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EDITED TRANSCRIPT

SMG - Q4 2017 Scotts Miracle-Gro Co Earnings Call

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OVERVIEW:

Co. reported FY17 GAAP diluted EPS of $3.29. Expects FY18 sales growth to be 4-6% and non-GAAP adjusted EPS to be $4.15-4.35.

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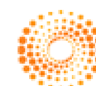

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CORPORATE PARTICIPANTS

James S. Hagedorn *The Scotts Miracle-Gro Company - Chairman and CEO*

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

Michael C. Lukemire *The Scotts Miracle-Gro Company - President and COO*

Thomas Randal Coleman *The Scotts Miracle-Gro Company - CFO and EVP*

CONFERENCE CALL PARTICIPANTS

Christopher Michael Carey *BofA Merrill Lynch, Research Division - Research Analyst*

David Michael Stratton *Great Lakes Review - Research Analyst*

Jason Matthew Gere *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

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

Krystyna Metcalf

William Bates Chappell *SunTrust Robinson Humphrey, Inc., Research Division - MD*

William Michael Reuter *BofA Merrill Lynch, Research Division - MD*

PRESENTATION

Operator

Good day, and welcome to the Scotts Miracle-Gro Fourth Quarter and Year-End Earnings Call. Today's conference is being recorded. And at this time, I'd like to turn things over to Jim King. Please go ahead.

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

Thank you, Kayla, and good morning, everybody. Thanks for joining. With me here in Marysville, Ohio, this morning are: Jim Hagedorn, our Chairman and CEO; Randy Coleman, our Chief Financial Officer; and Mike Lukemire, President and Chief Operating Officer. We'll get started in a moment with prepared comments by Jim and Randy, respectively. And that point, we'll open your call to questions.

I know that many of you have other calls or meetings this morning, so we'll try to move through the queue as quickly as possible. To help us manage our time, please just ask one primary question and one follow-up. If there are questions left unanswered, I'm glad to follow up with many of you later in the day or tomorrow.

One bit of housekeeping related to our IR activities in the months ahead. Unlike other years, we will not be sponsoring an Analyst Day this year in December. Instead Randy and I are going to be visiting many of you in person in the weeks ahead in California, Denver, Kansas City and New York. Our New York visit will include participation in the KeyBanc Capital Markets Consumer Conference at the InterContinental hotel on Tuesday, December 5. With that, let's move on with today's call.

As always, we expect to make forward-looking statements this morning, so I want to caution you that our actual results could differ materially from what we say here. 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 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 later today on our website.

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

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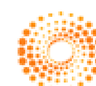

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James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Thanks, Jim, and good morning, everyone. I want to begin my remarks by pointing out a significant change in the year-end press release we issued this morning. It's a change that says a lot about our commitment to the strategy we laid out 2 years ago and the cultural change it needed to make it happen.

For the first time that I can recall, our year-end press release was headlined with the cash flow statement. And it shows that we reported record operating cash flow in fiscal 2017 of more than $350 million. The organization stayed focused all year long on driving for improved cash flow even when the core business hit some unexpected turbulence in the middle of the season. That effort allowed us to exceed our original guidance for cash flow as well as the revised guidance for adjusted earnings we communicated in June. As Randy will explain later, we could have operated the business for higher earnings per share but would have come at the expense of cash flow. And it's a trade we weren't willing to make.

That decision should reinforce for our shareholders just how serious we are about executing our strategy. When we announced Project Focus 2 years ago, we said we were focused on 3 things: one, getting the most out of our U.S. Consumer business, where we enjoy significant margins but operate in a low-growth environment; two, reconfiguring our company to maximize the value of non-core assets, like SLS and international, and invest in emerging higher-growth and margin businesses like hydroponics and live goods; and three, operating the business with a focus on cash flow and then employing a smart capital allocation strategy that helps drive double-digit shareholder returns on a consistent basis.

There were skeptics in the investment community when we said that cash flow would be a major priority going forward. Some of you were worried that we would chase growth that wasn't achievable and that cash flow would suffer as a result. So we overhauled our incentive plans and put our own pay on the line. 25% of the payout in 2017 for our short-term plan, which pays cash bonuses on an annual basis, was based on free cash flow. Next year, that number is 40%. And 2/3 of the performance criteria tied, to our long-term equity incentive plan is tied to cumulative cash flow over 5 years. I don't want to be dismissive of EPS. It's important and we're committed to improving it. But in terms of emphasis on priorities, I believe it's free cash flow, not EPS, that drives value.

Our focus on cash flow is paying off for our shareholders and for management. As I said earlier, we had $354 million of operating cash flow. That translates into $284 million of free cash flow and a cash flow productivity number, that's free cash flow divided by net income, of nearly 130%. Last year, that number was less than 60%. The reason we adopted cash flow productivity as a performance metric is that it forced us to compare ourselves with other consumer products goods companies. And we didn't like what we saw.

In fiscal 2016, we were dead last when compared against a peer group of more than a dozen other branded consumer products companies. Right now, it looks like we'll be in the top quartile this year. And the goal is to stay there. There are a whole lot of people who helped drive this result. And I don't want to start naming them because so many of them are responsible. But I do want to call out the leadership team in our supply chain organization, they are true believers in this cause.

I wanted to make sure I started my remarks by focusing on cash flow, but there are plenty of other things to talk about this morning as well. So let me move on. I'll begin with Hawthorne, which continued to overdeliver. We began reporting Hawthorne as its own business segment this quarter. So you can see that business grew 97% in the fourth quarter and 137% for the year compared to 2016. Obviously, those percentages are driven by acquisitions. But if you assume we owned the entire Hawthorn portfolio a year ago, we would have reported 20% volume growth this year.

In the first half of the year, we acquired Botanicare, a liquid nutrient supplement and hydroponic supply company. In the second half of the year, we added Agrolux, a European lighting company that complements the offering we already had with our industry-leading Gavita brand. And within the last few weeks, we acquired Can-Filters, the top hydroponic brand in air movement and filtration systems. We also acquired the 25% of Gavita we didn't already own.

We have quickly created the best hydroponic portfolio in the world. As Randy will explain in more detail, we expect to continue seeing strong top line growth in 2018. We're close to the end of the M&A process, but I continue to believe we can add to Hawthorne in ways that make it a stronger and more vertically integrated business. I don't want to be overly specific this morning, but I will say we're exploring further investments that will enable Hawthorne, not just to get bigger but more importantly to reach the same rate of profitability, if not greater, than our core business.

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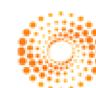

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Let me talk briefly about the U.S. Consumer business, again leaving most of the details to Randy. The 2% sales decline we saw for the full year was consistent with what we expected when we revised our guidance earlier this summer. And that story never really changed. We saw growth pretty much in line with our original expectations in the home centers, hardware channels and with garden centers. But we were down mid-teens in mass retail and there was no way to overcome that. In terms of consumer engagement, the story was about the same. When you back out mass retail and mulch, then the rest of the portfolio saw POS growth of about 4%.

We had a successful new product launch with Roundup For Lawns, which had sales of roughly $40 million. And even though we had a challenging weather through the spring planting season, we saw the real potential of the combination of Bonnie and Miracle-Gro. While Bonnie saw some of the same weather challenges in the peak of the season as the rest of our portfolio, it took off in the back half of the year and outpaced the rest of the business. You've heard me say it several times that we like the long-term growth opportunities in specialty live goods categories, like edible gardening. That's why we're investing hard in the space and why we'll make another big push with Bonnie again next season. Our attraction to this category is why we continue exploring opportunities to invest in other specialty growers.

In terms of our planned operating performance in 2018, we expect several recurring themes. New products will be a key part of the mix. We expect to see continued strong retailer support in the home center, hardware and nursery channels. At mass retail, we are not planning for a major recovery. The mass retail environment continues to evolve with more focus on second-tier and third-tier brands, like those owned by some of our competitors, whose names we won't mention. Of course, market-leading brands like ours continue to be a big part of the mix at mass retail and we continue to work with retailers in this channel to provide them with the products and programs they need to successfully execute their strategy.

Understandably, we've been getting a lot of questions about what we've experienced this year in mass retail. Frankly, I'd be careful not to overanalyze it. It's important to remember that lawn and garden is not a spontaneous activity. It's a planned activity, which makes it a destination category of retail. Tens of millions of consumers engage in lawn and garden activity every season. And we have the good fortune of owning destination brands in this space. We don't choose where consumers shop, they do. In fact, it's not our job to impact that decision. Instead, our job is twofold: first, to help consumers succeed with lawn and garden projects, whether that's maintaining a healthy lawn, creating a beautiful garden or controlling unwanted pests; and second, we must provide our retail partners in all channels of trade with the programs and support to help them win.

Unlike many other consumer categories, lawn and garden continues to rely on brick-and-mortar retail. In 2017, about 97% of our sales came through these traditional channels. Will that change over time? Probably. Will it change substantially? I don't really think so. Frankly, I'm not -- frankly, I'm okay with not aggressively participating in the online marketplace. As a consumer, I love it and make significant percentage of my personal purchases online. As the CEO of a consumer products company, I'm way less of a fan.

In a business like ours, loyalty matters. We're dedicated to the retailers who've helped us get where we are, no matter what their performance has been over the past year or 2. That said, I know the marketplace is changing and we're not ignoring that fact. We've just made some organizational changes to improve our direct-to-consumer efforts, and we're making the kinds of investments that you would expect. But we're not going to chase sales for the sake of sales if the outcome undermines the margin structure of our business, our industry and that of our most significant retail partners.

Across the board, I believe that Mike and his team are pulling all the right levers in our core business right now. We have a great innovation pipeline. Our new marketing campaigns for 2018 look terrific. And we're focusing on cash flow with every member of the team. The net takeaway is this, even with some of the challenges we saw this past season, I'm extremely pleased how we're running the business and the way we're executing against our strategic plan. And I remain extremely confident in our ability to continue doing so. We've created a realistic planning model to guide our efforts over the next several years and you'll see that in the guidance we provided this morning.

Randy will provide the specifics. But the basic framework lays out something like this. We believe our core business will continue to grow in the low single digits. We expect Hawthorne to grow in double digits over the next several years, which would add another 1 or 2 points to our company-wide growth. In any given year, we may benefit -- we may get the benefit of bolt-on acquisitions as we will in 2018. Margins will improve modestly going forward, giving us mid-single-digit improvement in operating income growth over most years. And to come full circle, that's why cash flow becomes so important. We plan to continue using cash to repurchase shares, adding another couple of points to EPS in most years. We also believe we can modestly raise our dividend each year. We may even choose to pay special dividends.

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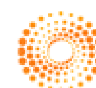

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Whatever the course returning shareholders takes -- returning cash to shareholders takes, the combination of these efforts is the basis for our goal to drive shareholder return in the range of 10% to 12% annually. We've obviously achieved that goal over the past year, and I'm extremely pleased with that result. If we stay focused on executing our strategy in fiscal 2018, I'm confident that a year from now, I will once again be able to report that we've done what we committed to do.

Before turning things over to Randy, I want to thank our associates. They have been patient with us as we reconfigured the business. They stayed focused on getting the most out of our core business and helped drive growth in our new ventures. This year will mark our 150th anniversary, a milestone that is truly remarkable. While I know CEOs and senior management teams often get the credit for the kind of success and longevity a company like ours has had, I know better. The real credit goes to those people who most of our shareholders will never get a chance to meet. And I want to thank each of them, and our shareholders should as well.

With that, let's switch gears and dig into some more of the numbers. Randy?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Thank you, Jim, and good morning, everyone. I know the fourth quarter and full year results are not the top thing on everyone's mind this morning. So I'll touch briefly on the highlights and then shift gears and provide a more detailed commentary on our 2018 guidance.

Before I start, I want to remind everyone that we moved our European and Australian businesses to discontinued operations during the quarter, eliminating them from our 2017 and historical results. While we filed an 8-K a couple of weeks ago with updated non-GAAP historical numbers, some of you may not have fully updated your models yet. So if you hear a comparable number that you do not follow, that is probably the reason why.

The other thing you will have noticed is we have now completed the changes in our segment reporting. The U.S. Consumer and Hawthorne segments are pretty self-explanatory. One item of note is the U.S. Consumer numbers have changed slightly to include our craft gardening products sold through traditional retail channels. These were previously part of the Hawthorne business and, therefore, recognized within Other. Other now consists mostly of Canada as well as Mexico, a very small operation in China and revenue from a supply agreement related to the sale several years ago of our professional horticulture business.

I know that following our results has been challenging at times as we've been reconfiguring our company over the past 2 years. We'll have a few minor tweaks to the P&L in 2018 that I'll explain later. But it should be far easier for everyone to track our results going forward. Thanks for your patience as we work through these changes. And before I forget, I want to thank our external reporting and tax teams as well. These folks have really earned their pay over the past 2 years with all the moving pieces. So let's move on.

The big news on the top line is obviously Hawthorne, up 97% in the quarter and 137% for the full year. Of the $166 million increase for the year, approximately $136 million came from acquired growth. But if you assume we owned all the businesses in the Hawthorne portfolio all year, the organic volume growth rate would have been about 20%. We have low double-digit percentage organic growth assumptions on our internal plans for the year. But we told you we would be disappointed if we didn't do better. As Jim said, the volume growth we're seeing gives us a lot of optimism going into next year.

The U.S. Consumer decline of 2% for the year and 7% in the quarter was in line with the change we made to our guidance back in June. The story is no different than it was earlier in the year. We saw a mid-teen percentage decline at mass retail for the year and the results were pretty much in line with our planned assumptions everywhere else. What's encouraging for next year is that retail inventory levels were down across the board. We're finishing the season with pretty clean stores and a high level of support for early season sell-in after the 1st of the calendar year.

Let me quickly move on to gross margin, where the adjusted margin rate was up 60 basis points for the year. Favorable product mix helped as did lower trade program expense and commodities. We could have potentially done better here. But the fact we did not reinforces Jim's previous comments about prioritizing cash flow. From a historical perspective, we have consistently prebuilt inventory for the following season, reflecting higher sales growth targets for the following year.

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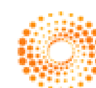

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Given our low-growth environment and our new emphasis on cash flow, we have made a step change to reduce our on-hand inventory and production levels and produce closer to the selling season. We've made significant investments over the past couple of years in our vertical supply chain capabilities that will allow us to continue to reduce inventory levels while also continuing to meet customer service expectations.

In terms of SG&A, I continue to be extremely pleased with our efforts. Expenses were up 2% in the quarter and 6% for the year, in line with our original guidance. Half of the increase came from acquisitions, half of the remainder came from increased investments at Hawthorne that we believe are necessary for long-term success. So we're doing a great job of managing SG&A here, a point that I will reinforce when we talk about 2018 guidance.

Non-GAAP equity income from TruGreen was a $3.8 million loss in 2017. The timing of the season and some top line challenges led to a lower sales and earnings number than we had expected. The synergies we expected from the deal have all been achieved on time and in full. So we remain pleased with the deal overall, especially given the approximately $290 million of cash we've already pulled out of this business and the fact that we still own 30% of the combined enterprise.

Interest expense is worth discussing briefly as well. We finished the year at $76 million compared with $63 million a year ago. Our leverage ratio was at 3x at the end of the year with average debt of $1.6 billion. We expected leverage ratio to hit 3.5x during the year, but the timing of deals and the proceeds from our divestitures as well as the TruGreen distribution required us to borrow less than I anticipated. We remain comfortable going to 3.5x. And I would expect us to hit that level in 2018. More on that in a few minutes as well.

Finally, diluted earnings per share on a GAAP basis were $3.29 compared with $3.98 per share a year ago. On a non-GAAP basis, EPS came in about where we expected when we lowered our guidance in June. The non-GAAP SLS adjusted EPS of $3.94 per share compares with $3.58 per share last year. Note the non-GAAP EPS result of $3.94 includes the $0.15 of dilution from the sale of Europe and Australia.

With regard to this divestiture, we're continuing to work with the buyer on the completion of the final working capital adjustment in amounts that may impact the final purchase price and gain calculation. And this will all be finalized in fiscal 2018 in due course. In addition, you may note a difference between the non-GAAP effective tax rate of 33.7% and our previous guidance. This is largely due to net operating loss carryforward benefits related to AeroGrow, which were accelerated versus earlier expectations. For next year, at this point, we expect the effective tax rate to return to a higher level before considering potential federal tax rate changes by Congress.

Jim spent a lot of time talking about cash flow, so I won't be redundant. I will say that I share his view that this is our most important financial metric that has quickly been embraced throughout the business. And I remain optimistic that we can continue to perform at this level in the future. Obviously, there are a lot of items I did not cover, and I'm glad to do so in the Q&A session or in follow-up calls with Jim later today.

For now though, I want to shift my focus to our P&L guidance for next year. The headline is this. We expect sales growth of 4% to 6% and non-GAAP adjusted earnings of $4.15 to $4.35 per share. Now let me bridge the change. In our core business, Jim explained that we are not planning for a big rebound in the mass retail channel. We expect a similar level of performance in the home center and hardware channel in 2018 as we saw this year. We also have some strong new products that we're introducing next year, 2 more Roundup brand extensions to be precise. And we also believe we'll see a recovery in our mulch business.

So our guidance assumes that the U.S. Consumer business will grow 0% to 2%. Many of you may believe this is a conservative target, and we hope you're correct. But if I look at the performance of the business over the past decade, I believe this is a realistic assumption entering the year. We expect Hawthorne will continue to see double-digit volume growth and expect it to add a little more than 1 point to the company-wide sales growth calculation. Acquisitions will add approximately 3 points of growth. So 4% to 6% sales growth feels like a reasonable assumption as I sit here today.

The gross margin rate is where you'll see the most stress next year. Our guidance assumes the rate will be down 50 to 100 basis points and here's why. We saw a margin rate benefit in 2017 from unbudgeted benefits of lower trade program expense. While this may be good news from a margin perspective, it's bad news to the top line. The reason that trade dollars were down was because retailer volume was down, too. So if we hit our sales targets for the U.S. core, the trade program benefits we saw in 2017 should reverse in direction in 2018. Commodities are likely to be a slight

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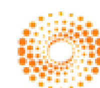

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headwind as well. While we are nearly 70% locked in both urea and diesel for 2018, there's been negative pressure on each over the past 2 months. And we're seeing pressure on resin as well. I would expect commodities to be a modest headwind next year, probably worth a few million dollars or roughly $0.05 a share.

Finally, acquisitions in the Hawthorne segment will be dilutive to the gross margin rate in 2018 as well. However, you've heard me say many times that I believe we have some nice gross margin rate opportunities in Hawthorne. I would expect those to start materializing in 2019. And while pricing has been a positive number on our core business in most years, it will be about neutral in 2018 due to the planned mulch pricing reduction offsetting small increases in other areas. Without being more specific, I'd just say that pricing will remain an important tool in future years. So longer term, I think you'll see gross margin rate turning in a positive direction once again.

Moving on to SG&A. I said earlier that we're doing a great job of managing expenses around here. As it relates to next year, I expect SG&A to be up 0% to 2% from 2017 levels. Acquisitions alone will account for 2% increase, so our strong performance should continue. Note that we booked fourth quarter restructuring charges of about $7 million with similar-sized benefits in fiscal 2018 that provide confidence around this outlook.

The way that I translate the operating margin rate is this. Our guidance assumes a rate of 16% to 17%, given the potential headwinds from the gross margin rate decline as well as the change to our P&L geography. Up until now, the interest income we earn from TruGreen and Bonnie, around $9 million combined, has rolled into the other income line in the P&L. Next year, we will present this interest income, along with income earned on a new loan receivable with Exponent as part of the international divestiture, into a new line in our P&L called Other Nonoperating Income. Since this line falls below EBIT, the income will not be included in our operating margin, costing us about 30 basis points. None of this affects our long-term goal. We continue to believe we can get to an 18% operating margin, although our expected 2018 results may hold us back an extra year from getting there.

Regarding the equity income line in the P&L, which primarily includes our TruGreen investment, year-over-year will likely be up slightly as a small acquisition made in late 2017 is now included in this line. For 2018 for our TruGreen investment, it appears that increased operating earnings will be offset by amortization, interest, restructuring and synergy cost and potentially future refinancing cost. Interest expense will likely increase $5 million to $10 million, depending on the pace of deals and share repurchase activity. As I said earlier, we continue to target a leverage ratio of 3.5x.

Finally, I would plan for tax rate of roughly 34% to 35%, assuming Congress does not help us. And I expect share count of roughly 58 million to 59 million shares. Pulling all this together, that allows you to calculate a range of $4.15 to $4.35 per share on a non-GAAP adjusted basis. That range allows for fluctuations within the ranges I provided across the board, which obviously are most pronounced for the U.S. Consumer gross margin rate.

Cash flow will remain a critical part of the story. I would expect us to anniversary and perhaps improve upon the $350 million we reported for 2017. But I don't want to be overly precise on that number right now. Also I believe we can drive a $30 million reduction in working capital in our U.S. business. That would require us to repeat and even improve upon the working capital gains we achieved in our U.S. business in 2017. And I'm confident that the team is up to the challenge.

Jim outlined his philosophy earlier about translating the mid-single-digit growth rate into a double-digit shareholder return. This guidance falls right in line with that view. The midpoint of our non-GAAP EPS range would be an 8% increase year-over-year. The high end would be 11%. If you assume a dividend yield of 2%, then we once again would achieve that target.

I know that issues beyond our control could disrupt that rhythm in any given year. But as we look ahead, I share Jim's optimism that we can continue to drive double-digit shareholder returns by continuing to execute against the plans. Overall, I'm pleased with the results we announced today, and I'm optimistic about our ability to achieve the guidance that I just outlined.

So with that, let's open the call for your questions. Thank you.

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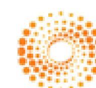

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll go first to Jon Andersen, William Blair.

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

I wanted to ask about the mass channel, given you're really expecting, I guess, not much more out of that channel in '18 than you experienced in '17. I mean, how would you characterize the performance of the lawn and garden category in aggregate in the mass channel this year positive or negative relative to the broader market? And this merchandising strategy change that they're implementing, if it's not a winning proposition from share perspective, why do you anticipate that, that would -- that strategy would persist and they would lean into Tier 2 and Tier 3 brands instead of your own?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Sure, John. This is Randy, why don't I start? And then I imagine Jim will want to add some color. But when we look at the mass strategy at this point, it was a bit different. It was focused much more on private label, much more on cash flow, getting into the season later to focus on cash flow, getting out a bit earlier. So the story hasn't changed from many months ago. But I think each retailer in any particularly year has a strategy that they're focused on executing in mass. I think our largest retailer was probably pleased with results this year. I would say compared to the rest of the category, the results lagged. But again, I don't think that was top of mind and the key goal where the mass channel retailer is going into 2017.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

I'm not sure I have much to add. I would basically say I don't agree with the approach. I don't think it will work. But they didn't ask me. And I think to some extent, it reflects who their customers are. And I don't see that being repeated at our other retailers. So I think if you just ask, "Are they losing market share in lawn and garden?" I think the answer is, "Hell, yes, they are." But again, they have their strategy. And I think Mike and my point of view on this is we'll offer the best products that we can offer them and ones that fit for their customer. So I think there's really a lot more exciting stuff for us at other channels of trade that's really exciting and new and is moving people upmarket. But we're going to continue to support mass enthusiastically and just be the best partner we can be to those guys. But if you ask me to agree with it, the answer is I don't. If you ask me if I think it's working, I don't think the data shows that. But we'll -- Mike's voice is terrible right now. He's been drinking honey-fied tea. But Mike, anything you'd add to...

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

No, Jim, (inaudible). So I'm sorry, they're for covering for me.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

But anything you'd add, Mike?

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

No, I think we participate with customer strategies, and we'll support whatever they're trying to do.

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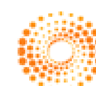

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Jon Robert Andersen - *William Blair & Company L.L.C., Research Division - Partner*

The follow-up is not for Mike. Well, just a quick one. So based on the guidance for '18, it seems like you're looking for about 10%, again low double-digit growth, out of hydro or Hawthorne. But you grew 2x at this year. You grew, I think, north of 3x at pro forma in the fourth quarter. Has there been some -- is this just conservative planning assumptions? Has there been some pull-forward this year or this latest quarter that we should consider? Any comment there would be helpful.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Sure, this is Randy. Yes, actually no pull-forward at all. I do think we point out over the year that the sales do come in lumpy quarter-to-quarter. But I'd characterize it as hopefully just conservative planning at this point. There's nothing fundamentally changing and nothing going on in the marketplace that make us feel like there's...

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Yes, I wouldn't say because I know that the Hawthorne people are on the call. I would say our expectations are the same as they were last year. And do I think that our numbers -- look, Randy and I have been pretty clear to the operating businesses not to overpromise in the budgeting process. It's too hard on the company in the second half of the year. And so I think we're not overpromising to you guys. I do think like we talked about at the investor conference last year in regard to Q1, I don't think we're seeing different things this year. California is in the middle of sort of implementing new changes to the rules in regard to Adult Use. And I think that you're seeing professional growers holding fire until they understand what the rules are in regard to rec in California and its America's largest market. So I think we're seeing some instability in regard to changes to or unknown changes to California rules that actually are good. Remember, this is a major expansion of the market in California. So it's good news. But people need to understand what the rules are and make sure that they don't get crossways with that. So do I think the numbers are conservative? Yes. Our expectations haven't changed in regard to Hawthorne is what we said to you, which is numbers below 15% we would view as discouraging. And the lumpiness to the market shouldn't confuse people. California is really good news, not bad news. But the rules are out like January 1. So I think it's adding to a little bit of just market fluctuation.

Operator

We'll take our next question from William Reuter with Bank of America Merrill Lynch.

William Michael Reuter - *BofA Merrill Lynch, Research Division - MD*

My question is around pricing. Given you guys are seeing some increased commodity prices and you guys have strong brands that are tops in many other categories, I guess, why are you guys making the decision that as a group, your products should be neutral? And I guess I assume that there are certain ones where you have increased some prices.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Yes. So we really covered this quite a bit last quarter when we talked about mulch. So we took a price increase in mulch for 2017. We lost some volume. Our margin dollars ended up pretty much neutral. So in an effort just to drive more footsteps, partnered with one of the retailers in particular, we expect to reverse that plan in 2018. So it's having an impact to offset small increases in other brands. There's nothing dramatic. So we think we're in a pretty good place. We've improved our margin rate quite a bit the last couple of years. And being down in 2018, it's not a reflection of pricing, it's just a reflection of decisions we're making around how we're going to manage the cash flow as well as just the impact of the trade programs year-over-year.

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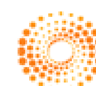

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William Michael Reuter - *BofA Merrill Lynch, Research Division - MD*

Okay. And then just one follow-up. In terms of your innovation pipeline, you've mentioned that you feel it's strong this year. Can you talk about how the pipeline this year compares to last year, when a couple of the products you guys rolled out you felt pretty happy with?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

So the largest launch we had in '17 was under the Roundup selected brand. So Roundup For Lawns, it reached first year sales of almost $40 million. So we had high expectations for that. And I'd say it almost got there $40 million a year in a first year product is really terrific performance. So next year, there's a couple other new products coming out. I don't want to be too specific about what they're focused on. But we expect continued performance under that Roundup flagship brand. And in addition, we have some other interesting introductions in related categories that will be new to marketplace next year.

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

Yes, I would say that -- in total, the portfolio is almost twice as strong as what we launched this year.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Could you hear what he said?

William Michael Reuter - *BofA Merrill Lynch, Research Division - MD*

I could, barely.

Operator

And we'll take our next question from Jason Gere, KeyBanc Capital Markets.

Jason Matthew Gere - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

So I'm going to go with the housekeeping question first. I guess when you think about the EPS guidance, and I know that with the exits, you had the $0.15 of dilution. When you think about the guidance for next year, has everything, all the offsets in there, has anything changed there, so maybe you didn't offset all of that $0.15? Or is that included in there? Just wanted to be clear on that.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

So yes, our guidance next year is apples-to-apples, so...

Jason Matthew Gere - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

But I know you're talking about like the buybacks and the level of buybacks and in terms of, I think, there were other factors in there that you were pretty confident you could offset that $0.15 dilution. I just want to make sure that, that's still the case. Or did anything change there?

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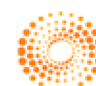

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Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Again, there's a lot of moving pieces. But we just want to focus on share repurchases. We expect that number next year to be equivalent to the $0.15 that we are taking out of our P&L related to Europe and Australia. And we have acquisitions as well. So nothing has changed in that story. It's just now we're clearing it up and it's apples-to-apples and hopefully a lot easier for everybody to follow the numbers now.

Jason Matthew Gere - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Okay. And then I guess the other question I was going to ask, when you think about the consumer business, the 0% to 2%, and there's certainly a lot of volatility there, can you just talk about what you're seeing or what you're hearing? I mean, over the last 6 months, we've seen a lot of catastrophes, whether it's hurricanes, wildfires in California. And the impact that maybe, is there any like boost that you might see this year in terms of some of the states that have been affected, whether it's Florida, Texas, California? Anything regarding -- that gives you a little bit more optimism that you might see a little bit more execution there from consumers to kind of rebuild their lawns, et cetera? Just wondering if there's anything kind of built into there or anything that you're seeing or any type of rhetoric.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Sure. We're trying to quantify the impact in both the Houston area and Florida. So the work we've done to date is we've probably missed out on just a few million dollars of POS during that period of time. So there will be a little bit of an impact year-over-year as consumers reengage but nothing dramatic that would require us to change our guidance or our outlook for next year.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Look, I'll just throw in there that Randy and I really pushed down the 0% to 2% to the operating unit. I think if Mike was croaking out loud and this was a private debate internally, I think he'd say, "I can do better than that." And I think Randy and I hope that, that's true. And so we have sort of thrown down on this issue of 0% to 2%. So I wouldn't take -- like I wouldn't get crazy over the fact that, that's what we're pushing out to you guys. I would say we're trying not to overcommit. And I think Mike is okay going along with this. But he'd argue that he could do better than that. And I think that's a good dynamic for us to have internally. What would be a bad dynamic is we overpromise to you and then we don't deliver. And so that involves a lot of gyrations around here when Mike was overoptimistic. And I'm not saying that he is. What I'm saying is if we let that get into our budgeting process, I think that creates a lot of work in the second half of the year, which is kind of painful.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

And a lot of it gets back to just managing for cash flow as well. So what we don't want to do is build a lot of inventory to try to hit a higher number, and then we have to work through that cash flow as well, which just puts more stress on the business in the back half of the year once again. So we're just trying to manage it in a more conservative, thoughtful way. And we can always ramp up production if we need to if planning capacity would be able to do that.

Jason Matthew Gere - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Okay. The last one, I'll just squeeze in. The trade program expense, I'm talking about the reversal here, have you run the sensitivity if you're saying -- I think your guidance is based on that 0% to 2%, what type of sensitivity is there if sales come in better, if you have that year and weather cooperates? Or if we end up seeing that another tough year and issue is still on the mass side? Where does that program expense kind of vary if you do better or worse than kind of within that bracketed 0% to 2%? Is there a huge sensitivity to the gross margin?

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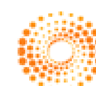

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James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

It's probably more positive than it is negative. I think on the upside, you're not going to see some big surprises. This is a little bit like our own incentive. If you don't make certain numbers, the programs don't pay out. And just like where we've had years where our internal incentive doesn't pay out, the next year, we budgeted it back in, just means that the comparison, I think, looks challenging when the only thing that's really happened is the program worked exactly the way it was supposed to work. Don't make your numbers, and it pays out less or 0. And so I don't think there's much risk on the upside. And there's probably benefit if it was a challenging year. And that's how it's supposed to work.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Yes. And I agree with that.

Operator

We'll go next to Chris Carey, Bank of America.

Christopher Michael Carey - *BofA Merrill Lynch, Research Division - Research Analyst*

So you mentioned you don't really expect mass retail to improve next year, which I guess implies organic sales growth of maybe 3% to 4% in the home and hardware channels next year to hit the midpoint of the U.S. Consumer guide, correct me if I'm wrong. If that's the case, can you just comment on your level of confidence on that acceleration? Obviously, POS was up around that level this year, excluding mulch. And you did note that inventory levels at retail were down going into next year.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Yes. I think you've captured the story, Chris. So starting with stores that look really clean heading into next year and we expect a bounce-back on the mulch business. So that cost us a couple points of growth this year. So that gives us a lot of confidence that we'll see some bounce-back there. And we do see not only the home centers but the hardware channel very engaged, so expect more of the same. And it really just comes down to how mass is going to perform. So our expectation for the next year looks a lot like the way things played out this year at this point.

Christopher Michael Carey - *BofA Merrill Lynch, Research Division - Research Analyst*

Okay. Excluding the mulch impact or normalized for that, I guess?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Somewhere in the middle. We expect a return probably...

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Mulch is additive. And I think a much deeper line of new products for this year is also additive.

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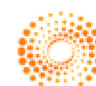

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Christopher Michael Carey - *BofA Merrill Lynch, Research Division - Research Analyst*

Okay. Got it, helpful. And then can you just comment on the Hawthorne operating margins? In the release, you mentioned that there were some planned investments in technology and other support functions. So are you hiring more salespeople to drive demand in that business? Or could you maybe provide some perspective on the amount of corporate allocation that's donated to the unit? Just trying to get a sense of underlying.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Sure. So let me start with the allocation question. There's a few million dollars that are allocated, whether it's technology systems, R&D, some people support services. What we saw in 2017 was a big investment in technology as we put an SAP for all the acquired businesses, so we have a common operating platform going forward, which will help quite a bit. We've had some other investments in other areas. So low double digits is where we landed in '17. And that also reflects some of the deal costs. As we've bought quite a few businesses in the last year, the cost to acquire those businesses are included as well. So when you unwind some of that next year, we get some growth. The acquisitions we've done, while margin-dilutive on the gross margin line, will be accretive on the operating margin line. You add all that up and we should be mid-teens next year. And we still feel really confident that we'll get to a 20%-plus number in the next few years. So no change on outlook for that at all.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Yes, I just want to throw out there in regard to Hawthorne. First, they've outperformed their deal cases, which is to us and the board. They've outperformed their budgets, which are to Mike and myself and Randy. There is at least 300 basis points of improvement on a go-forward basis in the short term. I think we have a lot of opportunity to further integrate these businesses, which they're working on hard. And I think probably as important as all that they've had no major stubbing of toes. And when you put businesses that are as sort of disparate as some of these hydro businesses onto systems like SAP, which I think is kind of big boy work, that hasn't screwed them up either. Has there been some expenses to make sure that they don't fall down, whether it's the work of putting them on the systems and help on the sort of side of the bandwidth support, I think as we call it inside? The answer is yes. But it's important that we made these investments and these businesses are outperforming deal case and budget and have not had any major integration issue so far. So I think we're really pleased with how that's going. And so a lot of those expenses are onetime and there's a lot of opportunity on a go-forward basis to further integrate those businesses and take expense out.

Operator

We'll go next to Bill Chappell with SunTrust.

William Bates Chappell - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Actually, just going back to the mass channel, I'm trying to understand your forecast of it even being flat next year. Because when we go back 5, 6 years, I don't ever remember the mass channel being a helper or a contributor to growth. And I'm pretty sure we started this time last year thinking it was going to be flattish as well and it was down double digits. So what gives you confidence you can even hold it flat if, as you said, Walmart was happy with their season, they're leaning more into lower brands? Why shouldn't it be down double digits again next year?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

So maybe our guidance wasn't clear enough related to mass. But we are expecting sales to be down again next year with offsets with home centers and hardware. So that is our expectation. And what we've seen over, call it, 8 to 10 years, there have been years where we've seen growth. It's been a slow, steady decline if you were going to draw a straight line. But if you look at it year-over-year, it's not been continuous and it hasn't been consistent over time. But what we're planning for next year is a slight decline again for 2018.

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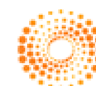

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William Bates Chappell - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

But not necessarily double digits, just a slight decline?

Michael C. Lukemire - *The Scotts Miracle-Gro Company - President and COO*

No. Because one of the declines is deloading and getting out of the season early. So that won't repeat itself, so...

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Did you copy that?

William Bates Chappell - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Yes, I did actually get that, yes. As a second, just trying to understand pricing. I mean, Randy, I think you had said in the past that the goal going forward is hopefully to do some pricing every year going forward. But you're talking about higher commodity costs offsetting gross margins, which I guess is not being offset by pricing. And didn't know if you look back if any of the weakness in volume had to do with you taking price and if that's holding you back from taking meaningful price going forward.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

So the one place where I'd make a direct connection to volume loss and pricing would just be on mulch. Aside from that, I'd say no. And the last -- we should probably update this analysis. But I think with 8 of the last 10 years we've gone back and look, we've taken net positive pricing. And I think the last year when we were flat was 2015, which is similar to what we expect for '18, we did take pricing in a few places. And in that year, we took Ortho down a bit, ended up about flat. So it's similar to 2015 and we had a good year that year as well. So we've been able to improve our EPS every year since 2012. We expect to continue more the same next year, even with just taking a brief hiatus on pricing for 1 year.

William Bates Chappell - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

So you will be taking a hiatus on pricing this next year. Is that right?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Well, hiatus meaning it's going to be about neutral overall but increases in some places and mulch being the first place to decrease for 2018.

Operator

We'll go next to Joe Altobello with Raymond James.

Krystyna Metcalf

And this is Krystyna on for Joe. I wanted to ask about your guidance for gross margin. I believe last call, you said that you expected it to be about flattish. I'm just wondering what changed. Was it just largely the trade expense program?

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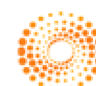

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Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

So a couple of things. One, it's largely the trade program expense. So we did see further reduction in sales in the fourth quarter for our U.S. business year-over-year. So related to that, we did see lower trade expense. And as that reverses next year, it just creates a bigger year-over-year headwind. And the other pieces, as we look more into our playing around inventory and leveraging fixed cost, as we're driving for cash flow, we're not expecting to see any kind of benefit from fixed cost absorption next year. And that's been an evolution over the last quarter since we last talked to everybody on the earnings call. That's a little bit more reason for why our gross margin guidance is a bit more conservative than what we were thinking a few months ago.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

Look, what I would just add in that context, which I think is important for people to sort of understand, is that through discussions with our retail partners, and this gets back to programs and decisions that were made both with us and with our partners, there was a purposeful decision to reduce inventories and at the expense of our sales. And that was not one that was made unilaterally. That was a decision that we made that said, "We're not going to chase in the fourth quarter, especially when programs were sort of helping us on that." And I think the benefit going into 2018 season is that our inventories have not been this clean in a long time. And that's not to say they were high before. But they are sort of exceptionally low at this point. And I think we're pretty happy with that and so are our retail partners. So that was a purposeful decision that I think actually benefits next year. And I think it was adult decision-making at both sides of the equation with our retailers and ourselves.

Krystyna Metcalf

Great. And then can you just talk about any additional M&A opportunities that you see for Hawthorne?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

Sure. Consistent with what we've done over the last 2 or 3 years, we have a pipeline where we have a lot of ideas. We have conversations pretty frequently either directly with the Hawthorne team or with our M&A staff here in Ohio. So I'd say we're continuing to look at a lot of ideas. And on a go-forward basis, as we do long-term planning, we're expecting to continue to do acquisitions in the range of $50 million to $75 million to $100 million a year. So that's on just a year-to-year basis for 3- to 5-year planning outlook. So I'd say more to come.

Operator

And we'll take our final question from David Stratton, Great Lakes Review.

David Michael Stratton - *Great Lakes Review - Research Analyst*

A follow-up to the previous question on M&A, how do you reconcile that with -- you said you're close to the end of the M&A process. Is that regarding to a culmination in the Hawthorne business? Am I thinking about that clearly? Is there something that delineates how you're responding to the last question versus the end of the process you mentioned earlier?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - CFO and EVP*

I think when we say the end of the process, there's never an absolute 0. So we're going to continue to look for ideas. And if there's good businesses out there that have a good strategic fit and they are priced right and they make sense and we can integrate and optimize and create a lot of value, we're going to do those every time. I think when you think about large deals, we've worked through a big pipeline of portfolio changes over the last few years. So we think that's largely come to an end. But again, I would never say never. And if there are good ideas out there and we can get deals done at the right price, we'll do that.

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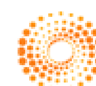

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James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman and CEO*

But I would just maybe just add a little bit to that, which is that I do think in that sort of $50 million to $100 million per year, we view that as kind of tactical filling in. I think what we're saying is that strategic acquisitions, while we're not done yet, we're getting close to being done. And I think we were pretty clear on where those areas of interest lie. And that would be sort of specialty live goods and Hawthorne. And that's where our interest lies. But I think that discussions we're in, we're in. And then we will quickly this year move in, to my view, into that area of just tactical part that Randy was talking of as kind of filling in and looking for opportunities that make sense.

Operator

At this time, I'd like to turn it back to our presenters for closing remarks.

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

All right. Thanks, Kayla. Thanks, everybody, for joining us this morning. If there are issues that we did not get to, feel free to call me directly. (937) 578-5622 is the way to reach me, if you don't have the number. And as I said earlier, Randy and I will be in New York on December 5 for the KeyBanc event as well. I would check with Jason's organization if you want to see us at that event. I think that's mostly going to be comprised of one-on-one meeting. Anyway, thanks everybody, for joining us. And our next public communication will be at the end of January, when we report our Q1 results. Have a great day.

Operator

That concludes today's conference. We thank you for your participation. You may now disconnect.

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