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SMG - Q3 2013 The Scotts Miracle-Gro Company Earnings Conference Call

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OVERVIEW:

SMG reported 3Q13 sales of $1.15b and adjusted income from continuing operations of $153.9m or $2.46 per share.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good day, everyone. Thank you for holding and welcome to the Scotts Miracle-Gro 2013 third-quarter earnings conference call with your host, Jim King. Today's conference will begin with a presentation followed by a question-and-answer session. Instructions on that feature will follow later in the program. I would now like to turn the call over to Jim King. Please go ahead.

Jim King - *The Scotts Miracle-Gro Company - SVP, Chief Communications Officer*

Good morning, everyone, and welcome to our third-quarter conference call.

With me this morning are Jim Hagedorn, our Chairman and CEO; Barry Sanders, our President and Chief Operating Officer, who is calling in remotely; and Larry Hilsheimer, our CFO.

Jim and Barry will provide an overview of the current state of the business, both in the context of our Q3 results as well as our overall progress. Then Larry is going to walk through the financials and the implications of today's results on our full-year outlook. After their prepared remarks, we will open the call to your questions. In the interest of time, we ask that you limit your questions to one and one follow-up. If there are questions we don't address, I'm glad to handle those with you separately off-line.

With that, I want to move onto call and remind everyone that our comments this morning will contain forward-looking statements. As such, actual results may differ materially from what we state. Due to that risk, we encourage investors to review the risk factors outlined in our Form 10-K which is filed with the Securities and Exchange Commission, or our most recent 10-Q.

So with that, let's get over to business. Let me turn the call over to Jim Hagedorn, to discuss our performance.

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

Thanks, Jim, and good morning, everyone. I hope that it's obvious why I am pleased with the news we announced this morning. Our team has every reason to take pride in what we have accomplished this year and the shareholders should take heart that we have a good handle on the state of the business and that we are executing according to our plan. Most importantly, the news we announced this morning makes good on the commitments we made to our shareholders a year ago.

Let me quickly touch upon the headlines and then turn things over to Barry to look more deeply at the business. After a slow start to the season, we have had an extremely strong recovery. Entering Q3, consumer purchases of our products were down 28% from 2012 levels. As I sit here today, that deficit is almost entirely erased. On a year-to-date basis, POS is now essentially flat.

After two years of gross margin declines, we have successfully reversed the trend, renewing our confidence in the long-term goal to get our margin rate to 40%. Year one of Project MAX, our cost out and productivity initiative, has been a success, allowing us to reduce SG&A at an even quicker pace than we first projected. Even with pricing increases and reductions in spending, we have maintained our aggregate market share.

Speaking of our overall performance, we now see the business trending toward a midpoint of our full-year guidance of $2.50 to $2.75 per share. As we have seen in recent years, hurricanes and other unforeseen events can negatively impact our fall business. So and for that reason, we are not changing the overall range. Regardless of where we land within the range, we also expect to exceed our cash flow guidance of $250 million.

As a result of our performance, we have reduced our leverage ratio below our internal goal of 2.5 times. And so, as we began discussing during our Q3 call a year ago, we are in position to start returning cash to shareholders. The 35% increase in the quarterly dividend that we announced this morning puts us solidly in the top quartile of our benchmark companies. As we said in the press release, we will also continue to consider other shareholder-friendly actions, the most likely of which will be, in the near-term, to restart our share repurchase efforts.

Larry will provide more detail in a few minutes of how we arrived at this level of increase for the recurring dividend, but I want to stress that the increase should be viewed as a strong vote of confidence through both the management and the Board in the underlying fundamentals of the business and our ability to continue generating significant levels of cash. I also want to stress that we have plenty of flexibility to fund the needs of the business, including acquisitions, while maintaining our targeted leverage ratio.

So there's a lot to feel good about right now and I'm not afraid to say so. Our focus throughout the year was to improve the quality and strength of our financials. We have improved our margins, we've strengthened our balance sheet. We have put ourselves in a position to show even more improvement in 2014.

Are we where I want us to be? Are we where we need to be? The answer to both those questions is no. And so, while we have had a solid year, I don't want to get ahead of ourselves. Our number-one long-term goal has to be growth. We can't cut our way to success, and we know that.

But as I said during this call a year ago and based on our experiences in 2012, we are not going to struggle too hard against broader macroeconomic trends. Our outlook for the consumer hasn't really changed all that much. While our business had a solid year in the DIY and hardware channels, we have not fared as well in the mass merchant channels where retailers got off to a slower start. Consumers in that channel also remain less engaged in our category, a trend that began in 2011.

So, until the broader consumer feels better and starts opening their wallet with more frequency no matter where they shop, then we still believe unit volume growth will be tough to get in the core business. That's not to say that we can't get growth in the overall business. We believe that low single-digit top-line growth is achievable in 2014, but we see it mostly coming from pricing, a slight rebound in our international business, growth in Scotts LawnService and perhaps some modest acquisitions in adjacent categories.

We are not going to provide any further guidance today for next year, but I will say that we see the potential for another strong year of earnings growth in 2014, getting us closer to our near-term goal of returning to 2010 levels of profitability. But I want to stress once again our long-term focus is driving the category and achieving a higher level of sales growth. The combination of improved consumer insights, product innovation and smarter retailer programs will all play a role in reuniting our organic growth. And then we can supplement that growth with partnerships and small acquisitions. I believe that that focus, combined with improved margins and a commitment to returning cash to shareholders, will allow us to deliver a higher level of total shareholder returns.

Before I turn things over to Barry to discuss the execution and to Larry to run through the numbers, I want to take a step back and put the results we are seeing this year into perspective. I'm not going to blame weather for the shortfall, given the strong recovery we have seen in the third quarter. But the fact is that the delay we saw in March was clearly related to weather. When the weather broke, the season took off. Our retailers a state engaged and helped drive the season, and I want to thank them for that commitment.

But even with their full engagement, when you look at our year-to-date results by geography, you can see that the late-breaking markets never fully recovered. Personally, I believe our team deserves a better result than we have seen this year because their execution this season was as good as I've seen in many years. When we designed our plans this year, we knew the results would be second-half loaded. March 2012 represented a nearly impossible comp and we knew the majority of our gross margin and SG&A benefit would not take hold until Q3 and Q4. So, after a late start to the season, it would be understandable if our team entered Q3 with a bit of nervousness.

But under Barry's leadership, the team exercised patience. They understood what was happening and didn't spend excessive money chasing the season. They didn't pull the trigger on unplanned promotions and they didn't lose faith in the strength of our brands and the resilience of the category. I want to recognize the work done not just by Barry, but also Mike Lukemire, Jim Lyski, Dave Swihart as well as the thousands of people who work in their organizations. They maintained confidence in our plans, they stuck to their guns and they executed as well as I ever recall seeing.

They are not to the finish line yet, a point I want to continue reminding them. But the performance we've seen from our people this year is something that requires the attention of our shareholders and I wanted to make sure that I gave them the credit they deserve.

With that, let me throw things over to Barry to discuss some of the details.

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Thanks, Jim. Jim already gave you the headline regarding consumer purchases, so let me be more precise. POS in the quarter was up 15% with year-over-year gains in every category. In our largest and most profitable business, lawn fertilizer, consumer purchases were up more than 40% for the quarter and now are up 1% on a year to date through last week.

Within those numbers, we continue to see strong consumer acceptance of Snap. Purchases of spreaders were up 31% in the quarter and are trending in line with what we saw during the introduction last year. Purchases of Snap packs are higher than a year ago. Consumer excitement for the product remains high and users of the product continue to feed their lawns at a significantly higher level than users of our traditional product.

Mulch has been highly successful for the year again. POS was up 17% in the quarter and 9% year to date. More importantly, we have had great success in improving the profitability of this business. We told you during our analyst day meeting that we're moving to a more vertically integrated manufacturing process in this business. That change has resulted in higher margins. While mulch is still dilutive to our overall margins, the growth we are seeing is important and we expect to see further margin improvement next year.

I also want to talk to you about the performance of our gardens business. Consumer purchases of Miracle-Gro branded soils and potting mixes were up nearly 10% in the quarter and 1% year to date. Overall, POS in soil was down slightly, but that is to do with the loss of some lower-margin private label listings. It's worth focusing on growing media for a reason. Many of you probably recall that this is a business that had a challenging year in 2012 and caught us off guard when the spring didn't materialize as we had expected.

This year, however, even with the late spring, consumers are more engaged in the peak weeks of this year, not just in buying our products, but flowers, vegetables and other live goods as well. As is true with the rest of the business, we won't fully recover from the slow start but we are satisfied with the result, given the circumstances.

The same holds true in our controls portfolio. Recall that both Ortho and Roundup had strong performances in 2012, so they did not have an easy comp. While both are still negative on a full-year basis, both have been coming in strong in recent weeks. Roundup, in particular, has been doing well, posting increases of nearly 20% since June as consumers try to fight off the weeds that have been aided by high levels of rainfall in much of the US. Ortho has been at about half that rate of growth over the past two months, due to a need for both selective weed and insect control products.

Switching gears a bit, retail inventory in the US has been a bit of a roller coaster this season, but we are seeing inventory now that is pretty much in line with what we expected prior to selling in product for the fall season. As we get ready for fall, we continue to see strong retailer support and we have a high degree of confidence in our marketing programs.

The broad trends we have seen in the US -- a slow start followed by consistent momentum -- has also been the story in Europe. After a slow start, also delayed by weather, we have seen a strong recovery. The business there should come close to meeting their original plan for the year and I am pleased with their overall progress. The European team has fully embraced Project MAX and we have started the restructuring efforts we discussed on previous calls. We expect to start seeing the payback from those efforts in the next year.

Finally, let me touch upon Scotts LawnService. This business remains on track for mid-single digit top-line growth that we expected as well as another year of record profits and improved operating margin. Our customer count is now at an all-time high; so is our customer satisfaction scores. All of this is true despite the fact that significant Midwestern markets like Chicago and Minneapolis have struggled this year because of weather delays.

On a separate note, the SOS team continues to get good learnings from the pest control test markets in Florida and remain confident that the long-term opportunity from such a product extension is both real and significant. We will move cautiously, but I do see this as an important growth areas we look ahead.

So I agree with Jim's assessment. Our performance in the third quarter was extremely solid and I feel highly confident that we will hit the bottom-line targets that we have outlined back in December. The early discussions we have had with retailers regarding 2014 are encouraging, and once again we expect Project MAX to help drive leverage in the P&L next year. To be more specific about both, let me now turn the call over to Larry to discuss the numbers.

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Thank you, Barry. Good morning, everyone. I have three objectives this morning. First, I want to recap our results for the quarter and, where relevant to the broader story, our year-to-date performance. Second, I want to help you better understand the implications of today's announcement on our full-year guidance. Third, I want to build on Jim's comments regarding our dividend announcement this morning. I will provide more comments on the strength of our balance sheet and our planned uses of cash going forward.

With that, let me address our results. Sales in the quarter rose 9% year-over-year to $1.15 billion, driven primarily by the strength of the consumer business in the United States. Sales in the overall Global Consumer segment were up 10% to $1.05 billion. Within the segment, sales in the US were up 8% during the quarter while sales elsewhere increased 21% excluding the impact of foreign exchange rates. As Jim said at the outset, weather had a big impact throughout the business in Q2, and that impact was most pronounced in Canada and Europe. Those businesses all rebounded well in Q3, leading to the strong sales I just outlined.

Finally, Scotts LawnService increased 2% during the quarter.

On a year-to-date basis, sales in the Global Consumer segment are still down 2% while sales at SLS are up 4%. Company-wide, year-to-date sales are minus 2%. But, you will recall that we adjusted our full-year sales guidance in June and said we expected the result to range from plus 1% to minus 1%, and our nine-month performance is indicative of that outlook.

In terms of the full-year results, it seems most likely that we will be flat to slightly down on the top line. However, as Jim already said, the team's performance with cost-out efforts and SG&A leverage provides more than enough support to make up that miss in the bottom line results.

Let me move down to gross margin, which, as we expected, was a very good story for us in the quarter. The adjusted gross margin rate in the third quarter improved 360 basis points compared to prior year, a result of improved leverage of our fixed manufacturing and warehousing costs in addition to favorable commodity cost, pricing and other cost efficiencies. We expect gross margin improvement will continue through the fourth quarter. You will recall that we said entering the year, we expected the gross margin rate to improve by up to 125 basis points. That top level of improvement is unlikely due to the volume miss we are going to see. Based on our updated sales guidance range, a full-year improvement of 60 to 100 basis points is still achievable.

Let's move onto SG&A, which has been a good story all year, especially so in the third quarter. During the quarter, SG&A decreased $8.1 million, a decline of 4% compared to a year ago. The year-over-year savings were primarily due to benefits of our Project MAX initiative. Those decreases are partially offset by higher year-over-year costs for variable comp.

With that said, variable pay, while still trending toward a targeted payout, will be less than what we had hoped. We had actually been accruing at higher levels earlier in the year in anticipation of hitting some stretch goals. So, even though the variable pay will be lower than our original goals, we will still see a targeted payout this year.

And I agree with Jim's comments this morning. Our team has done an outstanding job in executing our plan.

Let me pause for a moment and try to help you with your models. When we updated our guidance in June, the biggest change was in SG&A. Our original target entering the year was to reduce SG&A by 1% to 3%. In June, we increased that target to a range of 3% to 5%. Now, with just two months left in the year, we expect to be on the high end of that range.

Below the operating line, everything is in line with what we expected. Interest expense in the quarter was essentially flat at $16.8 million. The tax rate for adjusted earnings for the quarter was 36.5%, and we ended the quarter with a diluted share count of 62.6 million shares. All of that translated into adjusted income from continuing operations of $153.9 million or $2.46 per share during the quarter. That compares with $100.8 million for the same quarter last year, or $1.62 per share.

During the quarter, we had severance costs related to our European restructuring efforts of $8.5 million, which were adjusted out of earnings. We expect a less-significant level of restructuring in Europe in the fourth quarter. When you include these one-time items, our GAAP earnings were $148.2 million, $2.30 (sic-see press release "$2.37") per share compared with $96.4 million or $1.55 per share a year ago.

So what does this mean for our full-year earnings? Jim has already said we are trending to the midpoint of the range and we hope to do slightly better. July was a good month for us and August is relatively small but has started strong. So our September results and the kickoff to the start of the fall lawn and garden season will be important. Fortunately, our retail partners are engaged, so if weather cooperates we expect to have a strong finish to the year.

If you move on to the balance sheet, two things to stand out and are worth discussing. First, the change in accounts receivable is simply a function of the timing of shipments related to the higher sales volume. Secondly and more importantly, we are really pleased with the year-over-year change in inventory levels. We said going into the year that managing inventory lower would be a priority for our supply chain for the next two years, and so far they are doing even better than we expected.

While I'm talking about supply chain, let me anticipate one of your questions related to the current commodity environment. I know that many of you have been calling in, in recent weeks, to ask about the favorable trends in urea prices. We have been taking advantage of these trends and have locked in about half of our urea needs for 2014. We are not going to disclose our average price, but we do expect the amount to be lower than 2013.

So I know that begs the next question, which is about pricing for 2014. As Barry said, we continue to move forward with modest price increases in our 2014 planning. Since we did not take any pricing in 2012 when urea moved sharply higher, the pricing we took in 2013 combined with our plans from 2014 now essentially offsets the margin gap.

Finally, I want to talk about where we stand from a leverage perspective and also discuss our announcement today regarding the dividend and returning cash to shareholders. Entering Q4, our leverage ratio was 2.46 and we expect it to continue to improve slightly over the next few quarters. You will recall that we have said for the last several years that we view our optimal capital structure to be when our leverage ratio is within a range of 2 to 2.5 times. That calculation is based on a four-quarter average of net debt divided by trailing 12-month adjusted EBITDA. So we are back within the range, which allowed us to make the announcement about the dividend increase this morning.

Let me help you understand the logic with our decision. We decided not to focus on a specific payout ratio or dividend yield. Instead, we looked at what level we felt comfortable with. We also looked at our peers and determined we wanted to stay within the top quartile of benchmark companies from a payout ratio as long as we were comfortable. This increase puts us within that group and, as Jim said, it continues to give us plenty of flexibility to fund the business for the foreseeable future. We assessed our cash generation, considered risk and we feel extremely comfortable with this recurring dividend level.

In terms of near-term uses of cash, our philosophy of two-thirds to shareholders and one-third to the business still makes sense for us. We have been studying some tuck-in acquisitions in adjacent categories for the US consumer business that looks attractive. Our LawnService business also continues to look at those type of deals as well. In all of those cases, we can meet the CapEx needs of our business, fund those acquisitions, return cash to shareholders and still say within our 2 to 2.5 times range.

As we begin to look at next year, I believe the business has good momentum. I've been here for 4 months now and I'm starting to better understand the rhythm of the business and the challenges and opportunities that we face. Like both Jim and Barry have said, we need to get the category growing at a faster rate.

But I don't believe throwing money at the issue will get us very far. Our view of the consumer marketplace is mirroring what we continue to hear from peer companies and from our retail partners, so you can expect us to continue to manage the business prudently, to set reasonable expectations and to focus on driving solid shareholder returns.

With that, I wanted to open the call to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator instructions) Joe Altobello.

Joe Altobello - *Oppenheimer & Co. - Analyst*

First question -- I just want to understand the gross margin guidance a little bit better. I think in your prepared remarks, you mentioned that it had to do with volumes. And I was curious where volumes were not in line with expectations and what kind of elasticity you saw in terms of the pricing that you took this year.

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

Let me start with just saying that, Joe, this is a pretty big focus for us. So we have been spending a lot of time looking at the numbers and seeing what it means. I think that the biggest issue here was just an absorption issue based on the shortfall from our internal numbers that we had, which were probably a couple percent short of overall where we had wanted to be.

So I think that's the only thing that's really moving. And I would say on the pricing side that probably some puts and takes, but overall, we are not seeing any major market -- or share change. So we are comfortable with where we are and we are very comfortable where the progress we are making on gross margins. And so I don't know -- Barry and Larry, do you want to add anything to this?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Jim, I would add the most competitive category that we have is controls. So we are evaluating that, looking at what happened this year and evaluating our plans. But what I would say is it's right where we expected and we know what -- the actions that we can take. And Jim Lyski and his team that what the elasticities are, so that we can make our pricing decisions.

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

I would just add that it's primarily a volume issue relative to where we are shortfall -- and a little bit of mix. And other than that, we are really pleased with what we accomplished.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Okay, and then switching gears to the SG&A, obviously you are calling it down 5%. This year looked better than what we had thought going in. Could you tell us how much of that decline this year is really sustainable through cost savings, etc., and how much of that is deferring, maybe, some investments from fiscal 2013 into 2014?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

We believe that what we have taken out is very sustainable. These are fundamental changes in our business operating structure and really focused efforts on permanent take-out. The take-outs were actually even higher when you consider that we are now paying incentives at a higher rate than we were last year, and we believe that we will have additional take-outs next year that will offset what we anticipate to be in the incentive increases for next year.

Joe Altobello - *Oppenheimer & Co. - Analyst*

Great, thanks guys.

Operator

Olivia Tong.

Olivia Tong - *BofA Merrill Lynch - Analyst*

I wanted to start first on the top line guidance. Even Larry had said more flat to down 1 as opposed to the minus 1% to plus 1% range. First, why keep the top end of that range if it seems sort of unlikely? And that's still implying a pretty wide range for Q4. So can you give us a sense what gets you to the top of the even the flattish range versus the low end of the range?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

I would say you are thinking too hard, Olivia. I think what we are trying to do is saying that we still believe that the guidance we gave previously is correct and will be within that range. I think that's as much as you need to read through it. We weren't sending a message there, except to say, which is what I thought when Larry said it, that the range he gave before we are still comfortable with. And I think that's the case. We weren't trying to say we needed it except to say we will be within it.

One of the reasons that I wanted to see if we could get you pushed up in this was your comment on disappointment on the dividend. And I wanted to deal with that, if you don't mind. Are you okay with that?

Olivia Tong - *BofA Merrill Lynch - Analyst*

Okay.

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

Look, we haven't changed anything. We spent a lot of time. I ended up in the process of getting a new CFO. I think he wanted to get re-grounded with the banks and his advisers on how to do that. Cash flows are good and at or above what we expected. Our split that we have -- and I think consistent with over the last year or so, of two-thirds to the shareholders, one-third for the use of the business we are still good with. Then it's just a question of the recurring dividend. Where should it be, given that it's hard to unwind, one? And we've spent a lot of time looking at other companies and what kind of -- I'll use the word -- it's not precise -- but what kind of pop you could get in the equity and the efficiency of that, as far as saying if you put too much into the recurring and there's not a lot of -- it doesn't do much to the equity, then what is the perfect place for that to be?

And I think that between Larry and the banks -- and I think really good work, by the way -- both the Board and myself were convinced that this level is right. But it doesn't change anything. The amount of money we are planning to return is basically -- and my number on leverage is more like 2.5. But at 2.5 times leverage, two-thirds of our excess capacity will go to the shareholders, one-third used by the business. So what is left, then, is specials and repurchases. So we have also renewed our authority that was existing but unused that is like $300 million that we have -- just it was already kind of on the books with the Board. But we've worked with the Board so we have an existing now $300 million repurchase availability.

So as we start moving into the next phase of returning cash to shareholders, it will be some combination of specials and/or buybacks, and we are just trying to figure out what we think is best. But this was the first step of that process, and so we are absolutely committed to what we said before. And, really, the level of recurring dividend is just basically saying what do we think the best place for it to show up in the equity. And the rest will happen through specials and buybacks. I don't know if that helped at all.

Olivia Tong - *BofA Merrill Lynch - Analyst*

It does. By special, do you mean one-time dividends? And then in terms of share repurchase, what kind of going run rate are you looking at going forward? Because from the press release, it sounds like you didn't really commit to any particular level. And for four quarters now we haven't seen any share repurchase. So can you give us a sense for what share repurchase would look like going forward?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

Here's my issue with the question, which is I think that the math is not that hard to say, because the increase in the recurring dividend is not that high -- okay? And it was designed for what it was, which is to say at what level do you think we get the max return on the equity and then the rest will happen through repurchases and specials. As soon as we have visibility at year end, on exactly what our availability and leverage is, we will begin that process. I think you'll see it wholesale begin for real in fiscal year 2014. I think it's purely doing the math, and I think probably my finance team can help on that. But it will be a consistently approached campaign to return cash in those two ways of doing it that will begin as soon as we are ready. And I'm saying that we are in that process, but we've still got to count our money, figure what we've got, what our availability is, what leverage is. And I think you'll see it on in a big way in 2014. Consistent with what we've said -- I don't know, Larry, do you want to add anything?

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

No, I think you said it as I would have, Jim. And it's just going to depend on our judgment of what we think is the appropriate mechanism to return the money to shareholders, depending on what our stock price is.

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

Anyway, so that's that. I just wanted to take the time to advertise because we feel really good about it. I feel really good about it. And I think that when we took a look at the math on it, would I have liked to have seen a higher recurring dividend? Personally -- when I say personally, meaning intellectually, I guess, the answer is yes. That said, I think there was a lot of evidence to say, there's not a lot of bump in the stock to overpay and over-commit to a kind of recurring forever dividend. So we looked and said, where is the best point for that, and then the rest will just happen.

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Yes. The only thing I would supplement that with is I did put our team through the paces of stressing, okay, give me all the worst things that could happen to us in the last -- you know, whatever. And use that to help set a framework for me as to how much I would be willing -- because I don't want to lock into something that if the black swan stuff happens you are sitting here going, my gosh, why did we do that? So we feel very, very comfortable with this level.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. If I could just ask one additional question, what was the change in compensation expense? What are you expecting now versus what you had expected going into the year?

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

To make sure I have your question correct, are you asking about how much we reduced from what we were accruing?

Olivia Tong - *BofA Merrill Lynch - Analyst*

Right.

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

15.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it, thank you.

Operator

Bill Chappell.

Sarah Miller - *SunTrust Robinson Humphrey - Analyst*

This is Sarah Miller, on for Bill. I have a follow-up to Olivia's question and then one other question. On your variable comp for next year, is it going to return to that level of 15 above this year, or is it going to build on top of what you expected for this year?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

Let me just throw out there that we generally operate with a bunch of different sets of numbers. This is not to be dishonest. It says that we have our own internal stress numbers. We have numbers we get the Board to commit to, and that really is our target comp, meaning the bonuses pay at 100%, which is what we've called target. And then there's the numbers we conservatively transmit to the investment community. So I think what you can see here is that we are in that middle range this year, which is, we believe, at approximately target. It's hard to say where we end up going forward in our budgeting process, because I think the idea of having the management team operating the business toward more stretch goals is a good idea as long as we don't need it to make our investment thesis to you guys and our commitment to the Board.

So it would not be surprising to me if we started the budget year with more than 100% built into the incentive, like we did this year. That does not mean that we are going to be committing to either the Board or the street an exceptional year, if that makes any sense.

Sarah Miller - *SunTrust Robinson Humphrey - Analyst*

No, that's perfect, thanks so much for that. My second question is, can you just talk around -- give a little bit more color on the inventories at the end of the season and going into the fall and how that sets you up for next year?

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

I'll take that one. Inventory right now is down a little bit year-over-year. What we would expect for the balance of the quarter is around 10% POS increases, and that will drive roughly flat inventory to slightly up.

As we look at last year, and you have to look at the business year-over-year and the decisions that were made, the retailers were conservative going into the fall. We had great comps in August and September, which had a lot of pull-through in October. This year, from a planning standpoint we are planning on the fall being up. But operationally, we are going to shift most of the shipments about two weeks earlier. But we expect that with the strong run we're having on POS right now that it will consume that. That will end the inventory roughly flat to last year at the quarter and we will go into October in good shape.

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Just to clarify, Barry is talking about retailer inventories. Our inventories will be down in the target range that we identified.

Sarah Miller - *SunTrust Robinson Humphrey - Analyst*

Thanks so much.

Operator

David MacGregor.

Unidentified Participant

This is [Zorn] in for David. Thanks for taking my questions and congratulations on the results. First, I was just hoping to get your thoughts on market conditions in Western Europe. Clearly, you had very good revenue growth in that market this quarter, and a number of companies operating in building products and consumer goods industries have indicated during this earnings season, that market appears to be bottoming, or even trending up.

Understanding that your business is subject to seasonality, could you just talk a little bit about the environment there, and maybe what your expectations might be for the region over the next 12 months?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

Let me just throw in my spin, if I could. I think that primarily what we are seeing in Europe is a rebound from just really sort of crap weather in the beginning of the season. I think they have ended up where it has been actually pretty nice and kind of followed the US as far as warm.

My forward view of Europe is possibly, I guess, that it's bottoming up. But I don't think that here in Marysville, there's a lot of view that there's a ton of upside on consumer demand in Europe until, I'm going to say, their economies start to feel a little better. And I don't personally see that. And talking to other senior executives of European-based businesses, I'm not sure they do either.

So I think that, for us, it was -- a lot of what happened was weather. But I think that the consumer has just not been a big help in Europe. Barry, I don't know how you would take that and go with it, but good luck.

Barry Sanders - *The Scotts Miracle-Gro Company - President and COO*

Yes, I would say that there's three things that affect -- as I look at macro things; Jim said some of them, the weather, the retailer sentiment and the consumer engagement. Similar to what you are saying, our point of view is we had better weather in the summer. The retailers stayed engaged. We had a couple bankruptcies in the previous couple of years that had shifted things around a bit. I think that has normalized, and the consumer seems to be engaged.

So where I would say we are at and where we are planning is, is that the business has stabilized at these levels. But as Jim has said, we are not planning on big growth from here; we are planning on consistent growth. That is in line with what we said we were going to do to right-size our cost structure to these levels. So we are planning on the business being relatively flat and right-sizing the business to those levels. And then, as time goes on, we will watch it. We think there could be slightly some upturn next year based on exactly what we saw in the US this year, which is weather. But we are going to plan for it at the modest levels.

Unidentified Participant

That's helpful. And if I could throw one more in there, also can you expand your commentary with regard to potential acquisitions in both the Consumer and LawnServices segment? Specifically, we've seen in the past that you have entered new product categories, like animal repellent on your own, just given strong brand awareness for your products. So should we interpret maybe your commentary as a change in strategy going forward, or would you still prefer to enter new categories on your own?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

That's a really hard question, because I think it's situational. I think we've spent a lot of time looking at the repellent category, ultimately decided that the best way, for a whole slew of reasons, was to do it ourselves and the use of the Ortho brand. I think that that's going pretty well for us. I think there's other areas where we don't really believe we have the skills to do it, and if there's an opportunity that's priced properly where we can either partner with someone or acquire them, I think we are willing to do that.

And I think, based on the fact that we have reserved a pretty substantial amount of money relative to what we have spent over the last few years, there is opportunities, if it's properly priced and it's a category that we are interested in entering, particularly if we see that growth in our core categories is, to some extent, retarded, then I think this is an area where we are interested in where we have availability and the price is right to either enter it ourselves or acquire or partner.

I think that probably is different just because we haven't been in that mode of acquisition. As you know, gross margin is something that we are focused on pretty hard. I wouldn't say excessively, meaning we are walking away from business because of margin, but I would say that this idea of 40 points of gross margin is really important to us. And it's something that we are at or ahead of plan on getting to, especially if you take absorption issues that happened this year as a result of volume shortfalls.

So margin is a factor as we look at these categories of what we are interested in and what we'd pass on.

Within lawn service, this is a great gross margin category, both on do-it-for-me lawn service and pest control, where there's much higher margins that we see in our normal US consumer business. And so this is an area where Brian Kura is competing for money. I was jousting with him a little this morning, that he actually has to have a presentation that is capable of making the sale with me and Larry. And he says he is now ready for that presentation.

So there is a little bit of competition for candidates within the North American Consumer business and the SLS business for -- which is more money than we've spent in the recent past, but it's not unlimited. And they are -- based on two-thirds going back to the shareholders.

So I think that there are opportunities and we are chasing them and we have a fairly well-populated, I would say, business development process happening right now, and that's a good thing.

Unidentified Participant

Great, thanks so much, guys.

Operator

Alice Longley.

Alice Longley - *Buckingham Research Group - Analyst*

My questions are mainly on gross margin. So you've got your favorable urea prices for next year, but aren't maybe diesel costs going to be a headwind with rising oil prices, and also resin for your jugs? I'm hearing that resin costs are going up a lot. So can you give us the puts and takes to convince us that your gross margins can be up next year, in line with that 40-basis-point goal that you've got?

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

You said -- well, Alice, I mean, there are ups and downs. On an overall basis, we view it as being relatively down. We've locked in about half of our cost, so we feel very comfortable. We have been working well with our retailers and we feel comfortable with where we are at in our discussions on pricing with them. We probably are not taking as much pricing as we would have taken or would have thought we would, five or six months ago, related to that. But we are very comfortable with our trend on gross margin and feel confident that we are going to, over time, get to our 40% gross margin. Probably not going to get the level that we had hoped by the end of next year related to being back at that fiscal 2010 level, just because we don't see volume and leveraging of our fixed cost by that point, but we will make significant strides.

Alice Longley - *Buckingham Research Group - Analyst*

A couple of follow-ups to that -- so you have locked in half of your urea cost. Have you locked in half of your resin and other costs as well?

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Yes. And if I wasn't clear, it wasn't 50% of our urea; it's 50% of our total hedged commodity portfolio.

Alice Longley - *Buckingham Research Group - Analyst*

Of the total hedged? And do you hedge resin and transportation costs?

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Yes, we hedge across the board.

Alice Longley - *Buckingham Research Group - Analyst*

Okay. And I misheard you earlier. What is your target for annual gross margin expansion?

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

We haven't locked down our target for next year yet. We are still in the budgeting process.

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

But, Alice, what I would say on that is we are at or above the trends. As I said, the way that I'm going to say Barry and Dave and myself, now Larry is -- the pass-down from me is, within our strategic plan, where we want to get to. I've told you our goal there is call it 40-ish. In the journey down the road toward the gross margin we are looking for, we are on or ahead of plan. Okay? It's a little bit hidden in this year because of a volume shortfall which drove an absorption issue. If you were to exclude that, we are at or above plan.

The approach for next year is we are very positive on our costs compared to where we thought we were going to be, enough so that we have been somewhat more flexible in our pricing than we would have been, had that not been the case. So I think that the guys can take you off-line through more of the details on costs, but the bottom line is we are favorable based on the commodity market to where we thought we were going to be. So I don't think there will be any issue convincing you that our gross margin targets are achievable.

Alice Longley - *Buckingham Research Group - Analyst*

Okay, and then I might have missed this earlier. But in your guidance for, let's say, flattish sales for this year, what would be the components in fiscal 2013 of volume, price and mix?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

I think I mentioned that. And as far as the fractions, I'm not going to get into that. If other people decide they want to do that, off-line, that's up to them. I think what we have said is our recovery in Europe, continued growth in lawn service and modest low-single-digit pricing in the US consumer business -- those are the components of (multiple speakers).

Alice Longley - *Buckingham Research Group - Analyst*

And that means 1 to 2?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

That's fair.

Alice Longley - *Buckingham Research Group - Analyst*

Okay, and what is your ad ratio doing this year?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

Advertising ratio in comparison to last year? Is that what you are --

Alice Longley - *Buckingham Research Group - Analyst*

Right, yes.

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

We are down about a point on ratio. So we are in the 5.5 A-to-S ratio area.

Alice Longley - *Buckingham Research Group - Analyst*

Is that something that you cut because volume was a little weak, or did you plan that at the beginning of the year?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

We are on plan throughout this entire year, so it wasn't really volume-driven at all. It's really a matter of promoting our highest-margin products in our innovation coming out the door. So this is consistent with a 50% increase and then backing that down to a 25% increase from 2011.

Alice Longley - *Buckingham Research Group - Analyst*

Okay, thank you very much.

Operator

Jon Anderson.

Jon Andersen - *William Blair & Company - Analyst*

I just had a follow-up on the commodity question and how it relates to gross margin. With, I guess, the net commodity basket favorable relative to your expectations at this point, and the forward purchasing that you have done or hedging, how does that roll out as you look into 2014 and into 2015? Because my understanding is there's some carryover effect that would not only benefit 2014, but potentially 2015. So I'm trying to get an understanding for the timing when we might see substantial benefit from lower urea prices.

And then also, if you can just provide a little more clarification on your pricing commentary, are you now deviating from your plan to take about 2% of price a year, given the changing cost environment? Or is that something that's still your long-term plan and objective?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

Let me just take the second part and then leave two other smarter people than me when the benefits of lower commodities, how long it takes before it rolls out into the P&L.

Yes, I would say it was a very slight deviation, is that we talked earlier about -- I like an environment where everybody is taking pricing. When not everyone is taking pricing, and we take a look at what is happening, especially in competitive categories like our controls business, this would be Ortho, I think that this is an area where what the consumer is willing to bear relative to how other people are pricing does matter, where it's a more competitive set. And, therefore, we have basically shown some flexibility in the negotiations with the retailers, where we are still making our margin goals happen.

And so I would say this is a very small deviation, but it's meaningful within the negotiations as far as the retailers being clear that we are making our margin targets, which are a pretty significant expansion from where we were, call it the end of last year, that when the commodity news is good, there's some more flexible view as long as we are making our goals. And those are important to me.

In regard to rolling it out over time, when that happens, Larry?

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Jon, a couple of pieces of information. When you look at our inventory cost and our cost of sales, raw materials is basically 19% on commodity-sensitive stuff, and on packaging it's fixed. You get a little bit of free in transportation. So all in, that's just 28% of our cost of sales.

In terms of when it will roll through, with our inventory turns, basically all of that is going to go through one year. In terms of what quarters, I don't have all that at the tip of my tongue. We will make our standard cost adjustment at the beginning of the year; that will roll through the first six months of the year, just as it did this year. But everything will play through in 2014.

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

Well, it's also positive. If we start 2015 with lower-cost products than we had anticipated in our strategic plan, it's got to be positive for us.

Jon Andersen - *William Blair & Company - Analyst*

Okay, one quick follow-up. Jim, you called out the mass channel as somewhat soft, at least in the context of stronger performance in DIY and hardware. As you think about that channel going forward, is it just a matter of waiting for a potential recovery in that middle/lower-middle income consumer? Or are there some deliberate things that you are doing internally to try and turn that part of the business onto a better trajectory?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

It's a really good question, by the way. I think the answer is probably both. I'm not going to focus too much on the consumer recovery, but I think it matters, especially in a category where people are more sensitive to pricing. We've opened up our option with cheaper SKUs that are lower priced. That has done really well in the food channel; I think had a little less merchandising support in mass, but hopefully we will get more listings there because it's working pretty well in food.

I think that if we looked and basically said that the mass channel -- so we are avoiding using names, but it's a retailer. I think they got into the business late this season, and you show up in middle of April on sort of tax day and you see stores in the Northeast not set -- that's a big problem. And so I think that the issues in Bentonville are pretty well-known. I don't think we are the only consumer-products company that has talked about these sort of issues executing the year.

Now, to be fair and positive, Barry and the sales team have done a superb job of working very closely at senior levels within Walmart to rectify that. If you look at their summer business, their summer business, while it is relatively small in numbers, are, I think, exceeding the rate of increase that we are seeing in DIY. So, once the merchandising plans are being executed at the retail level, I think we do okay. But I think they got in late. The peak of the season was kind of, I think, a problem.

So I think it's two issues. It's both continued weakness at the bottom end of the consumer marketplace, meaning that demographic; and a sort of failure to execute on time, which is probably our fault, too. But I'll take that just as a matter of being fair. Barry and his team have done, I think, a really good job of working about as well as you can with a retailer to say, hey, we've got to fix this and let's get on it. And I think both sides, both Bentonville and Marysville, have really worked hard to solve that problem. And I want to give Walmart credit for getting on it and tell them that we appreciate it, not only for our own selfish reasons, but it says something good about Walmart.

Jon Andersen - *William Blair & Company - Analyst*

Thanks for the color and congratulations on really running the business well through a difficult season.

Operator

Patrick Trucchio.

Patrick Trucchio - *BMO Capital Markets - Analyst*

Just to follow up on the mass-market versus the home centers, how much were sales up in DIY in home centers? And, did they decline in the mass-market? And if so, how much did they decline?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

From my point of view, I ain't saying. But I think it's fair to say, they were better at DIY and what we call channel business, meaning non-mass, but smaller regional players and hardware than they were at mass. I think you would -- probably if you run the numbers and say, if anything, they are down at mass. That's fair enough, and I would say up everywhere else.

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But it is what it is, and I think I commented on it before. And I view this as, like I said before, in part just economic issues and in part merchandising execution and retail execution, on both sides, ours as well. So I think everybody is on top of that and the sales for the summer have looked, actually, really good there. But I think probably, for sure, I can easily say down compared to a year ago.

Patrick Trucchio - *BMO Capital Markets - Analyst*

And then just on the share repurchase, how much of the buyback is anticipated for fiscal 2014? And then separately from that, why have we been seeing so much more insider selling recently? And will the share repurchase bring the family's percentage ownership of the shares, or will it restore it?

Jim Hagedorn - *The Scotts Miracle-Gro Company - CEO and Chairman of the Board*

So I will go with the back part of that again. So I'm like 58, and there's four of us, two sets of twins, so everybody is 55 plus. My older brother and sister are like 10 and 12 years older, respectively. Within the family, there's a liquidity plan that gives people authority to sell a certain amount of shares. I think some people are setting themselves up for their future, and they are doing that. It does not indicate a lack of commitment to our family business, or what we see as our family business. So I wouldn't read anything into that, except that at a family meeting over the late spring, people said what they wanted to do. We as a group said, well, do what you've got to do. And that's what you are seeing.

But it's really just people operating within what we call a liquidity plan.

I think that on the repurchase side, and I probably can speak for not only the Hagedorn family, but for other significant shareholders, too, who believe that if the stock is undervalued relative to what we think its intrinsic value is, that using repurchase as a method is a good one, and that it will make all of us, percentage-wise, larger shareholders (technical difficulty) to people who are sellers. I think (technical difficulty) sort of for my sister or the other family members, but to say that I think it's probably some mix. I think we would anticipate some accretion of our ownership through the repurchase, but it would not be fair to say, I don't think, that the family will not be participating at all in a repurchase.

Larry, maybe you want to talk about what your view of timing is.

Larry Hilsheimer - *The Scotts Miracle-Gro Company - CFO and EVP of Strategy and Business Development*

Yes, in terms of timing, as we have said before, our plan is to take advantage of the share repurchase authorization that we have and execute on that to the extent that the valve would support that over the next year. And, we will also be looking for a supplemental return of the up to two-thirds of our cash flow that we've talked about, which would, again, align to next fiscal year.

Patrick Trucchio - *BMO Capital Markets - Analyst*

Okay, that's it for me. Thank you very much.

Operator

At this time, we have no further questions in the queue. Mr. King, we will send it back to you.

Jim King - *The Scotts Miracle-Gro Company - SVP, Chief Communications Officer*

If there are other follow-up questions for people that we didn't get to, just give me a call directly today, 937-578-562.

One other item before we close. Barry Sanders and I will be attending the CL King Best Ideas Conference in New York on September 12. As usual, that call will be webcast on our IR website. So if you are not there in person, you can listen in.

Other than that, we will be reporting our Q4 results and year-end results early in November and we will talk to you then. Thanks for calling and joining us. Have a great day.