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SMG - Q4 2015 Scotts Miracle-Gro Co Earnings Call

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OVERVIEW:

Co. reported 4Q15 GAAP loss of $23.6m or $0.38 per share. Expects 2016 sales growth to be 4-5% and adjusted EPS to be $3.75-3.95.

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PRESENTATION

Operator

Good day, and welcome everyone to the Scotts Miracle-Gro Q4 earnings conference call.

Today's call is being recorded.

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

Jim King - *Scotts Miracle-Gro Company - SVP & CCO*

Thank you, Cecelia. Good morning, everyone and thank you for joining the Scotts Miracle-Gro year-end conference call.

With me here in Marysville are Jim Hagedorn, our Chairman and CEO; Randy Coleman, our CFO; Mike Lukemire, our Chief Operating Officer; and several other members of the Management team. In a moment, Jim will share his thoughts about our 2015 results, as well as some of the headlines entering our upcoming Analyst Day in New York. And Randy will cover the fourth quarter and full-year financials, as well as provide a more detailed look at the 2016 guidance that we outlined in this morning's press release. After our prepared remarks, we will take your questions.

As I just referenced, we're hosting an Analyst and Investor Day event on December 10, at the Grand Hyatt hotel in New York. We expect the presentation portion of that meeting to begin at 9 AM. We will work though the morning and then hold a Q&A session, as well as a lunch with the entire Management team.

We're still working on some of the details and will communicate more to you in the weeks ahead. If you are interested in attending the meeting, you can register by visiting our IR website, investor.scotts.com, or by calling our Investor Relations department at 937-578-5968.

Given the proximity of our Analyst Day meeting to today's call, our intent this morning is to not provided a great deal of color on our 2016 operating plans, and we ask that you keep that in mind during the Q&A session. In the interest of time, we also ask that you limit your time to one question and to one follow up.

With that, lets move on to today's call. I want to remind everyone that our comments this morning will contain forward-looking statements and as such, actual results may differ materially. Due to that risk, Scotts Miracle-Gro encourages investors to review the risk factors outlined in our Form 10-K, which is filed with the Securities and Exchange Commission. As a final reminder, this call is being recorded and an archived version of the call will be available on the Investor Relations website.

With that, let me turn the call over to Jim Hagedorn to discuss our performance.

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

Thank you, Jim. Good morning, everyone.

We will keep our comments brief this morning, given the fact we have our Analyst Day meeting in just five weeks. I want to spend a few minutes sharing my thoughts about our strong performance in FY15, and then outline what you should expect to hear from us next month. At the offset, I should state the obvious. FY15 was the best year we've had in a long time. So I need to start by congratulating Mike Lukemire and his Operating team.

As an aviator and a CEO, I can tell you the same basic rule applies to being in charge of a cockpit as it does to being in charge of a business. That rule? No drama. When things get hairy, and they sometimes do, stay calm and execute the plan. That's what Mike and his team did this year.

The season got off to a slow start because of the long winter and then was negatively impacted by harsh weather in May that caused a decline in our Lawns business. The challenge we had with our Bonus S product also rose to the surface at the same time. While those issues posed serious challenges, there was no drama. And the professional handling of the season allowed us to deliver strong outcome that you are seeing today. I don't want to thank just Mike and his team, but all of our associates around the world for their dedication and staying focused until the last day of the year.

At the beginning of the 2015 lawn garden season, we told you the macro environment was the best we've seen in years. We expected to see benefit from a healthier consumer, increased retailer engagement in all channels, and a favorable commodity environment. And indeed, all of those factors played into the successful outcome that we are reporting today.

I'd also say that 2015 was one of the most productive years we've had in a long time. We launched three new advertising campaigns to support our Miracle-Gro, Ortho and TOMCAT brands. We launched two new and successful products, Nature's Care and Scotts Outdoor Cleaner. We completed eight acquisitions, including the purchase of General Hydroponics, the largest acquisition we've made since the late 1990s.

We successfully renegotiated our Roundup agency agreement with Monsanto, which gave us increased financial security, as well as new opportunities to drive future growth. We increased our quarterly dividend, continuing to make good on our commitment to return cash to shareholders. And in recent weeks, we issued new public debt and put a new credit facility in place, two moves that will help facilitate our plans going forward.

As you know, we also made additional reductions to our Executive ranks during the year. I've said in the past that these changes have improved our decision-making processes, but I don't want this to be a throwaway comment because of the impact that these changes, they have been profound. I now have only six direct reports, so having the right chemistry within this group is critical. And I can tell you with certainty that the chemistry right now is not just improved from the past, but perhaps, as good as it has ever been.

The way the team is working together is extremely productive. Whether it's related to day-to-day operations of the business, managing our business portfolio, or making decisions and recommendations around our people and human capital strategy, the trust, collaboration and comradery demonstrated by this team is setting an example for the entire Corporation. I truly believe the cohesion of this team will be a critical factor not just in 2016, but in executing the longer-term plans we will share with you next month. I especially want to thank Mike for his leadership in allowing that to happen. More than any Chief Operator I can recall, he understands that his success requires the support of the entire Corporate team. That has fostered a culture that is the most positive and energetic I have seen around here in a long time.

Getting back to our results, the 6% full-year sales growth we announced today was higher than our original guidance, and at the high end of the revised guidance we provided during our last call. Randy will break down the sales numbers in more detail, but the most important takeaway is that North American core had organic growth of 5% for the year. Remember, there's no pricing in that number, so that level of volume increase is the best we've seen in five years. Consumer purchases at our largest retailers, as measured by point-of-sale data, were up only 1% for the year, but that number is misleading. Ortho Insect was up 6%, Roundup up 3%, grow media up 4%, mulch up 10%, TOMCAT up 29%.

Nature's Care delivered more than $35 million in sales in its first year and doubled the size of our Organic business. You should expect to see even more focus on natural and organic products in the future, as we see consumer demand in lawn and garden finally catching up to what we have seen in other product category for the last few years. Our partnership with Church & Dwight has also paid off with the launch of Scott's Outdoor Cleaner. First year sales of roughly $8 million were in line with our goals. We should do even better in 2016, as we see the benefit of broader retail distribution.

The only weakness in the United States was our Lawns business. Consumer purchases of lawn fertilizer, our highest margin product, were down 8% and grass seed purchases were down 5%. Three things are worth pointing out here. First, the POS data does not include the independent channel, and we know that fertilizer shipments to those retailers were extremely strong in 2015. Second, when we look at the timing of declines in consumer purchases from those retailers where do collect POS data, it's pretty clear to us that the weather was the overwhelming culprit.

And third, consumer purchases of fertilizer and grass seed has been rebounding nicely as of late. POS of fertilizer units was up mid-single digits in the Midwest and Northeast in October, the two regions where the fall lawn care is most prevalent. In those same regions, grass seed purchases are up more than 40% in October, with strong results throughout the entire country.

Retailer support in all categories of Lawn and Garden were strong throughout the year. Home centers had another solid year, and we are extremely pleased with the strong bounce back in mass retail, where consumer purchases were up 8% year-over-year. Retailers in this channel were engaged throughout the year and are optimistic, as are we, about the upcoming season. In addition to solid volume growth, we continue to benefit from our recent acquisitions, and the integration of those deals continues to go well.

We are particularly encouraged by what we are seeing in General Hydroponics. Sales and profit for that business, which is part of Hawthorne Gardening Company, actually finished the year ahead of our expectations, and our plans for 2016 indicate continued above-average growth in this business.

Switching gears, we also had a solid year in our international business. Top-line growth was in line with what we expected, and the business continued to benefit from our previous restructuring efforts. Scotts LawnService had an outstanding year, with sales up 10%, driven primarily by higher year-over-year customer counts. Retention rates remains strong, as did customer satisfaction scores. All of this allowed SLS to report record operating profit for the year.

Expense control was strong in all areas of the business. Full-year SG&A increase of 3% included the impact of acquisitions. Excluding that impact, SG&A on a year-over-year basis was essentially flat. All this adds up to adjusted EPS of $3.53 a share, which is on the high end of our original guidance, and included a target payout for variable compensation. It also included a negative $0.04 per share impact from foreign exchange rates, and a $0.04 negative impact for mark-to-market on our 16 fuel hedges.

As I said earlier, I feel extremely confident about the state of the business right now. Over the course of this entire year, my team and I have been involved in wide-ranging discussions about the next steps in our strategy, and about what we want this company to look like five years from now. The outcome of those discussions will be the focus of our agenda with you next month in New York. I'll just say that across the board, the team sees the FY16has a significant inflection point as our Company moves forward.

I don't want to share too many details with you this morning, but during our Analyst Day meeting, we expect to outline a series of initiatives that we will execute over the next several years. Specifically, you will hear us address these three goals: First, of course, our goal is to continue investing in the North American consumer business to ensure its success for the next generation of leaders. Whether in traditional channels or emerging once, our business is changing. Organics will be more important. Hydroponics will be more important. Growing vegetables and succulents will be more important, and water conservation issues will be more important. Getting it right in each one of those categories today will be critical to the overall success of the business tomorrow.

Our second goal is to maximize the value of every asset we have. As I said earlier, Scotts LawnService just had a record year and our international consumer business is making steady progress in a challenging environment, but what comes next? What's the best way for these businesses to drive shareholder value? We will address that.

The third goal we will discuss is how to further enhance shareholder value with a capital allocation strategy that returns meaningful cash to shareholders. The meeting on December 10 will not be a routine presentation. We intend to have a detailed discussion about where we are headed and how we intend to get there, and what we expect the outcome to be for our shareholders.

This is a really exciting time in this business. I am convinced that Lawn and Garden remains a strong and relevant category, but it's up to us to take advantage of the opportunities that are out there. The plan we will share has been developed by this team, with input from our Board, from our banking partners, as well as other outside advisors. While I might not be objective, I will tell you it's a really good plan. I believe anyone interested in our story will also find it to be a compelling discussion and definitely worth a few hours of your time and attention. I hope to see as many of you there in person as possible, and I look forward to that discussion.

With that, let me turn things over to Randy.

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

Thank you, Jim. And hello again to everyone. I also intend to be pretty brief this morning. I will touch on a few highlights from our Q4 results, but won't get into too many details, as much of this has been covered in previous calls in FY15. Instead, I will focus my time and discussion on our outlook for 2016.

Jim said in his remarks that 2015 was the best year we've had an a long time, and I could not agree more. As you can see in the press release, company-wide sales in the quarter and for the year were both up 6%. For the quarter, volume was up 2%, acquisitions added 7%, and foreign exchange was a negative 3%. On a full-year basis, volume was up 4%, acquisitions added 5%, and foreign exchange had a negative impact of 3%. Like Jim, I am extremely encouraged by the strength we saw in our Global Consumer segment.

In the US, sales were up 7% in Q4, and 8% for the year. Outside of the US, sales were up 12% in the quarter, and 14% for the year, when excluding FX. Including the impact of currency, sales declined 4% in the quarter and 1% for the full year. Scotts LawnService was up 13% in Q4 and 10% for the year.

The only disappointment on the P&L this year was on the gross margin line, so I began signaling back in May that product mix could be a challenge. With the declines we saw in fertilizer and the strength in mulch, we simply cannot get back to last year's gross margin rate, which was our original goal. Although the rate was up a 140 basis points on an adjusted basis in the quarter, we were down 70 basis points for the full year.

For a variety of reasons, we expect the gross margin rate to be up again next year. I will get to that in a few minutes. Jim already discussed the great work done throughout the Company on SG&A, so I won't be redundant.

Moving on, interest expense was $11.5 million in the quarter and $50.5 million for the year. Both the quarter and full year numbers were about $3 million higher than a year ago, as a result of higher borrowings related to acquisitions we made during the year. Interest expense for 2016 is the biggest area where we are seeing a disconnect right now between our plans for next year and many of the models published on first call. So I will provide more clarity in a moment.

On the bottom line, in the fourth quarter we reported an adjusted loss attributable to controlling interest and continuing operations of $7.4 million, or $0.12 per share. That compares to an adjusted loss of $10.8 million, or $0.18 per share for the same period last year.

On a GAAP basis, the loss was $23.6 million, or $0.38 per share. That number includes another $24 million in charges associated with our Bonus S recall and consumer remediation efforts. The loss on a GAAP basis in the fourth quarter last year was $14.9 million, or $0.24 per share. On a full year basis, our adjusted net income attributable to controlling interest in continuing operations was $219.3 million, or $3.53 per share. That compares with $206.3 million or $3.29 per share last year. On a GAAP basis, full year earnings were $159.8 million, or $2.57 per share, compared with $165.7 million, or $2.64 per share.

Moving on to the balance sheet, there's not a lot of news, but the one item that stands out is the year-over-year increase of long-term debt of roughly $336 million. Of course the increase is associated with the deals we did during the year and driven primarily by the $300 million we paid to Monsanto in August as part of our revised agreement. Jim mentioned earlier that we just entered into a new credit facility last week, and that we issued new bonds in mid-October. The single most important feature of both of those instruments is the flexibility they give us, moving forward. The covenants in our credit facility enable us to take leverage up to 4.5 times, if needed.

Two things are important to understand. First, that's not our goal. And second, our modeling suggests that it would take major declines in operating income in back-to-back years, excluding one-time issues, to approach those levels. So if that is the case, then why even go there? Starting in 2012, we said we considered our sweet spot for leverage to be 2 to 2.5 times debt to EBITDA.

Earlier this year, you heard me say that I was comfortable with a leverage ratio in a range of 2 to 3 times. Now that I've been in this role for nearly a year and a half, I've concluded that we can leverage the balance sheet even a little bit more. In fact, I'm comfortable if we live in a range of 2.5 times to 3.5 times leverage, and obviously our banks are too. Our previous credit facility did not give us the kind of cushion I thought was necessary, so we did two things.

First, as I said, we can now take leverage to 4.5 times, and that's a half turn higher than the previous facility. And second, the leverage calculation in the new facility now excludes one-time items like product recalls or legal settlements from our adjusted EBITDA. This is also a change. Based on a four quarter average, that calculation gets us to a leverage ratio of 2.6 times at end of the fourth quarter.

On previous calls, I told you we expect to finish the year just about three times. Because the revised calculation of adjusted EBITDA now excludes the impact of the Bonus S charges, the leverage ratio comes down a bit at the end of FY15. The other important feature of the new facility is that there are no restrictions on uses of cash, as long as we stable up four times.

Our Treasury group did a good job putting this together, and I want to thank our team, as well as our banks. These refinements, as well as a $400 million tranche of new bonds we just issued give me a great deal of confidence that the capital structure we have in place is more than adequate to serve our needs for the next several years.

With that, let me switch gears here and focus on our guidance for FY16. Before I do, let me provide the proper context. Jim has told you in the past and again today that we expect to see more activity from a M&A perspective. Activities we are contemplating will likely require us to adjust our guidance later in the year. I plan to provide a little more clarity on that front next month, but my goal today is to get everyone to the right starting point.

In the press release, we outlined our goal to grow the top line 4% to 5%, and reported adjusted earnings per share between $3.75 and $3.95. Let me explain how we get there. On the top line, it's pretty simple. We expect acquisitions to add about 2.5 points of growth. We expect pricing to contribute another point. We expect unit volume to be up 1% to 2%.

On units, I know many of you see that number to be conservative, based on our 2015 results, and I hope you are right. But if we look at a five-year trend, taking this conservative approach makes more sense to us, as it's easier for us to ramp up to meet unexpected demand than it is to gear down.

The real story driving the earnings improvement next year will be in gross margins. We expect gross margin rate to improve 100 to 150 basis points. We will provide more clarity on this next month as well, but basically we see favorability with commodities and pricing, as well as the benefit of the revised Roundup agency agreement.

Going into the year, we're expecting product mix to be neutral. As we've seen in each of the past two years, mix has been the wild card. So I don't want to be more precise right now on further potential margin rate upside. We also see partially offsetting headwinds from higher input costs on certain new products and slightly higher compensation-related costs for supply chain associates. Given the flow of the business, I doubt we will provide any updates in gross margins until May, just like we did this year.

SG&A will likely track the higher end of our sales growth outlook, driven by acquisitions and increased brand support. We also weather higher variable composition expense, if we hit the high end of our earnings guidance. So expect operating income growth next year to be extremely strong, likely up in the range of 12% to 16%.

The biggest year-over-year difference on the P&L will be interest expense. Right now, we are seeing interest being up roughly $18 million to $20 million. This is based on the deals we have done to date. This assumes we'll be calling a $200 million tranche bonds when we have the opportunity to do so next month.

We're also assuming no share repurchases, so the share count will be close to $63 million, maybe a little bit less. Tax rate should be 35.5%. That gets you to a range of $3.75 to $3.95 per share, on an adjusted basis. Right now, we expect Bonus S issues will continue to impact our reported results, but most of that impact should be from recouping money from our insurance providers. Our current guidance does not reflect any major restructuring costs for next year.

When we meet next month, I'll provide more details, especially around the gross margin rate. By then, I would expect us to have more than two-thirds of our key commodities locked for 2016. I will wrap up, echoing the comments that Jim made. I really like where the business is right now. The macro environment remains favorable. We have better visibility into the day-to-day issues that affect us.

The team's operating better than at any time in my 16 years here at Scotts. And the plan we are executing, I am convinced is designed to fully leverage our strengths and maximize shareholder value.

All of us look forward to seeing you in December. Like Jim, I believe the story we will be sharing next month is an extremely compelling one, and I would encourage you to plan to spend the morning with us in New York. I hope to see you there.

With that, I'll turn the call back over to the operator to take your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Bill Chappell, SunTrust.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Good morning, thank you.

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

Hey, Bill.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Want to touch a little bit both on looking back and on the guidance and specifically on lawn fertilizer growth or decline. For the guidance next year, you were talking about a neutral mix, which would imply the other businesses grow faster than your highest margin business, the lawn fertilizer.

Is that just trying to take a line of conservatism? Are you looking at listings next year? Have you lost any share? Is there anything I'm missing as I'm looking at that?

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

No, I don't think you missing. I think there is times when you guys feel like we are sand bagging you. This is one time I think the North American business is sand bagging me. We've spent quite a bit of time on this yesterday, as a matter of fact, as we prepped for the call.

I think, overall, what's in the budget -- and this is not what I expect to happen -- but it's what's in the budget, is pretty much up a little bit but not recovering the decline. I think that's conservatism, that's what I would call it. I think it's probably upside, we hope it is. The fall business looks pretty good right now.

I think we are pretty satisfied that we understand that this sort of second half of the season in California hurt us, the late start in the Midwest and Northeast, and the rain in Texas definitely hurt the business. We are seeing normal business now in our fall markets.

I think it's probably -- there's some upside there, Bill, but I think it's one of those things where the numbers have come together really well without completely torturing the group. I was more or less happy to view it as conservatism in the budget that should allow us to get to the upper end of that, if everything goes well.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay, that's what I figured. Just wanted to check. The other question, looking at the channels, again on a look back, the past few years, the DIY channel has held in there okay, but the mass channel has really been the thorn in your side. It seems like it's gotten better this past year, but maybe you can give us a state of where we are on the mass channel, and how that looks going into 2016?

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

I would say it doesn't seem to be better. It is better. I think whether it's the attitude of the mass channel or the relationship with the Merchant team, all the way up to the most senior levels, I think it's back in the game is what I would say.

Bill Chappell - *SunTrust Robinson Humphrey - Analyst*

Okay, great. Thank you.

Operator

Our next question comes from Jeff Zekauskas of JPMorgan.

Ben Richardson - *JPMorgan - Analyst*

This is Ben Richardson, sitting in for Jeff.

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

Hey, Ben.

Ben Richardson - *JPMorgan - Analyst*

On the projected gross margin improvement for next year, what are the biggest movers there, in terms of raw materials or fuel, or the rest?

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

Ben, this is Randy Coleman. The biggest impact is largely pricing. So we will have about a point pricing across the business next year. And we will also see about $10 million benefit from commodity costs coming down year-over-year, whether we're talking about urea or fuel. There's some slight offsets in other commodities that -- plus visibility to peat costs or certain grass seed varieties, but we think $10 million is a good number.

And then if you're familiar with the revised agency agreement we have for the Roundup business, that will benefit by about $20 million next year, as well as a year-over-year increase. There are some headwinds to that. People in the plants getting small raises. There's some input costs from new products that we are taking pricing on next year that offset to that. But we feel pretty good about our range right now of 100 to 150 basis points next year as a starting point.

Ben Richardson - *JPMorgan - Analyst*

And one follow up on what you just spoke to. Just the year-over-year, what were the biggest improvements, particularly in Global Consumer, where you have better operating income in this year?

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

So 2015, looking backward, it was really a year of sales growth. We had fairly flat sales over many years, but our US business, up in mid-single digits in 2015, our home centers continue to do well. The mass channel did really well. Outside the big three customers, we saw nice growth from other customers and beyond that. As well as our LawnService business had a record year, and added about a point of overall growth, so--

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

What I would say is other than lawns, we've had a pretty darn good year. The fact that that's just a high-margin business for us sort of screwed our mix up. But this was one of those years where it wasn't just, it's -- TOMCAT again did really well, and that business continues to do well under our stewardship.

The Hawthorne business was well integrated by a really pretty young group who has done a really good job on a fairly complex integration. And the overall consumer businesses, Europe made its numbers. LawnService did great.

It's one of the things where it was a little bit of a hair-raising year. The late spring in the Midwest and Northeast, rain in Texas, drought in the West coast. But in spite of all that, it was fairly drama-free by the end of the year. I think pretty much about everything went as well as it did. You've got to feel a little bit bad for the Lawn team.

I think that part of what the investor community needs to understand is that the lawn business really is almost like a four-leaf business. If any one business gets impacted by a late spring, it's going to be the Lawn's business. Everything else, you've got this long summer, and the weed side, and the control side, the Miracle-Gro businesses. I would call that a short sleeve business. You've got a lot of time to make up there.

Lawn at Scotts is really concentrated. And it's not that the South helps very much, because a lot of those lawns come out of dormancy in late March, early April, so the whole season for the entire country is going to happen at one time. I think that is pretty much what happened. It just was a tough early season. But other that, I think everything else went really well.

Ben Richardson - *JPMorgan - Analyst*

Okay. Thank you very much.

Operator

I'll go next to Jason Gere of KeyBanc Capital Markets.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay, thank you. Good morning. I just have one housekeeping, and Jim, one real question. Randy, can you say what the FX impact you are expecting for 2016?

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

For 2016?

Jason Gere - *KeyBanc Capital Markets - Analyst*

I did not hear that. I don't know if you gave it or not.

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

For 2016, we think it's going to be very small. Call it $0.01 or $0.02 on the bottom line. This year, the cost is about $0.04. So really not a big driver overall.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Great. Then the other question, just thinking about acquisitions and obviously with some of the -- lifting leverage, M&A it's going to continue to be a bigger part. Can you talk a little bit about where some of the adjacent acquisitions could come in? What are some of the areas that would make sense within the core business? Obviously, hydroponics was a nice addition.

But one, I was thinking about how else we should be thinking about acquisitions and leveraging the portfolio? And secondly, maybe with some of the past acquisitions, the cross-selling opportunities that you see, whether it's fill-in distribution or really combining products and coming up with new R&D innovation?

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

I think it's a seriously good question. I also think we are seriously going to be as specific as we can. I think that there's a lot of variables between now and next month, but we're going to try to be very clear a month from now, I will call it, when we present.

I'd say if you go back to look at the script, we're saying North America good, Hydro good. We like the idea of products that are not just chemical. We believe water is important, particularly in the West.

I think that this -- we had a Board meeting last week and Jim went from, how are we going to signal (expletive) -- excuse me -- to the street? We went from laying crumbs to, Jim called it, laying croutons. So view this as the croutons, but the real meal is going to be a month from now. I would just say, if you go over and look at the script, I think the croutons are out there. But please just let us present it properly and I think the story will be one that people will appreciate. Anyway, we'll give a real answer in a month.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay. And then if I can throw in one last question? I know this is one you don't get too often, but as the retail environment shifts a lot more to D2C and online, and I know with some of your products it may not make sense to be heavily invested in the online, but I was wondering if maybe you could talk, and again, this may be croutons again for what you talk about next month. But really about the role of the D2C channel as brick-and-mortar really is changing out there, and how you guys can really benefit and tack on to the growth that you've been seeing just in the core channels? I was wondering if you could provide a little bit of croutons at this point? Thank you.

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

You got it. Mike, do you want to talk about it?

Mike Lukemire - *Scotts Miracle-Gro Company - COO*

I think in the D2C, all the retailers are going D2C and we are fully participating with them and so. And then we are also involved with Amazon. It's around 50 million of shipments at this point, and we will continue to explore that and develop that as that moves forward.

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

Remember we have a -- our service business is a direct to consumer business as well.

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

I think it's important. We -- this is one that's going to require a lot of care and coordination with our existing partners, in that the concentration of our business with four accounts in North America is huge. They have their own efforts there, and we want to participate with them. The Amazon business is growing. It's [the law of] small numbers, but growing very rapidly.

Personally I'm an online shopper. And sometimes I do it through one of the existing retailers, and a lot of times I do it with Amazon. I don't think we can act like that's not going to happen or isn't happening in Lawn and Garden. Certain products are a lot easier to ship direct to someone's home than others, but I think it's going to be a more important part of the business. But it's just very important based on our concentration with existing brick and mortar retailers that we have a balanced view, because we do enjoy a very positive relationship that is -- just look at last year's results.

A lot of what we're talking today was in dollars, in units. The volume was really nice this last year. The dollar is a little bit understate, the unit volume increase. What do I think? I think it's the future.

I think we're going to have to participate, and the retailers are going to have to participate. We've just want to do it in a way that doesn't get us into a battle with our really good friends, so that's where we are.

To the extent it's driving us to have to decide something now. Everyone is trying to figure it out, and we are continuing to work with sort of the big dog of the space, Amazon, as well. That's a good relationship, and I think they view you Lawn and Garden as an important category for them as well.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Yes, and I agree with that. And obviously your business is a little bit different than maybe some of the apparel companies out there, where it's obviously a little bit more seamless. But I'm sure next month you will talk more about it, especially in the context. Part of your strategy is getting customers in the store to make those purchases, especially during those weather-impacted seasons and stuff. Obviously this is a very different approach. Maybe it's the panacea to some of those issues out there, but I look forward to hearing more about it next month. Thank you, guys, for answering my questions.

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

You bet, dude.

Operator

We'll go next to Olivia Tong of Bank of America Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Thank you. First on the FY16 sales outlook. Just want to check if there's impact from acquisitions still in there, just from things you've announced or any expectation for acquisitions embedded in that outlook?

And then following up, how do you feel about your inventory levels right now at retail? We've had a couple of shifts through the quarter, and I'm just curious where you stand at this point?

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

Randy is signaling that he wants to deal with you.

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

Hello, Olivia. On your first question about the sales outlook and the impact of acquisitions, it's about 2.5% year-over-year. The biggest pieces of that are the revised agency agreement, which adds about $20 million, and the benefit from the General Hydroponics business. We didn't close on that deal until the end of March. So we pick up $25 million plus for next year on that number.

And then your question about retail inventory. It does bounce around a lot because it's just a point in time. We closed the end of September with retail inventories in the mid-single digits. Because we've had strong POS here in October, I think if we looked at it today, we'd probably would be a little bit behind last year, just because we had really good consumer takeaway. But again, that's not a big story, by any means.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it, got it. And then on Hawthorne, is there anyone else trying to consolidate businesses like you? Are there any other natural acquires for the assets which you have interest in?

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

Let me start with sort of philosophy. I think we are very interested in the category, and we're well capitalized. I think we probably are first-in. I think there's probably some non-strategic financial types that are interested in the space. And part of what Mike and I are concerned about, and we spend quite a bit of time with the Hawthorne folks talking about, is we think it is a pretty interesting category.

It will be interesting to see how Wild reports today, but we see it as a very interesting category that deserves further investment. I think Mike and I, the integration for that team, I think -- if you say that sort of since 2000, this is one of the big acquisitions we've done, the integration on something like that is hard. You're dealing with family businesses. Their accounting is not always as tight as we'd like. Therefore, there's just a lot of work to get everything up to speed and under control the way we want it. They have been successful with that.

Where I'm getting to is, I would say the concern Mike and I have, and this is part of how we've organized the business going forward, we have a completely rebuilt strategic group that includes both M&A and internal consulting. Which means we're running pretty skinny teams, so we are able to add bandwidth internally with good people who probably would've been released from the Company if we hadn't said, why don't we just stop getting consultants. We will do it ourselves. We have the ability to support our strategic initiatives, and I call Hydro one of them, is high. But they have been really head down since the GH acquisition.

Remember that was two companies, because the dirt company was a separate business. It was slightly different ownership. And we have General Hydroponics Europe, another -- so all of this stuff is coming in, plus a whole bunch of brand introductions. Again, I'm not lost here, I'm telling you. The story is that -- the concern we have is that if we don't deal with getting our footprint the way we want it, as quickly as possible, and I mean safely.

I think that you're likely to see an emergence of people who say, Scotts is not the only people with money. And like a willingness to look at a category that's growing above average, maybe a lot above average. Our view is we're well capitalized. We have a strategy. We will talk more about it with you guys in December, but the bottom line is, I don't think anybody waits for us. I think we are likely to see an emergence of more competitors in the space if we don't execute. I don't know, does that answer the question?

Olivia Tong - *BofA Merrill Lynch - Analyst*

It does. Thank you very much. Appreciate it.

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

You bet, Olivia. Thank you.

Operator

Our next call comes from Joe Altobello of Raymond James.

Joe Altobello - *Raymond James & Associates, Inc. - Analyst*

I want to go back to the pricing discussion, get a sense for how those discussions went, since many retailers at least publicly seem to be very resistant to price increases. In fact, some have talked about trying to recoup, using the commodity costs and currency savings. And much visibility do you have into that incremental point? Is there a chance that some of that might get spent back on promotion later this year?

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

First of all, we love promotional support. Promotional support goes together with off-shelf. We like off-shelf. And I don't know what the numbers are today -- Mike might have a better one -- but we probably sell half of our business off-shelf. And these Black Friday events are becoming a big hunk of the business, and they kind of make or break the season in a lot of ways. So I would say that, I think the pricing happens.

I'm not sure what Mike would say about increased -- he can pick it up. If there's an increased promotional activity -- I thought the pricing discussions were pretty good, to be honest. I wanted more from Mike, so he disappointed me a little bit. (laughter) I thought the pricing conversations actually went pretty well.

The only thing that I -- we adjusted Ortho pricing down, based on our view, and it didn't really affect the margins very much. We took cost out of the products where we said the consumers really wanted to pay for XYZ innovation. Where we said, we don't think so, we took some money out of packaging, et cetera, and I think it's been good for the Ortho business.

But that said, I have heard some whingeing from retailers that we took pricing down. So I don't know, it's like you can't have it either way. They don't like it if you take prices up. They don't like it if you take prices down. I'm not sure what to take away from that except to say, we just have to run our business. Mike, what your view of how the pricing went and promotional support behind it?

Mike Lukemire - *Scotts Miracle-Gro Company - COO*

I think the net of the pricing is, we are doing more promotional activity. But it's not the net pricing that Randy is giving you is going to stick, and we work with the retailers on that activity. I don't think -- it's always strange what happens when you're working with the retailers and you're working on maximizing space, maximizing their profitability as well as ours.

Joe Altobello - *Raymond James & Associates, Inc. - Analyst*

So pricing is really independent of the commodity line, is what you are saying?

Mike Lukemire - *Scotts Miracle-Gro Company - COO*

It depends on each category. We have 12 different categories, so we took pricing where we could, where it made sense. And then we do more promotional activity. And we're also doing willing to trade for space and that type of thing. I started with a much higher number. This is a net number based on --

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Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

I will just throw out there that to me, what's clear is gross margin is a major driver for the profitability of the business. And allowing it to decline over time, which I think back in some of the early days made for some difficult conversations with you guys. A lot of questions on our part was, did we really need to do that?

Again, I think we're talking pricing here that's sort of less than what we're going to be paying our folks more. To me, this is one of those things where this is, again, I think pretty marginal pricing increase. But I think if you're dealing with less than one point a year, we would start seeing erosion of margin, and it's just not worth it.

It's so much easier to steward this business when we're maintaining margins. It does good things for our returns on capital. It's just -- I don't think we can afford to be weak on pricing. And to some extent, I think there's a belief. And Randy, again, can speak for himself.

It's a really good question, Joe. Which is, if you look at us compared to our peer group, we pretty substantially below average on gross margin. It's not like we're trying to beat the retailers or beat the consumers. Where we thought we were high priced on Ortho, we took the pricing down. But I think, generally, we do not view a point or two of pricing as ridiculous.

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

Joe, this is Randy, just to throw a little more color. We did not take any net pricing for 2015. As Jim said, Ortho was down. We were up in a couple of other places, but effectively zero for 2015, after taking a point or so of pricing in the two previous years. And because commodities were favorable, we were a little less aggressive than we'd planned. Before we hit the pricing -- I think it's a fair rationale.

I'd also say we feel a capability that's much better than what we were a few years ago. So it's much more analytical, it's not peanut butter based. It's category by category, SKU by SKU. It's not tied necessarily to commodity prices. We're not being greedy, but it's an important part of our toolkit to grow our margin rate year after year. We will see that again in 2016.

Mike Lukemire - *Scotts Miracle-Gro Company - COO*

We'll also key investments back into driving the category, so once we changed the advertising, we actually saw category growth. We need to continue that fuel.

Joe Altobello - *Raymond James & Associates, Inc. - Analyst*

Got it. That's very helpful. And just if I could shift gears on use of the cash this year. You guys mentioned that you're not assuming buybacks in your guidance. You're at the low end of your target leverage ratio or your sweet spot, as you call it. Is that because you are sort of saving the dry powder for potential lemonade this year? If that doesn't materialize, what's the likelihood that we could see a pick up in buybacks towards that second half of the year?

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

How about Randy and I both play with this one? I think that what we're trying to do is provide a standard of guidance. Which in this case does not include repurchasing. That does not mean that we don't plan to. We're trying to set guidance where everybody is talking the same thing.

I think we do view it as relatively low on the leverage scale. We do think that shareholder friendly continues to be important. We'll talk a lot more about this a month from now. But I would not say that it means we will not be shareholder friendly within the fiscal year. I think it just means that for the sake of trying to get everybody on a level playing with guidance, we're saying exclude that.

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

Adding to that, we're trying to establish guidance earlier now that we typically would. Just so come December we'll have more to talk about, so stay tuned.

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

I think this is an important point for the December meeting. Pulling a little bit of guidance forward into this call is trying to free up more time to talk about what I think is a really interesting strategy. And I think the best one we've had since I've been in the Company or maybe since we rolled up Global Lawn and Garden. I think that we are trying to free up some time to stick to a longer, more in-depth conversation about a five-year plan or maybe more. The guidance was an important part of this call.

Joe Altobello - *Raymond James & Associates, Inc. - Analyst*

Okay, I understand. Thank you for that, and I will see you guys next month.

Operator

Our next question comes from Jon Andersen of William Blair.

Jon Andersen - *William Blair & Company - Analyst*

I wanted to start by asking about mulch. When you look at your core North American businesses, I think mulch has probably been the fastest-growing of the businesses over the past few years. So could you talk a little bit more about how big that business is today? Your growth expectations going forward?

Then on the margin side, because it's been affecting the mix in the business, where are you from a margin standpoint in mulch? I know there's been a focus there. What is the ultimate opportunity for margins in that business?

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

Let me just throw out my points of view on it. First, I think mulch is a good and bad story at the Scotts company. It clearly is an important category, and I think it's just a -- if you look at it from a consumer point of view, you do four bags for $10 or whatever they're pushing out on a Black Friday event, five bags for $10. It is a ton of value, because we kind of invented this category of long-lasting color on wood mulch. But you put it down. It makes your garden looks super fine. It makes your home really look fine.

You come home with 20 bags of that stuff, people are going to come up and say, wow, you going to do all of that for $20, and that's kind of the bad part. It's become -- to some extent, we've allowed it to become a pretty serious commodity, but it definitely brings retailers in the store. I've talked to a lot of the Senior Executive teams of the big retailers about it. I've kind of had a point of view going into last year, going into 2015, that said maybe we should support the category less. It's clearly eroding our margins, and it's down to the point of five bags for $10.

But what I saw this year after spending quite a bit of time in retail environments during the peak of the season was how important it is to the consumers' early purchasing. So I don't think it's something we can abandon. I think it's something we've got to make better. I think we continue to look to not take cost out, but to streamline our supply chain on the commodities side. And we've got to get back to a more value-added mulch.

Because while the mulch is good, I can just tell you the stuff that gets delivered to my house, they run it through a grinder like three times. They put extra colorant on it, the product that I get is not the same product that consumers get. The product that I get is going to be sold, I think it is in the Midwest and Northeast, this coming year. I think we're calling it Triple Shred. We're going to look to try to get more value-added back into that category. Not like it's going to be three times expensive, but maybe it's another $1 or $2 per bag, I think it's still really great value. I think that it's one of these categories that it just -- I really was kind of negative on it.

It's not like I don't understand that it's challenging, but I do think that we can add value, and I see the importance to the retailers of an early season Big Bang, Black Friday event like super high value. I think we have to work with it. We've got a fabulous supply chain. We've got great people doing this. But I think we just have to work within this sort of commodity, because it's kind of what it's become. But I don't know, Mike, what you'd add to it.

Mike Lukemire - *Scotts Miracle-Gro Company - COO*

I also think it's, from the supply chain perspective, supportive to our soil business. Ultimately, if you're going to go direct to consumer with that time of activity allows you to build a footprint. So keep in mind that those facilities are multipurpose. It's a freight, and these products working together leads to a better business model overall.

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

Randy, your view on mulch?

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

We talked about it a lot over the last few years, because it's grown from practically zero to $300 million today. So it's about 10% of our business. The margin rates, Jon, are in the low- to mid-teens right now, but if we can get that business to 20% gross margin on an operating margin basis, it's almost equivalent to the Company average. So that's the target we set for ourselves. And through what Mike talked about, as well as vertical integration, supply chain, optimization of our network and some innovation, for example, this Triple Shred product being rolled out next spring, we think we have a clear line of sight to get to that 20%. And then I can stop harassing everybody about mulch around there. (laughter)

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

You know, the Hydro category is growing at that rate. Our TOMCAT business is growing at that rate. It's not maybe the fastest growing, it's for sure one of the fastest growing categories.

Jon Andersen - *William Blair & Company - Analyst*

Okay, that's really helpful. The last is more of an explanation-question around the gap between, I think you cited 5% North America core organic volume growth, or shipments, and 1% POS growth. I understand there were variances in performance by segment within that, but how do you explain the 4% delta between shipments and point of sale?

Mike Lukemire - *Scotts Miracle-Gro Company - COO*

I think it's even worse if you are talking units. Remember, Lawns drove a lot of that and Ortho reduction in price. That was a 2015 issue, also dealt with that. We're talking in dollars. If you're putting that in units, it's more like 8% in unit increase for the year 2015. Normally, we talk dollars with you guys. I think we wanted to stick to a common theme, but you want to get into the 4%?

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

Jon, when we measure POS dollars with the big three, it was up about 1% this year. It's difficult to understand because the actual shipments and the products was higher than that. Our shipments to the customers was higher than that, rather. Our units shipments were about 3% to get to that 1% in dollars. Ex the big three, we had about another point of growth from other customers. And then our retail inventory has been up mid-single digits, added about one point. That's how you get from one to five.

Jon Andersen - *William Blair & Company - Analyst*

Perfect. Thank you.

Operator

We'll go next to William Reuter from Bank of America Merrill Lynch.

William Reuter - *BofA Merrill Lynch - Analyst*

Just with regard to your comments about acquisitions. It sounds like the highest probability is that they would be in adjacent categories. I'm curious whether you guys would ever consider purchasing companies that would be in nonadjacent categories, but might be selling into some of the same customers that you guys currently do?

Mike Lukemire - *Scotts Miracle-Gro Company - COO*

Like what?

William Reuter - *BofA Merrill Lynch - Analyst*

I don't know. That's why I'm asking you. (laughter)

Mike Lukemire - *Scotts Miracle-Gro Company - COO*

I think we're pretty clear on what we think is interesting. I think, generally, we're selling into people who sell into the same channels. The only difference would be the Hydro channel, I think as Jim laid, a distinct channel. So if we have interest in the Hydro channel, a lot of that business is not sold through our conventional retailers today.

William Reuter - *BofA Merrill Lynch - Analyst*

Okay. Yes, I think this is more the context of 2.6 times of leverage and a bank covenant that would allow you to go up 4.5 times. Just wondering whether there are things in which you guys have, when you have a whiteboard up there, thought or imagined this would be something interesting that maybe people haven't thought of as a traditional kind of opportunity for expansion for us that maybe we should be thinking about?

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

I've done that before and lost a couple of hundred million dollars in the process, to be honest. We had a sale acquisition in long-handled tools and failed, meaning it didn't get completed. The Board asked the question, where do we go if there's no big deals in what we consider Lawn and Garden? That's where Smith and Hawking came in, which I still think it could work, but I don't think my team agrees. We exited that business very painfully. I do think that in the areas that we view as adjacencies, there's really a lot of opportunity right now that we are interested in. So we don't think we have to range very far outside of what we think is interesting.

But I think that if you can hang on there until December, I think you'll -- it might actually redefine, because I think what we would say is, does it just have to be lawn and garden chemicals? I think if you basically say, we believe ourselves that -- I'm not going to call it lifestyle, because I don't want to get back into the Smith and Hawking and lead you guys down some rat hole.

But I do think that we've got to think about why people garden, and what it is they're trying to get for themselves and their families and in their kitchen. And how they're trying to represent themselves in their community. I think it's more than just chemicals. I think we'll talk more about that next month. But I think it's a pretty big category to start thinking outside of lawn and garden chemicals.

William Reuter - *BofA Merrill Lynch - Analyst*

Okay, that's very helpful. I'm looking forward to it next month.

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

Thank you.

Operator

And with no further questions in the queue, I'd like to turn the conference over to Jim King for any additional or closing remarks.

Jim King - *Scotts Miracle-Gro Company - SVP & CCO*

All right. Thank you, Cecelia. A couple of housekeeping items. On November 18, Randy Coleman and I are going to be presenting at Morgan Stanley conference in New York. That will be a webcast event at 8 AM that day, so we'll have more information out on that next week.

Again, if you're interested in attending the Analyst Day event, two ways. Go to our website, investor.scotts.com, or call us directly at 937-578-5968. If there's any follow up questions from today's call that we did not get to, feel free to call me directly. That number's 937-578-5622. Other than that --

Jim Hagedorn - *Scotts Miracle-Gro Company - Chairman & CEO*

I just want to throw one more thing in there. It's just that we just last week finished that new credit facility. We sold some bonds a couple of weeks before that, so I really want to thank our finance partners out there on the street that have really done a great job, getting those bond sold, and producing a credit facility that I think really will work with us going forward, as we talk to you guys next month. So thank you, guys for all of your help.

Jim King - *Scotts Miracle-Gro Company - SVP & CCO*

All right, other than that, we will see you all next month in New York on December 10. Thank you. Have a great day.

Operator

(Operator Instructions)