and they're growing in 20% levels. If you go back 2, 3, 4 years ago, last year, we did have some supply-and-demand imbalances largely tied to regulatory challenges in California. But having said that, in the long term, when you look at consumer demand, we believe that's increasing in the mid- to high single digits on a year-to-year basis.

And then cash flow. So this is a metric that, believe it or not, we largely ignored and become a result many years instead of what we focused on, which was top line and bottom line. And we've recently changed our incentive plans, both long term and short term, to focus on free cash flow generation. And as a result of that, we've seen tremendous progress in the last couple of years and really optimistic about the free cash flow that we'll generate this year as well.

And then the management team, Jim Hagedorn, the CEO, has been in the lawn and garden industry his entire career after leaving the military. But the rest of the executive team around Jim has average tenure of about 20 years, so lots of experience and knows how to navigate a seasonal business and make sure they're delivering year-after-year on our commitments.

This slide is intended to outline our long-term investment algorithm, not necessarily what we're planning for guidance for 2019, but the way we thought about our business in the past and the way we're thinking about it going forward beyond 2019. So 2% to 4% top line. When you think about how that breaks down, usually 1% to 2% to 3% in our U.S. and North America business. We also have a nice Canadian business in addition to the U.S., and the brands within the categories are very similar. And then we expect to get at least 1 point of growth a year for the total company by incremental growth off our Hawthorne business.

Operating income, we expect to get leveraged from improved gross margins. We have history of doing that as well as demonstrated very tight control of SG&A. On top of that, we've had shareholder repurchases of several hundred million dollars in recent years. We're on a temporary hiatus for that here in 2019 given our relatively high leverage level. But share buybacks is definitely part of our long-term plan. And then we have an annual dividend at the yield of 2% to 3%. And that, on top of our operating income, share repurchases, we believe we can deliver predictable and consistent double-digit total shareholder return on a long-term basis.

So Project Catalyst is our new project that continue to outline how we're going to optimize our strategic advantages on our core North American business, but also catalyze Hawthorne and integrate it into the mothership more or less.

So again, if you go back to the 1990s when we integrated Scotts and Miracle-Gro, and shortly thereafter Ortho and Roundup, we had the best brands in the industry. Along with that, we had R&D support and the best innovation. We had the top and largest field sales organization in the industry. And even on top of that, the largest and the best supply chain. All that was enabled by the introduction of SAP about the turn of the century. And since then, we developed what we called one face to the customer, much more easy to get business with and we've seen almost a 20-year run of success since that point.

When we think about the Hawthorne business, our thought process is very similar. We had the best brands in the industry with General Hydroponics, Botanicare, Gavita, Sunlight systems. We also represent many other brands through our distribution partnerships through the Sunlight business.

We have the best brands. We have best R&D. We have the largest and best field sales force, and we clearly have the best supply chain in the hydroponics supply industry. So we expect around a similar play and have similar success as we look forward.

Just thinking about 2019, I'm glad to say that through February, our Hawthorne business on a year-to-date basis is now comping last year. So sales are about flat to a year ago. Double-digit growth in January and February. And as we look forward to the rest of the year, we expect to see more growth. Our expectation for the full year is mid-single-digit sales growth. And we believe we're clearly on track to reach that guidance.

As far as our Consumer business, this is a big year for innovation. So I'll be talking a little bit more about 2 or 3 of our largest introductions, but really proud of the success we've had in the partnership between our R&D people and our marketing folks to bring new and exciting innovations to the market.

And then, as I mentioned earlier, cash flow is our #1 performance metric. It is about 40% of our short-term incentive plan for 2019. It was 25% in the past and it was 0 if you just go back a couple of years ago. And for the long-term plan, free cash flow represents 2/3 of our metrics, so clearly a driver for focus and as you know, what gets measured gets done.

A little bit more color on Hawthorne here in 2019. So through February, our year-to-date sales are flat. Historically, California has been 52%, 53% of the total pie across our U.S. business. Through February, California was about 47% to 48%. So California is still down a little bit year-over-year, while business is flat. And I could tell you that we're seeing terrific growth out of some of the new and emerging states. Whether you're talking about Florida, Ohio, Massachusetts, Michigan, we're seeing far north of double-digit performance in those states, which is contributing to our year-to-date results.

In addition to the top line, we've outlined a synergy plan of $35 million, the first $20 million of that is tied to people redundancy. And glad to say that we've identified and we've realized a lot of those savings already that have to be realized in our P&L through our annual 2019. The balance of the $35 million is largely tied to supply chain savings, whether it's redundant DCs, redundant manufacturing. We're in the process now of closing down certain locations and have a lot of confidence about that $35 million number.

So $60 million is our full year operating target, operating margin target, okay, and that's more or less about a 10% operating rate. We think we should do a lot better than that. 2019, I don't expect to see that. But going forward, as we scale up and we see more growth in the out years, we do expect to see much higher operating margins.

When you think beyond the markets or the states where we're already seeing medical marijuana legalization, we've also seen a lot of states that are flipping over to adult use legalization. So looking forward, New Jersey, New York, Illinois, we expect those to be big growth states going forward.

In addition, I mentioned this earlier, but consumer consumption, we estimate 6%, 7%, 8% a year. We did see supply and demand challenges in 2018. But we think on a long-term basis, we should be approaching double digits. Sometimes, those sales will be lumpy as you see different states turn over in different periods of time. But as a long-term, sustainable number, we think approaching double digits is a very reasonable place to be.

And from a competitive standpoint, for the people who are not familiar with the supply industry for hydroponics, there were 3 major distributors historically, largest being Sunlight Supply that we acquired and we closed on last June. A couple of other smaller distributors, the smallest of which has recently liquidated its inventory. So at this point, we have a lot of confidence that we are taking market share, and we'll continue to do that not only in '19 but going on.

So given all that, what are we doing about it? So this slide says Our Goals, so I'd say we're -- these really are plans that we're actively working against right now, bringing products to all these categories. And I think sometimes there's a misperception that the end consumer is more of a hobbyist. And while there are a lot of people out there, we estimate that 5% to 10% of the total market, really most of the market the people who are buying hydroponic supplies, are really growers, whether they're small growers, perhaps larger growers with tens of thousands of square feet, whether they're in California or the West Coast or increasingly the Midwest and the East Coast, but all trying to have good crop yields and produce better products than their competitors. So we're helping them do that. Our technical expertise is a core competency. When you think about, again Scotts has been in business for 150 years, we have a lot of R&D expertise going back to professional business, where we used to provide supplies for strawberries, different specialty crops, grass seed, shrubs, trees, we know how to develop and provide the right kind of products for what consumers and what growers need.

In addition to that, we've been able to marry up our expertise in sales, category management, marketing, R&D, IT, like I mentioned earlier, with the SAP platform, with the historic expertise and the credibility of the people that have worked for the companies that we've acquired. So really nice partnership of bringing in people from both sides of the business, and we think the result would be something even better than what we've seen in the past.

So let me flip a bit to our U.S. Consumer, North America consumer business and talk about that. So our largest customers: Home Depot, Lowes, Walmart, January 31 year-ends, so as they start their Q1 every year February, March and April, they want to make sure they get off to a good start. And lawn and garden is a very important category to help them do that. Year-after-year, we're seeing a lot of emphasis on our category. In addition, when you think about it from a consumer point of view, a lot of pent-up demand, people having cabin fever, they're ready to go on spring breaks and we can get outside. So again, very predictable, can't tell you exactly what day, what week, depending on where you live, but year-after-year, people are waiting to get outside, and that demand is there.

And then finally, when you think about where younger consumers and millennials like to spend their time in a category, it's increasingly in growing their own food and vegetables. And our partnership with Bonnie Plants has helped us bring together Miracle-Gro and Bonnie Plants build displays in the stores and talk to consumers, whether they're older consumers or younger consumers who want to grow their own. So very happy about our partnership with Bonnie Plants.

And then finally, our lawns category tend to be a bit more mature. And given that we're thinking about ways to make the so-called work a bit easier for certain consumers who don't want to spend a lot of time working on fertilizing their yards, so we've developed more combination products that will help them spend less time and get even better results.

So again talking about our retailers. In our last earnings call, we mentioned that we expect sales for the first half of the year to -- could approach up to $100 million better than a year ago. That's really tied to load-in plans and activity that we've seen across, really, our big 3 retailers getting ready for the spring a bit more aggressively than we saw a year ago. So we expect about $100 million improvement year-after-year, again, tied to the load-in.

Second bullet on the slide, thinking about POS for like-for-like products. So this requires a little bit of explanation. But coming out of line reviews last year, there were certain products that were delisted that, frankly, were not productive for our retailers and really were not productive for us as well. So that put a little bit of drag on our unit volume growth this year. But when you think about our Like-to-like drive SKUs, the products that consumers really seek out and ones that are always listed by our major retailers, we expect to see a 4% to 5% improvement on those SKUs, given pricing is about 3% on average and we expect better performance results on those SKUs this year.

And then thinking about the seasonality and how the year will unfold, when you think about our second quarter that ends in March, it's always a little bit difficult to predict shipments at that point in time just because POS sometimes starts earlier than others, retailers going to be loading earlier versus later. What we know is, from last year, April was about the worst April we've seen as far back as we could find going on record. May was outstanding. Early June was excellent as well. So what we expect this year is a bit of the reverse. We expect to have a really strong April. We expect when we get to our earnings call late April, early May that things will look really good and it'll be a matter of trying to hold on to where we are. So we're a little bit different from last year when early May, we were down double digits and we had to really make quite a recovery, which we did. But a little bit of understanding is required there for how this year should unfold.

So again, innovation, I mentioned earlier. Ortho GroundClear is being shipped right now. It's a new product we're very excited about, it provides alternative to people who purchase products in the nonselective weedkiller category. We expect this to grow the category for people who're looking for alternatives. And you can look for that now in your stores.

The second SKU I want to mention is Scotts Triple Action Turf Builder. So we have different SKUs for the North and the South, both combination products that are combined weedkillers, fertilizers and then depending on your geography, a third feature that, again, makes it more efficient for consumers who can spend now less time on their lawns.

And then finally, the one that we're most excited about for this year is Miracle-Gro Performance Organics. And personally, I expect this product to probably compete with EZ Seed, which if you go back several years, was our largest first-year innovation, at least in my history; I've been here about 20 years. Miracle-Gro Performance Organics doesn't require consumers to compromise at all their expectations for performance. So it's a natural product. It's composted. It brings in the best-quality ingredients that we could find on a more organic basis. And again, the results are comparable.

So I'm going to show you a little bit the creative that we've developed both for TV and for social media that will be coming out this spring. We're going to have an aggressive media marketing campaign behind his new product, and we really expect it to do well. So here goes, I hope you enjoy this as much as I do.

[Presentation]

Thomas Randal Coleman
Executive VP & CFO

So you can see why we like the Miracle-Gro Performance Organics rollout so much. You'll be hearing more and more about this as we provide updates and communicate with you going forward. But again, really high expectations for that new product.

So I'm going to switch a little bit now to more closed-in, short-term financial guidance. So for 2019, our guidance is unchanged from what we delivered 2 months ago. Start with net sales that we expect to be up 10% to 11%, and I'll break that down for you. First, 8% is the year-over-year impact of the Sunlight Supply acquisition that was closed in June of '18. So that should be the first 8 points of growth. We expect again our Hawthorne hydroponics business to grow mid-single digits, which should add about 1 point for the total company. And then about 1% to 2% for our U.S./North America Consumer business. Again, we took 3% pricing, so a little bit of a decline that I mentioned earlier from certain SKUs that were just not productive either for us or for certain retailers.

So 10% to 11% going all the way down to the EPS number on the bottom. We expect to go from about $3.71 to, call it, $4.10 to $4.30 for 2019, about a $0.50 improvement year-over-year. When you boil it all down to that bridge, it's effectively the addition of Sunlight Supply. When you think about the other big puts and takes in our P&L., we did take 3% pricing. However, we have some drags against that. So our agency agreement on the Roundup business, we're going to lose about $20 million through contractual arrangements with our partner. We've recorded an extra $20 million in 2016, '17 and '18. And we knew that in 2019, that was going to roll off. So that's the first headwind.

The second, I would say commodities and tariffs. Tariffs are not an enormous issue for us. It's a little bit more for the Hawthorne business than our core, like commodities being up, distribution challenges and '18 rolling into '19 as well. So that's a bit of a headwind.

Labor costs, affecting a lot of companies, it's a little bit of a headwind as well. And then our incentive plans for last year, the short-term incentive plan, we delivered only about a 50% payout to our associates given the lackluster results that we delivered. So we're now playing for a more normalized target in '19, and that's a headwind as well. So 3% pricing effectively offset by those matters I outlined, with the net benefit of Sunlight Supply being added year-after-year. So confident about $4.20 as our guidance for 2019, and we'll have more to talk about when we have our next earnings call.

And then finally, I want to talk with even more emphasis about cash flow. So again, #1 metric for incentive plans, short term and long term, and what gets measured gets done. You could see from the bar chart that while we've had strong cash flow over time, we're a strong cash flow generator, that the performance has been inconsistent in certain years. 2017 was the first year that we implemented the new Long-Term Incentive Plan. You can see the terrific performance of that year. Last year, again, disappointing from a P&L and EPS perspective. Nevertheless, we're able to deliver on cash flow almost as good as 2017. And our expectations for 2019 are very similar to a year ago. I think the blue bar chart requires a little bit of explanation. So we did have an accrual in 2018 for some onetime legal settlements that we expect those to be paid out in '19. So that will affect our free cash flow, so we're adding it back for purposes of illustration here, just to provide a more apples-to-apples point of view. We have a lot of emphasis on working capital management. So I give a lot of credit to our supply chain team who has really taken charge and champion our cash flow efforts, so big credit to that team.

And right now, when we last talked publicly, our debt leverage was north of 4x. We're planning to get that ratio down to about 3.5 by the end of 2020, really, through operating cash flows. But there's also the possibility that we might be able to drive that down a little bit faster. If you're not aware, we own 30% of TruGreen business in partnership with Clayton, Dubilier & Rice. And we are discussing with CDR the potential opportunity that we divest that stake. If we were to do that, our strong bias will be to delever a little bit faster. So nothing's finalized at this point, but heads up that something could happen there in 2019 or beyond. And if so, again, our strong bias is to delever quickly back to that 3.5x place, upon which we will start repurchasing shares as well as continuing our annual dividend that's about $110 million, $120 million a year.

So bringing all together. Again, Hawthorne we're seeing recovery in 2019. So some improvement month to month to month. First quarter, we're seeing January and February positive and strong expectation for the rest of this year. And the long-term expectations are really optimistic.

The U.S. Consumer segment, again, steady performance. It's not high yesterday, but big country. We're feeling confident that new innovations are going to drive our business this year. And we're really excited by the amount of engagement across all of our retailers.

Cash flow productivity, we're now aligned with shareholders better than ever, and we're delivering against where our expectations are.

And then finally again, we will be delevering, we'll be getting back to that 3.5 level in 2020. Once we do that, our strong bias is to begin returning cash to shareholders. And historically, several hundred million dollars of share repurchases but also, we have done special onetime dividends in the past. But regardless of the form, we do expect to return cash to shareholders once we get our leverage back in check to where we expect it to be.
So with that, we're really excited about 2019. We're even more excited about where we're going beyond that. And thanks for your time. Thanks for listening this morning. I'll see a lot of you in one-on-ones over the rest of the day, and I think we probably have time for a couple of questions.

Question and Answer

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

Yes. Just a couple of questions. Actually, if I could ask the first one. You mentioned potentially selling your stake in TruGreen. Would that be back to Clayton, Dubilier & Rice or to somebody else? And how much do you think that's worth?

Thomas Randal Coleman
Executive VP & CFO

If we were to divest our stake, we'd probably do it through the TruGreen enterprise. So CDR would, at that point, own 100% more likely than not. And the expectations are that we recover north of $100 million of after-tax cash proceeds. But for a little bit of perspective, to date, we've collected almost $300 million tax deferred without having to pay any tax from the deal that we created just -- it'll be about 3 years ago in April. So there is some tax slippage that's going to fall through, but well north of $100 million would be our net proceeds after tax if we were to consummate a deal.

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

Anybody else?

Unknown Analyst

So [when talking about] delevering, is it fair to say that the Hawthorne M&A is over for a couple of years or are you happy with the portfolio as it stands now?

Thomas Randal Coleman
Executive VP & CFO

Yes, so the question for people who could not hear is, are we done with M&A activity around Hawthorne for the time being given our relatively high leverage? And the answer is yes. So we always have an active pipeline of different ideas that run through our strategy group. But at this point, we're really happy with the portfolio. When you think about what the Sunlight Supply acquisition brought us, we already have the premium brands in the category. So Sunlight Supply let us fill that out. So A to Z, we have every product covered. We really had -- from a good, better, best strategy, we had purchased the best brands and now, we're able to fill in the good and the better. So we have good, better, best, almost anything that a grower-consumer would want to buy. So M&A pipeline is tight. We feel really good about our supply chain. We already have the best brands. And right now, we're much more focused on integration, optimization and making sure that we're getting our business humming the way it should be.

Unknown Analyst

[indiscernible], if you're interested.

James S. Hagedorn
Chairman & CEO
All right. Thank you for your time.