The Scotts Miracle-Gro Company
NYSE:SMG
Company Conference Presentation

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Call Participants

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Presentation

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

Okay. Good afternoon, everyone. Thank you for joining us for our next presentation of the day, Scotts Miracle-Gro. The company is the unquestioned leader in the U.S. lawn and garden space with the portfolio brands that includes Scotts, Miracle-Gro, Ortho and Roundup. The business is coming off a very strong year in 2019, boosted by a healthy dose of pricing and greater retail engagement in the category. In addition, after a roller coaster ride over the past few years, the company's hydroponics business is back on an upswing with very strong double-digit growth last year, driven by -- little bit driven largely by the sweeping legalization of cannabis at the state level throughout the U.S. Here to tell us about it is the company's CFO, Randy Coleman. Also in attendance is the company's long time Head of Investor Relations, Jim King. And with that, I'll hand it off to Randy.

Thomas Randal Coleman
Executive VP & CFO

Thank you, Joe. And thank you, everybody, for joining us today. So a quick outline of what we'll be covering here today. So we'll do a little bit of background on just with the last several years as we look at our top line and bottom line and the improvement we've made in cash flow generation, talk about our long-term strategies for creating shareholder value and deploying that cash, talk about our world-class U.S. consumer business. And we've gotten a lot of questions already today about everything going on with the virus and we can give you some backdrop on how we're prepared for that. And then Hawthorne, if you're less familiar with Hawthorn and then our traditional U.S. consumer business where you see the brands on the bottom of the slide with Miracle-Gro and Scotts and Ortho and so on. The Hawthorne is -- it's a supplier of inputs and nutrients and even hardware to the indoor growing and hydroponics market, largely focused on North America for us, but we also have a presence in Europe. And there's a lot of parallels between what we've done with our U.S. consumer business 20 to 25 years ago and what we're doing with Hawthorne today. So I'll dig into that as well.

So when we think about, in the long term, how we plan to and how we have been creating shareholder value, I think, this slide really represents well the way we think about our business. And this is really much more of an organic look at how we run our business year-to-year. So 2% to 4% sales growth in our U.S. business, which is 75% or so of our pie. That's usually a 1% to 2% to 3% growth business that more or less grows with GDP. Hawthorn, however, when you look at the long-term demand profile, we expect that business to be growing 8%, 9%, 10%. And in certain years, like last year and this year, even well ahead of that profile. But we think eventually, long-term demand is what's going to drive the top line for that business. But all in, 4% to 6% is our guidance for 2020. We think 2% to 4% in the long run is a very prudent place to be.

So operating income, we expect leverage largely from Hawthorne as we improve our gross margin rates, that means your operating margin rates and then EPS. So as we deploy cash, we expect to continue to repurchase shares, which would help our EPS, but we also have an annual dividend at the 2% to 2.5% yield and that number has been increasing 4%, 5%, 6% a year for the last several years. We plan for that as well. So you roll this all then together, we believe we can promise a 10% to 12% shareholder return on a year-in, year-out basis purely organically, and that provides you good baseline that we can even outperform when years are good.

This provides a look at how we've actually performed from 2014 or so when we talked about Project Focus and how we were going to run our business differently at that point in time. What Project Focus entailed was essentially a portfolio review where we said, we should divest our service business, we should divest international. They're slower growth businesses, they have lower margin profiles. Let's divest those, let's focus on generating cash flow out of North America and use that cash flow either for shareholder-friendly purposes or to acquire businesses with a faster, higher growth profile with higher margins. And that's what we've done with Hawthorne.

You can see a lot of traction was made in 2015, '16 and '17. 2018 came along -- and actually, prior to that point, there was a great amount of anticipation that California was going to become a legal cannabis state for adult use. It was already essentially a legal state for medical use. And then there was a big supply and demand imbalance [indiscernible] after that January 1, '18 transition. So at that point, we did see a big dramatic decrease in our sales for 2018. You could see drop down there. And we continued to not perform and not do what we said we're going to do during that year. Since then, 2019, we rebounded. 2020, we have the same kind of momentum, and we're getting a lot of credit. Obviously, this slide was prepared before last week. But when you think about the virus and all the concerns that people have asked us about today, I can give you a few notes about Scotts. So about 5% of our cost of sales is sourced from China. And when we look at our supply chain and our exposure for 2020, we think we're completely mitigated at this point. There were a few concerns several weeks ago. We think we've mitigated those completely. We don't think we have any kind of top line exposure from a supply perspective in 2020.

Also, historically speaking, when you look at how our business has performed in tough times or when the economy has suffered, if you go back 2008, 2009, we actually performed really well. When you think about it from consumer point of view, when people don't travel as much, they tend to stay home, take care of the yards, paint the indoor of their homes as well. So we expect to perform pretty well. The one watch out, which is obviously probably consistent across almost every business are people going to be able to get out to the stores and shop. Assuming all that is the case, we expect this is actually going to be very much a help for our year. So time will tell, but we think we're very well positioned for 2020.

If you look at how our revenue breaks down. Like I said, U.S. business, with the brands that you most recognize, is about 75% of our sales. Hawthorne about little north of 20% right now, expect that to be 25% to 30% as we continue to work over the next 12 to 18 months. And then other really represents our Canadian business. So we're really largely a North America focused business.

If you look at our sales over the last several years as well, we have CAGR of about 8% through 2019, starting in 2014. Much of that top line driven related to Hawthorne-related acquisitions. But also we've had a really nice run rate success on the top line, not only in Hawthorn rebound in '19 and here in '20, but also our U.S. Consumer business. So 2019, we took some market share, we performed well. Here in 2020, we believe we've taken more market share, and we expect to have a really nice, robust top line performance for U.S. Consumer here in 2020 as well.

When you look at our earnings profile, over the same period of time, as you expect, it looks very consistent, so nice steady growth, kind of little bit of a bump there in 2018, but nice recovery in '19 and a lot of optism here in 2020.

So I think more importantly, one thing that we hadn't focused on years past was cash flow. So you can see very much a solitude performance here. And about 3 or 4 years ago, we said we're going to have to do something differently to get a better improvement and more focus on cash flow. So we've changed our pay program. So at that point, 25% of our short-term incentive plan was based on free cash flow, and our long-term plan, it's 2/3 focused on free cash flow. So as you'd expect, with pay becomes more focused, and you can see the dramatic change we made in '17. But '18, again, we had a P&L year that was not as strong as we expected, yet, our cash flow was strong. Last year, 2019, cash flow was strong, around $300 million. Here in 2020, we expect a similar performance again. So year after year after year, very strong cash flow performance, which is what you expect from a business with the brands that we have.

What have we done with the cash? So strong cash flow is great, but what have you done with it? And I can tell you the annual dividends increasing mid-single digits for the past several years, and we have also been opportunistic in repurchasing our shares at points in the past. So ideally, if we had a good M&A candidate or something that would be inorganic that was a good strategic fit that fit into our capability set or perhaps added to our capability set at the right price, we'd clearly be biased towards that. Right now, there's nothing in the pipeline that we're actively pursuing. And share repurchases would not -- would likely be our default, if we're in a position where we want to do something with our cash.

I can also tell you our leverage position at the end of last quarter was about 3.5x, which is essentially our target. So we have a lot of flexibility right now on how we use our cash. So I'm diving little bit more into our U.S. Consumer business, which you'd recognize the brands here. They're often synonymous with the products that we sell. So Scotts with fertilizers, Miracle-Gro with plant food. We don't have round up on the page, but people want to round up their weeds as well. So we have high market shares, we have high share of voice. Typically, 85% to 90% of the category advertising comes from us. And we're really proud of the brands and the portfolio we've put together. Related to that is innovation, and the products that we've developed in recent years are easier to use, simpler, largely more focused on natural and organic offerings, and yet, still very efficacious. So really proud of the innovation, the combination between the R&D folks and the marketing team as well.

Then our in-store execution. We have an army of associates out in the field that meet with consumers on the weekends, that build relationships with the store managers and the department managers in lawn and garden, and they really are helping us to drive the business.

And then our supply chain. So when you think about a business as seasonal as ours, where April, May, June and March combined usually represents 75% to 80% of the POS or the consumer takeaway within a year, you see some really violent and chaotic weekends. So our supply chain is able to come in on a Monday and a Tuesday and a Wednesday and replenish, get those stores set up and ready to go for the next weekend. And due to that, our suppliers come up or -- excuse me, our customers rely on us very much as an important supplier and vendor.

So when you think about consumer behavior, this time of year, at least where we live in Ohio, people are really looking forward to getting outside, engaging with nature, get in the yard, even mowing the grass. So brick-and-mortar retailers knowing that, so the Home Depots, the Lowe's and the Walmarts and the Ace and the Costco very much rely on us to help drive their business. They typically kick off their fiscal year on February 1, and they want to use us to drive footsteps year after year after year.

Related to that, but a little bit different, is the online presence. So each of our big customers has their own online business that's D2C. We also sell through Amazon, and we also have our own websites that we sell from. Our D2C business has been growing 30%, 40%, even 50% over the last several years. So small base. At this point, it represents about 5% of our total sales base is e-commerce, but growing really, really fast.

And then millennials. We get a lot of questions about millennials, and will they be as engaged as their parents and grandparents? But I can tell you, from the research that we've recently done, millennials tend to even be more engaged. I think they just want to know what to do. But as millennials are buying homes, engage in our category, they're just as likely or perhaps even more likely to purchase our products. And we think that really bodes well for the long-term success of our business.

What we're doing to appeal differently to millennials is different kinds of products and different ways of communication. So a couple of the products we've innovated and introduced in the last couple of years. One is Miracle-Gro Performance Organic. So rather than a synthetic fertilizer ad that we would typically have in a soil product, this is completely natural and organic, and yet, we had the same performance and arguably even better from this versus the typical synthetic products that we historically sold in Miracle-Gro.

Another new product we introduced last year with a lot of success was Ortho GroundClear with a new OMRI-certified formulation, really intended for patios, driveways and so on, but also could be used for gardening. We had almost 100% [indiscernible] ratio on this product last year because we wanted to make sure it had a lot of momentum, performed really well, and we expect to see even more growth this year.

We also have created some digitally native brands that are a little bit different that you might not be as likely to recognize. One being backyard. So people have pets, still want to take care of their yard and have pet spots. This is intended to help them with that. And this is really a product intended to be purchased online. And we have a lot of excitement about what that's going to look like.

But different from products, we're also talking to our consumers differently. So we've recently switched agencies. That's something we did last year, being a lot more aggressive, a lot more D2C focused on how we communicate. So it's more often, it's more direct and getting a lot of credit, not just from millennials, but from other consumers as well as far as our communication approach.

That would be helpful to provide an update on Roundup. So if you're following the Roundup situation in the press, lots of information there. I can tell you, we don't have any kind of special insights. We don't know -- as they talk to plenty of attorneys and potential settlements, we have no special insights on what's going on there. But I can tell you from a commercial side, which is where we do engage with the very people, the business is performing really well. So we're up more than 10% entering March, which is slightly better than our U.S. Consumer portfolio. And again, Ortho GroundClear, the product I talked about earlier, is performing strongly as well. So when you think about consumer behavior, people want to kill their weeds, people are continuing to buy Roundup, other consumers are buying Ortho GroundClear as a different alternative, but this category is healthy. And in the long run, we expect it to continue to perform very well.

From a retailer point of view, as we're getting ready to really kick off our season right now and tell you, retail inventories are up double digits. So ready and set to go. I can also tell you that our POS is up 8% through into February. So well ahead of our expectations for the full year, where our shipment guidance of 1% to 3%. And our shipments year-to-date through February are up 8% as well. So we're very well prepared for the season, ready to go. And in addition, just being prepared, I'd say, we did pick up a nice amount of market share this year. Especially at Costco, it's a very important customer to us, has historically been our fifth largest customer. And this year, it may rival and move up to #4. So we're really pleased with the success we're having at Costco.

Let me switch now to Hawthorne. And again, these brands might be a little less recognizable to certain people's knowledge here. But I tell you, in this particular channel, when you think about the hydroponics category, these are very much the premium brands. If you go back to General Hydroponics and Gavita, Can-Filters, Botanicare and even Sunlight, which was a distributor, all these businesses were created in the '70s, '80s and '90s. We didn't enter this space until 2015 when we purchased General Hydroponics, which is based in Santa Rosa, California. But that was our first entree. We've rolled up the industry with the best brands, and the capstone of that really was our purchase of Sunlight Supply in 2018. Sunlight Supply was really important for us because, while we had the premium brands in nutrients and hardware up to that point, Sunlight Supply let us fill out really the entire line for A to Z and really employ a good, better, best strategy from a marketing and a brand hierarchy point of view. So that's gone well. And now we're really shifting to the point where we're trying to figure out how to create turnkey solutions and leverage our R&D and really become the one-stop shop provider for whether you're a small grower, a medium grower or a large grower.

So sales by geography within Hawthorne are largely in the U.S. and Canada. That's largely a cannabis-focused business. And tell you that the rest of world is really Western and Eastern Europe, and that's really a leafy greens and food-focused business. It's about $100 million, $110 million a year. So as we think beyond this year and the year after, but we think about the long term, there's very much an opportunity for us to engage in the food space in the United States and Canada. There's also an opportunity for us to engage in the cannabis space in Europe where we're focused completely on leasing agreements at this point. So lots of opportunity as we look beyond 2020 and '21.

And then looking at Hawthorne sales over time, a little bit of deciphering on the slide here. So the orange numbers are acquisitive sales impacts year-over-year. And then the gray numbers are just more organic apple-to-apple numbers over here. So like I'd pointed out, 2018 was very much a challenging year with the regulatory issues that we had in California. It's essentially corrected itself. But California was 50% plus of our sales at that point in time. Today, it's about 40% as new states continue to roll out East of Colorado, but the business grew really nicely last year. And I can tell you, our 2020 estimate in and here which was our original guidance, is up about $90 million or 14% to 15%, and we're a well ahead of that number at this point.

So our long-term plan here, again, is to provide turnkey solutions to whether you're a small grower, a medium-sized grower, a large grower. We've a lot of historic and legacy R&D expertise. So if you think about Scotts Miracle-Gro and Scotts, in particular, we've had professional businesses in the past, whether it was golf courses, whether it was professional specialty ag formulations intended for strawberries and bananas.

So we still have a lot of that expertise that can be focused on specific crops. In this case, with Hawthorne, is largely cannabis related. And we're also being able to provide a lot of professionalism and leadership that this industry hasn't necessarily had in the past. It's relatively a new industry, a lot of family businesses. And what we're able to do is provide the scale, bring together the brands with the innovation, grow sales force with the supply chain with the scale and the professionalism and bring all that together.

So in long run, on Hawthorne, in particular, we expect more markets to continue to flip. So as you know, Illinois recently became a legal state. We have 5 or 6 states coming up in November that are up for ballot initiatives that we think could move to the legal space. We think New York, New Jersey and just the Eastern Corridor, in particular, is very exciting place for us to be. So we think there's a lot of runway from a demand perspective.

Also consumer consumption. Regardless of legalization, but when you look at states like Colorado, now been legal for several years and you look at the per capita consumption, Colorado used to be, on average, 10% to 12% of the people in that state were consumers, in one form or another. Now that it's legal, that number is closer to 18% to 20%. So legalization plus increased consumer demand as well as the different forms of the product, all that combined is really what's driving the category.

From a competitive point of view, when we purchased Sunlight Supply, it was the largest distributor in this space. We're #2 and #3. #3 dropped out when times were tough in 2018. And I can tell you, we're taking market share from #2. A lot of this is anecdotal. We don't have Nielsen data, and we can't sight perfect statistics. But anecdotally speaking, I'm confident saying that, well, the category is going really fast, we're taking a lot of market share as well.

And then operating margins. So last year, coming off of challenging 2018, we really focused on the top line. It was very successful for us. We took a lot of market share, but our operating margins last year were only about 8%. Our target for this year is 10%, and our long-term target for Hawthorne is 15% from an operating margin basis. And I think it should only take us a few years to get there.

So how we'll get there? Innovation, synergies. We recently implemented SAP, and that provides a nice platform for efficiencies and growing our business better and more insights, pricing, and just overall professionalism and how we manage the business. So confident, 15% is the right target for us in the long run.

So year-to-date. So I mentioned this earlier, but our initial guidance for Hawthorne was 12% to 15% top line growth for 2020. At this point, we're running at 50% rate through February. However, well, that sounds terrific and very much is. Last year at this time is when we really started seeing the rebound. So we start seeing really difficult comps starting essentially today with the month of March and April. So we'll be updating guidance for the full year here in a couple of months on May 6, when we have our Q2 earnings call. So we'll have 60 more days of visibility at that point. But we do not expect that run rate to slow down, but we are seeing much more challenging comps going forward. But I think suffice it to say, 12% to 15% was overly conservative as we set our guidance a few months ago, and we will be updating that here in a couple of months.

The other thing I'd point out is related to promotions. So we were very promotional last year in an effort to take market share. We're continuing to spend about the same amount of dollars this year. But as the growth rate has increased, we're not seeing the same kind of rate. So dollars are similar. The rate is actually going down. And I think the promotions that we are using have been more successful, and we're focused on target that we saw a year ago. So success there.

So what do we expect? Continued strength at Hawthorne in 2020. I think, long pathway ahead of us of success and more profitability to come. U.S. Consumer segment, very much a consumer staple as far as consumer behavior and how our retailers, our important retail partners think about our U.S. Consumer business. And cash flow productivity. No reason to think we won't be at $300 million plus of free cash flow again in 2020. And that's become our new benchmark. So no more solitude performance there.

And then that cash flow generation gives us a lot of optionality, and we can do a lot of things. So again, if there are any organic opportunity in front of us, we would definitely be looking at it. Given that there's nothing in the pipeline, our bias would be to repurchase shares, and we'll continue to maintain our annual dividend and likely grow that 4%, 5%, 6% a year. So a lot of room in front of us. We're really excited about 2020, really bullish on the long-term prospects of the business. And I guess we'll have time later today to spend time with some more of you.

So thanks for your attention today. Thanks for listening, and thanks, Joe, for having us today.

Joseph Nicholas Altobello
Raymond James & Associates, Inc., Research Division
With questions here, we may go to breakout.

Question and Answer

Unknown Analyst

Can you bridge a little bit the move [indiscernible] 15% [indiscernible] on Hawthorne's margin, one of the key variables [indiscernible] investors?

Thomas Randal Coleman
Executive VP & CFO

Sure. So if you assume that we're at 10% operating margins this year in 2020, the big piece is, I think, innovation with better mix. That's going to be helpful, pricing. So less promotional, and we're actually taking more invoice sales pricing in certain categories throughout the year, just putting SAP, just having visibility to how we run our business better and synergies within supply chain. So we're consolidating some warehouses. We're getting better service and saving money. And if you wrap all that up together, along with just the benefit of scale and volume, it's not too difficult to get from 10% to 15%. I'm going to call it 3 years.

Unknown Analyst

[indiscernible] most of that is a gross margin level or OpEx [indiscernible]

Thomas Randal Coleman
Executive VP & CFO

Mostly at the gross margin levels, where we're seeing a lot of leverage. So we're continuing to invest SG&A. So R&D for sure, SAP, and it's going to come free. We have had to invest incredible amount of marketing so far just because the demand was so high. Sales force, though, and different salespeople in different geographies is an area we're going to spend some more money. So we'll continue to invest, and we're trying to find right balance. So we're not thinking too short-term here. We can make 15% this year if we wanted to, but really trying to think long term, grow this business, continue to take share and as the category grows, grow along with it. Yes, sir.

Unknown Analyst

I have a question [indiscernible] leverage [indiscernible]

Thomas Randal Coleman
Executive VP & CFO

That's on leverage in our -- so right now, we're a 3.5x leverage. We were as high as 4.5 after the Sunlight acquisition which not too long ago, call it, 18, 20 months ago. So we did a big focus on cash flow generation, cash flow -- and reduce our leverage, really, at 3.5x, pretty comfortable with that. If you go back a few years ago, we've been trying to actually increase our leverage to get to that point. We divested our international business, and we divested lawn service -- the proceeds from that, we continued to float around 3. But we're very comfortable with 3.5x. And it doesn't look like interest rates are going to be going up anytime soon. So we're really comfortable with that. We think we're recession not completely resistant. But we've done well and performed well in recessions in the past and really comfortable with 3.5. Yes, Joe?

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

[indiscernible] in February. And you also mentioned that retail inventory were up double digits on top of that -- on top of a year that [indiscernible] retail inventory was fairly [indiscernible] and I think, this year you weren't expecting any additional inventory build in your sales number. How do you view that double digit growth [indiscernible]

Thomas Randal Coleman

Executive VP & CFO

So I don't know if everybody could hear that, but you might [indiscernible]

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

Yes.

Thomas Randal Coleman
Executive VP & CFO

Okay. So Joe's question was around retail inventory. So we're up double digits right now, our outlook for the full year is to be essentially flat. And what we're seeing right now is just a successful build up to the season. So we don't expect it to be up double digits when we end September 30. But we're really encouraged that retailers are set up and prepared for the season and ready to go right now. But expect that number to dip back down to something back to about flat to last year, by the time we exit the year.

Joseph Nicholas Altobello
Raymond James & Associates, Inc., Research Division
Okay. For breakout, we'll go to the next room. Thank you very much.