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SMG - Q2 2016 Scotts Miracle-Gro Co Earnings Call

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OVERVIEW:

Co. reported 2Q16 sales of $1.25b and GAAP income attributable to controlling interest from containing operations was $226m or $3.64 per share.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Scotts Miracle-Gro 2016 second-quarter earnings conference. Today's conference is being recorded, and at this time, I'd like to turn things over to Mr. Jim King. Please go ahead.

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

Thanks, Greg. Good morning. And thanks, everybody, for joining us this morning at the Scotts Miracle-Gro second-quarter conference call. With me this morning are Jim Hagedorn, our Chairman and CEO; Randy Coleman, our CFO; and Mike Lukemire, President and Chief Operator.

We're going to start in a few minutes with prepared comments from Jim who will update you on our strategic plan as well as provide an overview of the on consumer activity we've seen in our US business so far this season. Randy will then go through the numbers, including a review of our new reporting segments.

We've got a lot of things to cover this morning, so when we get to the Q&A, I would like to ask everyone to ask one question and one follow-up. I have already set up follow-up calls with many of you for later in the day and I have set most of my day aside tomorrow to do the same.

Before we get started, I want to remind everyone that our remarks today will include forward-looking statements, and as such, actual results may differ materially from what we say. We encourage investors to familiarize themselves with the risk factors that could impact our business, a complete description of which can be found in our form 10-K which is filed with the SEC.

Today's call is being recorded. A replay will be available later in the day, as will a transcript, and the call will be archived on our Investor Relations website as well. So let's get started this morning, and to do that, I will turn things over to Jim Hagedorn.

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

Thanks, Jim. Good morning, everyone.

As we were preparing for this call, Jim and I were laughing that the first few lines of the initial draft of my script sounded just like they did last quarter and the one before that and the one before that. However, if you are the CEO of a public company and you begin every quarterly conference by talking about how pleased you are with the business, I guess that that's a good thing.

So let me tell you, I'm pleased with where we are right now. Q2 was a record quarter for us, even when you strip away all the tail winds related to the shifts in our fiscal calendar. We have a high degree of confidence in our full-year guidance for sales, for gross margin rate, and for adjusted EPS.

Consumer purchases were outstanding through the first half and have been solid all season when weather didn't cause a disruption. The fact that we are up 1% entering May is in line with our guidance and keeps us on-plan for the full year. Remember, April was a month of extremely difficult comps and the weather wasn't that great either. May and June should be easier.

Even though the comps get easier, we know that some of the most critical weeks of the year are staring us in the face, so we can't let up when it comes to focus and execution. More importantly, we need to continue balancing our execution for 2016, while simultaneously implementing our long-term strategic plan, which we are calling Project Focus. So let me start there, and then I will go into some more details about what we're seeing so far this season.

As a reminder, Project Focus is all about putting our emphasis on our US consumer business, specifically in areas like organics, live goods, hydroponic gardening, the support of water-positive landscapes and bringing Internet-enabled technology to the garden. Each of these areas provides us with an opportunity to achieve incremental long-term growth.

Moreover, shifting our focus to the US consumer business will allow us to improve our operating margins to roughly 18% over time and allow us to generate significant operating cash flow, which we'll use to reinvest in our business, most likely by repurchasing shares. We've made great progress in each pillar of Project Focus over the past 90 days, so let me fill you in.

The first steps we've taken relate to our reconfiguring of our portfolio. To that end, in mid-April, we closed on the joint venture of Scotts Lawn Service and TruGreen, giving us roughly 1/3 of the combined business. We continue to be big believers in the service industry and that's what drove this deal.

Our choice of being a perpetual number two or being a 30% owner of the market leader was an easy one for us. Contributing our business to the JV not only is a path to future growth, but also the best way to drive our shareholder value.

Both SLS and TruGreen had a solid start to the year and integration got off to a strong start. We remain confident the business will achieve the $50 million in cost synergies we outlined when the deal was announced. Both Scotts and Clayton Dubilier believe there is opportunity to accelerate the growth of this business. Remember, the economics of the deal itself were based solely on the cost synergies.

We see the growth potential as real and all of it would be upside to the business case. We also told you we've been pursuing a transaction in our European business.

Discussions with the partner we had been in talks with were terminated a few weeks ago. Here's what happened.

As our talks progressed, it became clear our business was outperforming others in the industry to a greater extent than we had realized. So to do a deal we had envisioned, there was going to be a value gap that would have forced us to chase a deal that we didn't think was worth chasing. Our potential partner had another opportunity that we never would have replicated, so both of us have moved on.

That said, our business in Europe continues to perform well again this year. In saying that, I want to emphasize that our bias toward Europe has not changed. Our first choice remains to find a potential partner that would allow us to expand both the reach and profitability of our existing business. From there, our bias is to exit.

But we've been in Europe for 18 years and we're not going to get impatient. We're going to pursue a path that makes the most economic sense for our shareholders. As it relates to our focus on the US business, we're making great progress. We expect to announce in the next few weeks a further expansion of our hydroponic gardening business, which is a foundational pillar of the Hawthorne Gardening Company.

We've made great progress in pursuing opportunities to expand Hawthorne's product offering and to become a house of brands for hydroponic retailers and gardeners. We told you in December we expected to invest another $200 million to $300 million against these goals and that guidance still holds.

In live goods, we are also making great progress. We completed the transaction with Bonnie Plants during Q2 and now have a 25% stake in that business. If you visit major retailers this spring, you will see a noticeable improvement in the cross merchandising of Bonnie and Miracle-Gro products. These improvements are being made without a great deal of planning, since the deal was not done until after the start of the season. But our soils business is off to a great start this year and we think the Bonnie deal is contributing to that success.

In natural and organics, our progress has been even better. At our three largest retailers, consumer purchases of natural organic products are up 36% so far this year. What's more encouraging is what we're seeing in R&D.

We continue to make great progress against a multi-year effort to develop truly innovative technology focused on bringing effective control release organic fertilizers to the consumer market for the first time. While it will take time, our ultimate goal is to transition the majority of the Miracle-Gro business to organic without compromising on performance.

In the world of water, there are several things to report. First, we're days away from announcing a series of strategic partnerships with a network of environmental groups around the United States that are committed to both water quality and conservation. We will support the work of those organizations over the next several years and use their input to help shape our own thinking.

Over the last several months, we've also been working with universities, landscape architects and environmental consultants to help us better understand the landscape of the future. That knowledge is being put to use to explore partnership or investment opportunities in precision irrigation and in growers of drought-tolerant plant varieties that can redefine the yard. We've also begun examining opportunities to re-engineer our existing products or develop new ones with water consumption and quality issues in mind.

And finally, our efforts to bring internet technology to the garden got off to a great start last month. We launched our concept of the connected yard during the South by Southwest Conference in Austin by unveiling our new Gro app.

Interest by technology writers across the country far exceeded our expectations and reinforced our belief that we are on the right path here. The Gro app aggregates data relevant to what is happening in your own backyard, helping homeowners better understand when to water, when to feed, and how to care for their lawn and garden. The app also provides product information to users, giving us direct opportunity to market to them.

While TV remains a critical medium for us, we know that digital marketing will be more and more important going forward. The Gro app is just one of the steps we are taking to support the connected yard and I'm confident we will be the leader in this space.

Speaking of being leaders, I want to spend a few moments explaining our announcement last month to exit a classification of pesticide called neonics. While the science is still being debated, many believe that neonics are one of several things potentially contributing to colony collapse amongst honey bees. In fact, several states are currently considering a ban on neonics for consumer use. I want to be clear. I'm not an authority on the science and our decision wasn't about science.

I'm the CEO of a consumer products company that happens to sell pesticides and this is what I do know: when consumers buy our products, they are physically interacting with the environment. They care about the environment and they expect us to care as well. We can't simply play lip service to the issue. They need to know that we have their back.

While others in the industry continue to defend neonics, for us, it just wasn't worth the fight. Consumers preferred a different solution. The financial impact is immaterial to our P&L and our replacement products will fill the gap. But this was not a decision about making money. It was a decision about corporate responsibility and acting like a leader.

While our decision has been applauded by environmental groups, some in the industry are less than happy and have let us know. I'll just say this: if we had the choice to make again, we would do the same thing. My only regret is we didn't do it sooner.

I want to transition to talk about the results from the quarter. I'm not going to spend time on the P&L. It's a good story, but I'm going to leave that to Randy. I want to focus on what we're seeing with consumers and retailers.

Before I do that, I want to provide some context about consumer activity. You've heard me say many times that lawn and garden is not for the faint of heart. So before anyone gets alarmed about 1% POS going into May, I have one word for you: relax.

The last month has looked like a roller coaster around here. We've got a tough comp this week and easy ones after that. But when all is said and done, we remain confident we will finish right where we predicted, somewhere in the low-single digits. As always, May will be critical and so will June. We are now entering the peak weeks of gardening.

In fact, this weekend, which is Mother's Day, is historically the biggest weekend of the year for lawn and garden retailers. So we feel we are in a good place right now, especially considering the slow start we've had in Texas, our second-largest state for total POS and most important market for fertilizer sales.

While El Nino provided some drought relief to California, it's had a terrible impact on Texas, which for the second straight year, is seeing record flooding. The good news for us is the heavy rainfall nearly brought our Texas business to a standstill last May, so our comps are pretty easy over the next month. We also believe we will have some pent-up demand that should break loose when the rain subsides.

On a category basis, we are especially pleased with what we are seeing in our gardening business. Consumer purchases of soil are up 5% and we still haven't hit the peak weeks of the gardening season. I've told you already that organic and natural products are leading the way as we've seen tremendous interest in brands like Nature's Care, Eco-Scraps, and Whitney Farms. Both of the last two are craft brands being managed by the Hawthorne group.

In fact, POS for the entire Hawthorne line is up 270% from last year, off an admittedly low base. That notwithstanding, we are pleased by our craft portfolio and also with the progress we're seeing with general hydroponics. We don't get POS data for the GH brand, but our shipments on a year-to-date basis are up nearly 20% against the strong comp a year ago.

Our Scotts cleaner line, which we introduced last year, is up more than 65% so far this year as we continue to get strong in-store support from our retail partners. The success we've seen with Tomcat continues, with POS up roughly 40% on a year-to-date basis. Roundup is up more than 6% already and is coming off a solid year in 2015.

In Ortho, we are down slightly from last year with both weed and insect products, off in the low-single digits. Again, the timing could be misleading. Ortho was up on a year-to-date basis just a week ago.

Mulch is down about 5%, but this too is weather-related. Shipments are up 15% and we still have a significant portion of the season still ahead of us. Retailer support has been strong again and we've done a much better job this year of managing inventory and distribution challenges that come with this category. This has helped us avoid some of the margin challenges we've seen in mulch over the past two seasons, so hats off to our supply chain team.

We've had a solid bounce back with our grass seed business, which is up 12% so far this year. The category picked up a lot of momentum last fall, which has continued with the break of the new seasons.

One area of decline worth noting is lawn fertilizers, which are off 8% so far. Headwinds from Texas have been tough to overcome. But we have an easy comp in May for Texas and the month is an important one for fertilizer in the midwest and northeast, so we expect to narrow the gap for the year.

So we are seeing some categories as stronger than others, but that's always the case. However, the overall level of growth across the portfolio is consistent with what we had projected. And as always, we have solid contingency plans in place that are designed to absorb any unexpected weakness. When we look at our full-year guidance, all of us have a high degree of confidence.

More importantly, all of us remain confident in our ability to deliver the year while also delivering on the future. Executing our plans will drive shareholder value. I'm convinced of it. And allow us to position our business for the next generation of growth.

I look forward to your questions in a few minutes. Right now, let me turn things over to Randy to discuss the numbers.

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

Thank you, Jim, and good morning, everyone. I will start by building upon Jim's remarks.

The year is off to a very strong start, our margins are in great shape, and I share his confidence in the guidance that we provided for the full year. In addition, the integration of the SLS joint venture has gotten off to a great start, the early results from the Bonnie partnership are encouraging, and the deals making their way to through our M&A pipeline will give us new avenues of high growth.

As it relates to our full-year guidance, my biggest concerns are things that we can't control. All of you saw the negative impact that weather had on our business last May and early June. In theory, that should make for some pretty easy comps going forward, but then again, we can't do much to control the weather. But we remain focused on the things we can control and with keeping our consumers engaged.

Given our positive start, and contingency plans we put in place every year, I'm confident we'll be fine. With that, let me jump in the quarter, admittedly a very confusing one.

With a shift in our fiscal calendar, two new minority ownership positions, new reporting segments and further changes anticipated in the second half, our financial statements are going to be pretty confusing for a while. Given that complexity, my bias is going to be to over communicate to make sure you understand how I'm looking at the underlying performance of the business.

Accordingly, I'm going to cover the numbers like this. First, I'll walk you through the P&L on an adjusted basis, just like we do every quarter. This excludes the impact of restructuring, impairment and other one-timers. Next, I'll jump to an adjusted numbers on a pro forma basis.

This format is a new non-GAAP reporting convention for us. Our intention is to use it for the next year until we anniversary the TruGreen joint venture. It is intended to represent both historic and current results, bridging our former 100% ownership of Scotts Lawn Service and our new 30% ownership of TruGreen.

While there is no reference to TruGreen in this quarter's P&L, beginning next quarter, you will see it in the line titled equity in net earnings of unconsolidated affiliates. The pro forma numbers are important, given the timing of the SLS transaction. On a purely adjusted basis, we essentially get a double benefit on the P&L in 2016.

First, the accounting rules require us to exclude the losses from the first half, since SLS is now in discontinued operations. However, we will then include the benefits from our 30% ownership in the TruGreen business during the second half when the business makes money.

Since we did own SLS in the first half, however, and it reported a loss during that period, just like it does every year, I believe the pro forma format will give you a more complete understanding of the business over time. This is also the approach we used at our December analyst day when we told you that we expected the SLS transaction to result in $0.10 of EPS dilution in 2016, but would be offset by share repurchase activity at a higher than expected gross margin rate.

Finally, I'm going to cover the GAAP numbers, which are significantly higher than the adjusted and pro forma results. I'll explain the reasoning when we get there.

Why three sets of numbers? Each serves its own purpose. The GAAP numbers obviously are required. The adjusted numbers are used on a leverage calculation with our lenders and will once again become the primary focus for all stakeholders by this time next year. And the adjusted pro forma numbers, they remove all the noise and therefore, we believe, provide investors with the best year-over-year assessment of the business.

In the interest of brevity and clarity, I'm going to stick with primarily discussing results from the quarter. I'll touch on year-to-date result only in the context of our outlook for the full year.

Before I get started, one more thing. SLS sales are excluded from everything we're discussing today, except pro forma EPS. In our new reporting segments, our US consumer and European consumer, which are pretty self-explanatory, as well as other, which is comprised of Hawthorne Gardening Company, Canada and Asia Pac. Depending on the pace of acquisitions for Hawthorne, it could become its own reporting segment by the end of Q3.

Okay. Let's start with sales on the quarter, which aren't necessarily black and white either. Sales were $1.25 billion, up 16% from last year. Recall that our reporting convention is based on a 4-4-5 calendar. In other words, the first and second months of each quarter have four weeks and the third month has five weeks. This convention results in a six-day shift in our calendar every six years.

So in years like 2016, there are six more days in Q1 and six fewer days in Q4. Q2 and Q3 both start and end six days later than a year ago. Given the seasonal nature of our business, that shift is definitely material to our results in both Q2 and Q3.

Of the $173 million improvement in company-wide Q2 sales, approximately $103 million is attributable to this shift. Last quarter, I told you we expected that number to range from $75 millions to $100 million. As Jim already said, we had a great start to the season in March, which increased shipments roughly $30 million or so in the quarter. When you take out all the noise from the calendar, sales growth in the quarter would have been roughly 7%.

From a segment perspective, sales in US consumer were up 16% in the quarter, European consumer declined 3% and other improved by 50%. The strength in the US, aside from the calendar shift, was obviously due to the strong POS numbers through March. In Europe, currency and the closing of a business there led to the decline. And in other, the results were driven mostly by acquisitions, and as Jim said, strong organic sales growth from general hydroponics.

So on an apples-to-apples basis, sales in the quarter were on the high end of our internal goals, driven by the strong consumer engagement through the first six months. We gave some of that benefit back in April, which I expected, and we continue to believe sales growth in the low-single digits is an appropriate estimate for the full year. For your modeling purposes, based on what I know today, I would anticipate the calendar shift could go up $100 million in the opposite direction in Q3. Obviously, on a full-year basis, this shift has no impact at all.

Let's move on to gross margin. The rate improved 220 basis points in the quarter to 41.9%. There are a lot of good stories here.

The benefit from our new Roundup agreement added 90 basis points. Improved material and distribution costs, as well as fixed cost leverage, all had a relatively equal role in the improvement.

Recall that our new agreement with Monsanto added $20 million to our result in 2016 and also 2017 and 2018. That number is not spread out over the year. Given the structure of the Roundup profit sharing, the entire benefit occurs the moment we begin to make money on the business, which is typically in Q2. On a year-to-date basis, the gross margin rate is up 300 basis points, essentially twice the rate of improvement as we indicated in our full-year guidance.

I've said some from the outset that we thought gross margin guidance could be conservative, but if you're sitting in my shoes, it is still too early to make that call due to several factors. Right now, our product mix is slightly negative, though we are anticipating a strong May and June for fertilizer business, given the comp from last year. But that rebound is largely dependent on what happens in Texas, which is one of the few markets that has been negatively impacted by weather all season long. If we don't have a strong balance of the year in lawn fertilizer, I would expect to see some negative impact on the margin rate.

Also, as I just discussed, the benefit from Roundup on a gross margin rate will diminish over the balance of the year due to timing. Additionally, the benefit from fixed cost leverage is expected to decrease as shipments eventually dovetail with POS.

Finally, our Q4 comps in gross margin are extremely difficult and will likely be down on a year-over-year basis. On the positive side, however, incremental pricing will have a much larger impact in the second half of the year. Given all these moving pieces, I'm keeping the guidance where it is right now, with an admission that it is an area for potential upside.

I want to stress that any upside on gross margin could mean downside in SG&A, so let me move there. For the quarter, SG&A is up 6%, which is in line with our internal targets and driven by SG&A from historic acquisitions, deal cost renew acquisitions, and expected increases in compensation. The tie to gross margin is an indirect one and is related to a potentially higher variable compensation expense.

If we over deliver on gross profits, those dollars flow down to the bottom line, but then get offset somewhat by higher variable compensation expense. It's a circular equation of sorts and one that we won't have a firm handle on until late in the fourth quarter, but it is another reason to keep our adjusted EPS guidance where it is.

Let's start to bring all this to the bottom line. On an adjusted basis, which excludes impairment, restructuring and other charges, income from continuing operations was $196 million or $3.15 per share, compared with $142 million or $2.29 per share. Of that amount, we estimate the calendar shift had a positive impact of roughly $0.40 per share.

Remember, the adjusted number treats SLS as a discontinued operation. So the loss we would normally see from the business in Q2 has been excluded.

So with that, adjusted pro forma results, and these include the loss from SLS, would have been roughly $3 for the quarter and you still have the benefit of the calendar shift. So if you include the SLS loss in the quarter and exclude the calendar shift, we would have delivered roughly $260 million versus $206 million last year.

So let me describe things on a pure GAAP basis, all one-timers included, and SLS treated as a discontinued operation. On a company-wide basis, income attributable to controlling interest from continuing operations was $226 million or $3.64 per share, compared with $139 million or $2.24 per share for the second quarter of 2016. Those results include impairment, restructuring and other charges.

In Q2, that means a benefit of approximately $50 million of reimbursements from insurance providers. You will recall that we booked significant expenses in the second half of last year related to problems with our Bonus S product in the south. We treated the cost of repairing and replacing consumer lawns as an adjustment to earnings at that time.

Our insurance providers have reimbursed us for the vast majority of the costs we incurred last year, but we still expect additional dollars from them later in this year. Just as we excluded the initial expense from our results last year, we are excluding the reimbursements this year.

I know there are a lot of moving pieces here. I'll try to cover them in Q&A, but I will also be participating throughout the day on follow-up calls. So we'll try to make sure everyone is on the same page.

Let me cover a few other quick items. There's no news of note on the balance sheet, but you will see that our long-term debt continues to increase as planned. At the end of the quarter, our leverage ratio on a rolling four-quarter basis stood at 2.5 times. Given the M&A pipeline, I continue to expect this number to reach three times by the end of the fiscal year and up to 3.5 times in the quarters that follow. At that time, our intent is to maintain that ratio into the foreseeable future.

During the quarter, we purchased roughly $43 million worth of shares at an average price of $66.50. Our intent is to remain an active purchaser in the months ahead and I'm targeting a total repurchase amount of roughly $100 million to $125 million by the end of the fiscal year. I'll wrap things up by coming full circle.

I'm pleased with the results we are seeing so far this year. I feel extremely confident in our guidance. But we told you back in December, our focus would be Project Focus, which is all about putting the Company on the right trajectory for the next several years. On both fronts, I'm pleased with what I'm seeing and confident we are taking the right steps to drive shareholder value.

So with that, let's open up the call and address your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Jon Andersen, William Blair.

Jon Andersen - *William Blair & Company - Analyst*

I just wanted to ask about the year-to-date point of sale, but more importantly, and maybe your expectations for May and June. How difficult was the April comp and how easy perhaps, or undemanding, does the May and June comp get?

And I'm trying to kind of just ascertain, on a little bit more granular level, your level of confidence at this point in the season as it relates to consumer engagement and your ability to hit your full-year top-line expectations? Thanks.

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

Sure, Jon.

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

I think we will all share this one a little bit. I start by saying we were up, on a POS basis, in sort of the low-teens entering the end of March. So that gives you some idea of, I think when the weather was really good, how active the consumer was. So that's good.

April and May are pretty big numbers and so just the weather we are seeing up in the northeast right now, rain in Texas, have pulled the numbers back, but remember our budget numbers don't demand us to be -- I mean, if we ended the year above 2015, it would be like absolutely blow-away and we weren't expecting that. So at the end of last week, we were up like 4.5% POS on a national basis.

So what you're seeing is it's pretty rocky at the moment, but I think that when weather's good, the consumer has been performing great and we have great programs and promotions online with our big retailers throughout the month of May. So we're feeling pretty relaxed, but I think that's what you're seeing is just -- this weekend was like 15 degrees below normal here in New York and rainy as heck on Sunday.

So I think that's all you are seeing is big weeks and kind of crappy weather here in the northeast. The weekend forecast, Saturday looks great here for New York at least, thank God, and the midwest looks like good forecast as well. So I think we are confident. Remember, our budgets only required like 1% or 2% and so we don't have to outperform to make our numbers.

Jon Andersen - *William Blair & Company - Analyst*

That's helpful, thanks (multiple speakers).

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

Jon, this is Randy, to add a little more color to this, just to remind everybody. The largest months we have on a POS basis, in this order, are April, May, June and then March. So April is the largest month, but followed by May and June. And it has been an interesting ride over the last few weeks. Even just a week ago, we were up 5% year-to-date. So obviously, this last week had a big impact on the numbers we're looking at.

Just for context, Jon, to answer your question directly, last year's April was the second biggest month we've ever had as a company. So it was a very difficult comp. Looking at May, last year, it was about flat. June was down about 5% and then Q4 was low-single digits last, so we have a lot of opportunity going forward and I don't think we should have the wrong impression from one week.

Jon Andersen - *William Blair & Company - Analyst*

Totally agree. I was out watching soccer last weekend and it was 45 degrees and raining here in Chicago as well. So good luck going forward. Just a quick follow-up. Randy, you mentioned point of sale, excuse me, that you could see leverage going to from about 2.5% to 3% and maybe 3.5% at some point in time. Can you just talk about what's driving that increase, how soon that may happen and kind of what your expectations are for leverage longer-term? Thanks.

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

Sure. So in the short-term, we're still actively pursuing our M&A pipeline and we would anticipate spending potentially a couple hundred million dollars between now and the end of the fiscal year. We are also continuing to purchase our own shares and, as we've said many times in the past, once we shift to 2017, we will be much more aggressive in buying ourselves back versus pursuing acquisitions. So that's really where the uses of cash will come from and naturally we will just increase our leverage over time, living somewhere between 3% and as high as 3.5%.

Jon Andersen - *William Blair & Company - Analyst*

Okay, thank you. That's enough.

Operator

William Reuter, Bank of America.

William Reuter - *Bank of America Merrill Lynch - Analyst*

When you guys talked about the increased gross margin dollars that you guys might see due to better gross margins, you also talked about the fact that variable compensation could increase and this would offset part of this. Is there any way you can talk to us a little bit about how that relationship works?

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

Sure, I think the most obvious way to think about it is our management incentive plan is largely tied to operating earnings and the better year we will have, the better we will get paid. So it is a sliding scale. If we don't perform, we get paid less. If we over perform, we get paid more.

We're still really optimistic in our results through Q2, assume that we're going to pay ourselves out at a higher level than would be the normal target, but again, that is somewhat dependent and that gives us a lot of confidence about being able to land the year regardless of how POS performs. But even on that, we're still feeling really optimistic.

William Reuter - *Bank of America Merrill Lynch - Analyst*

I guess maybe I was thinking such that if gross margin dollars were up, let's just take a number, 100, that therefore, we would have 50% of this would be offset through increased compensation or is there any way for us to think about that just to think about how the gross margin dollars flow through more quantitatively?

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

Well, thinking about our variable compensation expense, if we were to hit the high end of our range versus the middle, it is probably worth about $0.10 or $0.15 per share, so that kind of gives you a sense of what that would look like.

William Reuter - *Bank of America Merrill Lynch - Analyst*

Okay. And just a follow-up for me, it sounds like the acquisitions you're targeting this year are still kind of a modest size relative to the size of the Company at this point. I guess I'm wondering whether on your guy's wish list or whether you guys have seen opportunities that might be a little larger at this point that you guys have been contacted about or thought about.

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

I will take that. Our pipeline is active and I think full for what we're trying to do, but the deals are of relative modest size. If you look at the big deals that we have done, I think getting the Roundup deal done last year was very important for us, that was what? $300 million-ish? The lawn service Chemlawn deal was a super important deal for us.

I have to admit to being a little disappointed that the European deal didn't happen, but again, what we saw in diligence was a emerging valuation problem to our benefit that we weren't quite sure how it was going to get solved and the seller just took a different choice and I think that kind of resolved the problem for them. Our biases have not changed. After that, our reconfiguration is really about getting Europe done and hydroponic deals closed within the context of what we've told the shareholder community.

Beyond that, what we've said the Company we like the best is us and that we would like to significantly reduce our share count over time. So I think that the big deal you're talking about probably is us and that's kind of what we are headed for. A lot of the bigger ones, we've done. There's a few small Pete deals on the horizon. I think one actually closed yesterday.

Where we're, again, just along the lines of what we've told the street up through now, that being in a position with difficult Pete harvests, more restrictions on the ability to harvest in Canada, we wanted to be more basic in the supply. So we continue to do, again, these are what I would consider extremely modest deals, to build our supply up so that we either own or control through long-term agreements approximately half of our annual Pete requirements which are very basic for our soils business.

So I think that part of what we like about our strategy is it's pretty simple. We did some big deals. I think we really like the lawn service deal and then we got a bunch of kind of, I'm not going to call them minor because I think they are very strategic, fast-growing, high-margin businesses on the craft and hydro side.

Some small Pete deals, and then turn around and use our cash flows and, to some extent, modestly, some leverage capacity, to buy our own shares back. That really is our plan and we like a lot. The board likes it, and I think, up till now, the street has been favorably inclined toward it as well. So I don't know if that answers the question.

William Reuter - *Bank of America Merrill Lynch - Analyst*

That does answer the question. Okay. Thank you very much.

Operator

Bill Chappell, SunTrust.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Good morning. I guess just a side note. You commented that Hawthorne may be separated out as a standalone business depending on different factors. Does that mean we are reaching kind of 10% to 15% of total sales or is there another reason why that would be split out?

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

It would be sales or earnings or asset base and, depending on which deal get consummated over the foreseeable future, it will probably be on the asset base more so than the sales at this point.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay.

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

But closely approaching both.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay. And also just on a general terms --

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

Look, Bill, I just want to just throw in on that. This was actually, our January Board meeting was out in California and we did that at the GH headquarters in Santa Rosa. And I think it was interesting in the discussion with the Board to look at sort of the five-year plan for Hawthorne. It becomes a very significant part of our North American business within less than five years. So I think that's the basis where sort of no matter what we do it's going to become a reporting segment.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Got it, thanks. Then when I look at be it Hawthorne or other kind of M&A and especially you were talking about Europe, is there a risk that all these things kind of carry into 2017 and you're still trying to negotiate and so we are not doing share repurchase or other things?

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

I'm going to start by saying I hope not. I think on the acquisition side, I'm not going to allow that. It is a commitment we made internally. We all sort of, what's that TV show where they sort of spit in your palm and shake hands, and brothers' oath kind of thing.

That on the M&A side, I think we've got -- we understand what is there, we understand the pipeline, we are, within reason, operating about as quickly as we can, meaning to keep things under control and sort of progressively move from deal to deal. This is generally on the hydro side, where we're I think right where we want to be and I don't think it will extend into 2017 so I think that's clear.

I'm going to say, and I just said it a few minutes ago, I'm somewhat disappointed in what happened in Europe, to be honest. I don't think it's changed our view. And so what we have to do is begin to focus on running our business, because it is still our business, and that is going fine. And then we have to sort of we evaluate what the next move is and I think we have got ideas.

But I think that the most important thing right now is that we are in season and we've got to run the business. So could that part push into 2017? I think probably. But I don't think that will affect -- because remember the -- I don't know exactly what we told you guys, so I could step on dog doo here.

Because I think we told you guys that we probably would have had to re-inject cash to re-capitalize that business in Europe under the existing deal structure that we had talked about. Obviously, we don't have to do that now. I don't think this affects our cash flow ability to begin buying shares back. I don't think it significantly affects our go-forward plans, although, final sort of conclusion of what happens in Europe probably does slip into next year I would bet.

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

I think so too and regarding Europe, I think it would have been a real head scratcher for everyone if we had actually been able to go forward with the deal. The original terms we had in place made a lot of sense. As we add more visibility to numbers on our end and their end, it became obvious that the deal wasn't going to work and we could have tried to chase it down and overpaid, but that's not what we are in the business of doing.

So it made sense just to let that go and go out and essentially start from scratch to a degree but it is also encouraging that, if the company we were pursuing was able to find the valuation and found a buyer for their business at such a high multiple, I think it is pretty encouraging for us going forward as well. A lot more to come on that and I wouldn't expect anything to happen by the end of the fiscal year for sure.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay. And then last, Randy, while I have you, on the gross margin, I understand the conservatism and the variable comp that would offset it, but are you basically saying give it one more month through Texas and there should be meaningful upside? Because it's tough to kind of stay within your range in light of current spot prices and what you've done year-to-date.

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

Well, on the commodities and fuel, we have almost perfect visibility now. So we are 90%, 95% hedged on urea and fuel, so that's not a question mark anymore. The question becomes more about volume and fixed cost leverage, so as shipments and POS come closer, we're not going to end up 16% ahead on sales by the end of the year like we were at the end of March, so a lot of the margin benefit from volume should dissipate over the balance of the year.

The Roundup impact is all front-loaded, so by just the math plays out. So it becomes a smaller impact by the end of the year, and then the mix question, we will have to wait and see how that turns out. We need to make up some ground on fertilizers, and if we do, we should have some upside on gross margins and if we don't, it will pull a step back down a little bit.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

And sorry, are you going to give an intra-quarter update or will we next hear from you in August?

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

You will hear from us in August.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay, thanks.

Operator

Olivia Tong, Bank of America.

Chris Carrion - *Bank of America Merrill Lynch - Analyst*

This is Chris Carrion for Olivia.

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

Hi, Chris.

Chris Carrion - *Bank of America Merrill Lynch - Analyst*

Hi. Thanks for taking my question. Just following up on the outlook. I actually just have two housekeeping items, then a follow-up question. Just on the housekeeping end, you mentioned that you expected a $100 million shift from Q3. Is that correct?

And then if you could just provide any commentary on the implications for Q4, that would be helpful. And then just on the Roundup deal, can you just confirm what the contribution was for the quarter? I think you had mentioned it, but I just wanted to make sure I have the numbers correct.

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

Sure. So the impact that we saw in Q2 from the calendar shift was, call it, about $100 million. We expect that to come out of Q3. Difficult to predict exactly with position, but call it dollar for dollar as an estimate at this point and by the time we get to the very end of the fiscal year, all the timing issues will work themselves out. So not a big number in Q4.

Then regarding Roundup, the $20 million impact year-over-year, we saw that 100% in Q2 so that was also a big contributor, not only to the sales growth in Q2, but as well as our gross margin rate in our earnings.

Chris Carrion - *Bank of America Merrill Lynch - Analyst*

Okay. Thanks. Yes, I thought I had seen that $20 million number. And then for my question, it is actually shifting gears a little bit around the Monsanto recently, the agreement that you restructured. Just wondering if there's anything new you want to share, I mean how you're running that business differently, any new changes that are coming, any developments that you had originally planned for that deal. If they're playing out, that would also be helpful. Thanks.

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

Sure. So as part of the deal, we have access to use the brand in that other category, so we're making a lot of progress on the R&D side. And we'll do, perhaps not a national launch, but we will be launching the new product next year on a test basis and more to come on that. And there's two or three more that will follow, probably 2018. So I'm happy with the progress we're making so far.

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

And remember all progress relating to the disposition of our European business is enabled by this update to the agreement. That was a very important part of that deal for us was the ability to revise our portfolio.

Chris Carrion - *Bank of America Merrill Lynch - Analyst*

Got it. Thank you very much.

Operator

Eric Bosshard, Cleveland Research Company.

Eric Bosshard - *Cleveland Research Company - Analyst*

Two questions. First of all, in terms of retail engagement and commitment to the category, I'm curious on your observations year-to-date and also moving forward.

Mike Lukemire - *Scotts Miracle-Gro Co - President and Chief Operator*

This is Mike Lukemire. On the home centers, I would say pretty equivalent, I would say hardware is up and I would say mass is down.

Eric Bosshard - *Cleveland Research Company - Analyst*

Anything different than you expected within those three pockets?

Mike Lukemire - *Scotts Miracle-Gro Co - President and Chief Operator*

Not anything different other than we expected a lot more cap activity out of mass. That was probably the biggest change.

Eric Bosshard - *Cleveland Research Company - Analyst*

Can you explain that? I don't totally understand that.

Mike Lukemire - *Scotts Miracle-Gro Co - President and Chief Operator*

It is a weekly promotional circular. They reduced it significantly. It went from like 53 a year to 13.

Eric Bosshard - *Cleveland Research Company - Analyst*

And that, within those, that doesn't change your ability to get to the full-year target that you have in terms of (multiple speakers)?

Mike Lukemire - *Scotts Miracle-Gro Co - President and Chief Operator*

No, there's a commitment and everything we built, everybody was talking about POS, we built the original budget. We loaded most of our upside into May. We moved most of our promotional activity to May, which is about 10 times more active than we were a year ago. So we are actually really confident about where we're going to be.

Eric Bosshard - *Cleveland Research Company - Analyst*

The second thing I wanted to understand was I think you had talked earlier about $200 million or $300 million of acquisitions, I think in Hawthorne or GH. Can you just expand a little bit on that?

I know that you've talked about smaller deals and the Pete deals and I understand the strategic nature of the latter, but can you talk a little bit more specifically about directionally where you're going? Is this a chunk of money on a bunch of smaller deals, I guess is the first piece of what I'm trying to understand.

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

Sure, Eric. This is Randy. Trying to quantify for you a little bit better, I would say that the couple deals on the pipeline right now that we are pursuing most aggressively would be not quite the size of GH, both in the purchase price and the size of the sales, but similar to. So pretty nice, reasonable businesses that would complement what Hawthorne has built to date. That gives you a little bit better idea.

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

Look, I think, Eric, we put it in the script, we called it house of brands or something like that. I would suggest that if you went out in sort of, call it, roughly the 2,000-ish hydro stores, particularly west coast and just look at what's there.

I think that if you look at sort of Scotts North America and the strategy we pursued really since, call it, 1999 on our US consumer business, I think we're interested in that sort of approach in the hydroponics supply side, meaning ferts, nutrients, pesticides, various other consumables, and to some extent, some hard goods, within the area and generally branded products. So I don't think it's actually that hard to figure out and I would just say go out and do some store visits. It's more interesting than probably consumer lawn and garden.

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

The other thing I'd add is if you look at the one acquisition that we did do about a year ago with general hydroponics, it's actually ahead of the business case, which wasn't any kind of a lay-up anyway. So we feel really good about how the business is performing right now.

Eric Bosshard - *Cleveland Research Company - Analyst*

Last, if I can, within this, the asset that you levered as you grew the consumer business was the brand and the selling effort at retail and there was certainly more than that. I guess, Jim, do you feel like those assets are leverageable within this market or are there other assets of the organization that you've levered as you grow with these 2,000 stores that you called out?

Jim Hagedorn - *Scotts Miracle-Gro Co - Chairman and CEO*

I think I would say yes and no. I think generally it is a unique distribution channel, although this year, we have been in discussions with many of our largest retailers about some hydro products in what would be viewed as sort of conventional lawn and garden channels and you are seeing like Black Magic launch within Home Depot this year, which is soils and nutrients-based.

I think that what Scotts offers within the channel is not just sales execution, it is management, financial systems, capital, to some extent, some process and managements that, the ability to use our IT systems to better control these businesses and there's a lot of, I'm going to say, duplicative overheads.

So I think that what Scotts offers up goes beyond just sales support and execution support, but in R&D, in manufacturing, I could take you, regulatory and legal, there's a lot of things that we can offer to sort of these Hawthorne companies that they don't really have the scale to do today and I think that makes these deals pretty attractive.

And again, this is a sort of strategic discussion we've had at the Board level in that we are very much today, I'm not going to say low growth, but I think what we've told the street is we're going to budget based on 02 and I think that is what makes, by the way, not fiscally challenging for us based on where we are today. But it tends to be a west coast business. We tend to be a kind of central and east business.

This is high-margin, high-growth, young, urban and rural, more independent than the big three. So there's a lot of things we like about that space that we don't see in our existing lawn and garden space, although the existing lawn and garden business really pays for everything. And so we think it's a pretty good combo and we wouldn't want to miss this opportunity.

Eric Bosshard - *Cleveland Research Company - Analyst*

That's helpful, thank you.

Operator

Joe Altabella, Raymond James.

Unidentified Participant - - *Analyst*

This is Christina on for Joe. I was just wondering, do you expect shipments to be below POS in the second half of the year given that you were ahead in the first half?

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

Hi, Christina. This is Randy again. No, we expect everything to dovetail for the most part. I mean, we've seen retail inventories over the last couple of years at the end of each quarter be roughly up mid-single digits. That's where we are right now coming off last weekend. So the trade does not stop by any means. I think we're in a good place, we just need it to stop raining in New York City today and get some good POS in Texas and everything should work itself out.

But everything eventually normalizes for the most part. And shipments in POS and retail inventory come together by the end of the year, not always by the end of September, but by the time we get all the way through the season and call it Thanksgiving.

Unidentified Participant - - *Analyst*

Okay, great. And then can you just talk about the pricing impact on the quarter?

Randy Coleman - *Scotts Miracle-Gro Co - CFO*

Yes. Pricing for the quarter was down a little bit. A lot of the trade programs we have built this year, we developed earlier in the year and they are much more performance-based, so we've phased those trade programs with sales and with sales being so high in the quarter, a lot of that expense hit earlier this year than it did last year or years in the past.

So that muted some of the price increases on an invoice sale basis that we saw take place as we flipped over to calendar 2016, so as we roll out over the balance of the year, we will see that pricing impact increase quite a bit, which again, I mentioned in my script, gives us more confidence for a gross margin rate. I think mix is the one area that I think is of greatest concerned. Those are the two that we will be trying to balance, but pricing will definitely be a good guy, much more in the second half of the year than what we saw in the first.

Unidentified Participant - - *Analyst*

Great. Thank you so much.

Operator

And ladies and gentlemen, we have nothing further from the audience at this point. I will turn things back to Jim King for any additional or closing remarks.

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

Okay. Great. Thank you very much. Again, if anybody has follow-up calls, feel free to call my office later today. You can reach me at 937-578-5622. Otherwise, those of you who we have calls scheduled with starting later this morning, we will be in touch with you later in the day. And right now, our Q3 call is tentatively planned for Tuesday, August 2, I believe that is, at 9:00 AM. So we will communicate with you then. Thanks for joining us today and have a great day.

Operator

Once again, ladies and gentlemen, that does conclude today's conference. Thanks for your participation.
