



The Scotts Miracle-Gro Company
2/5/18
Price Target: \$106.00
Prepared for Frostgate Capital, L.P.



Market Cap: \$5.19 B
52 Week Range: 81.48 – 110.12
RSI: 23.83
Beta: 0.35

Company Description

The Scotts Miracle-Gro Company (NYSE: SMG) offers consumer lawn and garden products, as well as products for professional horticulture. SMG offers 10 different brands for pest, weed, lawn care and gardens. The company was founded in 1868, and is headquartered in Marysville, Ohio. I am proposing a buy thesis, with a price target of **\$106.00**, which is roughly a **20%** upside. In light of the strong bull market experienced since the Housing Crash of 2008, I think it is important to focus on companies with strong balance sheets, rather than those with recent, explosive growth in their income statement.

Scotts Miracle Gro was founded in 1868 by O.M. Scott, after he was discharged from the Union Army. It was initially founded as a seed company, but grew to an international marketer of industry leading brands, following a merger with Miracle Gro in 1995. Scotts Miracle Gro key brands include *Scotts®* and *Turf Builder®* lawn and grass seed products; *Miracle-Gro®*, *Nature's Care®*, *Scotts®*, *LiquaFeed®* and *Osmocote®* (*Osmocote®* is a registered trademark of

Everris International B.V., a subsidiary of *Israel Chemicals Ltd.*) gardening and landscape products; and *Ortho*®, *Roundup*® (*Roundup*® is a registered trademark of *Monsanto Technology LLC*), *Home Defense*® and *Tomcat*® insect control, weed control and varmint control products. SMG has exclusive rights to the patents of all aforementioned brands. SMG is the exclusive agent of the *Monsanto Company* for the marketing and distributing of consumer *Roundup*® non-selective weed-killer products within the United States, as well as other specified countries.

Jim Hagedorn is the CEO of Scotts Miracle Gro, and has been since 2001. He has been with the company since 1995, when he was named Senior Vice President of the Consumer Gardens Group. He has been an instrumental key in the company’s success in both the United States and abroad.

Randy Coleman is the Executive Vice President and CFO of Scotts. He has been with the firm since 2014, and has helped the company grow and manage all of the financial woodworks of the company.

Through several acquisitions, SMG has become a leading producer of liquid plant food products, advanced indoor garden lighting and ventilation systems, as well as a wide variety of accessories for hydroponic gardening. Their wholly owned subsidiary, *Hawthorne Gardening*, is a leader in the hydroponic, urban, and indoor gardening. From 2016 to 2017, we saw assets, revenue, and operating income climb substantially for the *Hawthorne* business segment.

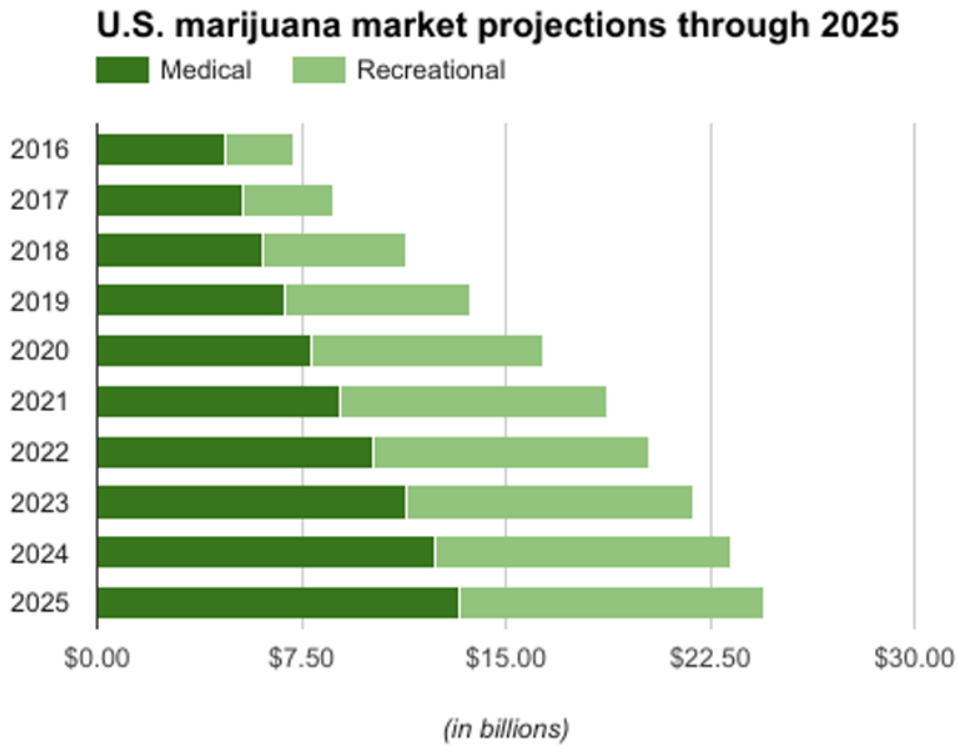


SMG has three main business segments; US Consumer, Europe Consumer, and “other”. The three businesses account for 77%, 13%, and 10% of revenues, respectively. The company has a strong network of brokers and distributors, and most clients include home centers, mass merchandisers, nurseries/garden centers, and hardware chains. Their largest customers are The Home Depot, Lowe’s, and Wal-Mart. These three are their most important partnerships.

The company has high operating margins, and we continue to see growth out of the Hawthorne business segment, which deals directly with cannabis farmers. Currently, revenue projections for the Hawthorne segment were cut due to stalls from California county

governments in instating the new law for recreational and medicinal marijuana. However, if we look at the expected growth of the industry we can see that the future potential for the Hawthorne segment revenue is promising.

Hydroponic gardening is the future for the marijuana industry. In urban environments, it is many growers only option to farm hydroponically, whether it is concerns for space, soil, environment, etc. The Hawthorne business segment is the main driver of these products, and they are industry leaders in lights, systems, valves, and other equipment necessary to ensure efficient urban growth.



Recent Acquisitions

In December of 2016, the company acquired two technology companies, Blossom who manufacturers smart water controllers, and PlantLink, which manufactures soil sensors and smart water valve systems for gardens. This is a huge breakthrough for industrial farming- it will boost efficiency on farms, therefore increasing output.

Both businesses are extremely relevant to the main business lines that SMG offers. Smart water controllers are a pivotal piece of equipment for hydroponic gardens. They are an up and coming technology that farmers, gardeners, and homeowners worldwide will be able to utilize in order to make better use of their time, and run their gardens more efficiently.

Blossom offers an app for androids and apple devices, so that sprinklers and watering systems can be controlled remotely.

PlantLink is revolutionizing the gardening industry with their soil sensors. Not only is this smart device able to water plants remotely, but the soil sensors they manufacture can alert you to water the plant, depending on the type of plant and type of soil. Both companies together offer optimum efficiency for any gardener.

The tie between the two companies makes both acquisitions very strategic, as the controllers manufactured by Blossom are able to control the smart water valve systems that are manufactured by PlantLink.

In May 2016, a wholly owned subsidiary of SMG acquired 75% of Gavita, and company that produces special lights for indoor gardening. Gavita completes the trifecta of acquisitions, where SMG now owns companies that produce and manufacture lights, smart water valves, smart controllers, and soil sensors. Their shift from lawn and garden supplies to cater more towards the cannabis industry may have been early, but I still believe it was the correct move.

Why the Stock Tanked

SMG went down significantly after market close on 1/31/2018, after earnings were missed. On call with CEO Jim Hagedorn after news was released, the CEO cited that revenue projections for the coming year were being slashed. This can be attributed most to the sluggish start for California's recently legal recreational market. Hagedorn says that revenue in the hydroponics business may be flat, or decline, this year. This is after the company projected a 10% gain.

The root of the problem is counties in California. On January 1, California expanded legal pot use from medical patients to all adults. However, roughly 90% of California counties have yet to regulate their own towns, specifically pertaining to the production and sale under the new law. Because of this looming uncertainty, many growers have been hesitant to buy the necessary equipment, such as lights, smart valves, etc. in order to grow the marijuana.

However, there is still light at the end of the tunnel. Hagedorn bets that Scotts will rebound in the long run, especially as more states decriminalize, and the market for marijuana growing equipment increases.

A recent Seeking Alpha article sites that the monstrous decline is "overblown", and "represents a buying opportunity".

Industry Updates – Home Products

As interest rates rise, homebuyers are frantically attempting to secure loans before they have to pay a premium. Mortgage applications jumped 4.5% last week than the week prior, and application volume is up 6.1% from what it was at this time last year, according to CNBC. We can expect homeowners/home sellers to want to maximize their return, by maximizing their property value. That means having all the amenities of a good home; lawn, garden, plants, etc.

Industry Updates – Lawn Care

The home/lawn care industry has been in a bull market since the recession. According to the State of the Industry Report from *Lawn and Landscape*, median revenue for landscaping companies in 2017 was \$291,000, which is up almost \$70,000 since 2014. The report cites significant growth in specific business areas, such as maintenance and chemical applications.

With SMG turning to organic chemicals, it is reasonable to expect that the company will benefit from these industry shifts. People are now spending more money on their lawns. In a 2015 survey by Mintel, 90% of respondents indicated that a nice lawn increases the value of their home, while 75% indicated their lawn is a reflection of their personality. America spend roughly \$90,000,0000,000 on lawn care in 2015- which is roughly \$90/person. This number has been increasing, as people seek to improve the value of their residence.

Medical and Recreational Marijuana Industry

The global medical marijuana market size was valued at \$11.4 billion in 2015. The growth projections for the industry suggest an expected CAGR of just over 17% through 2025, according to Grand View Research. SMG has significant market share in the horticulture industry, which means the growth of this industry will be strongly correlated with the revenue figures for SMG. Currently, 29 states have legalized medical marijuana, and seven have even legalized it recreationally.

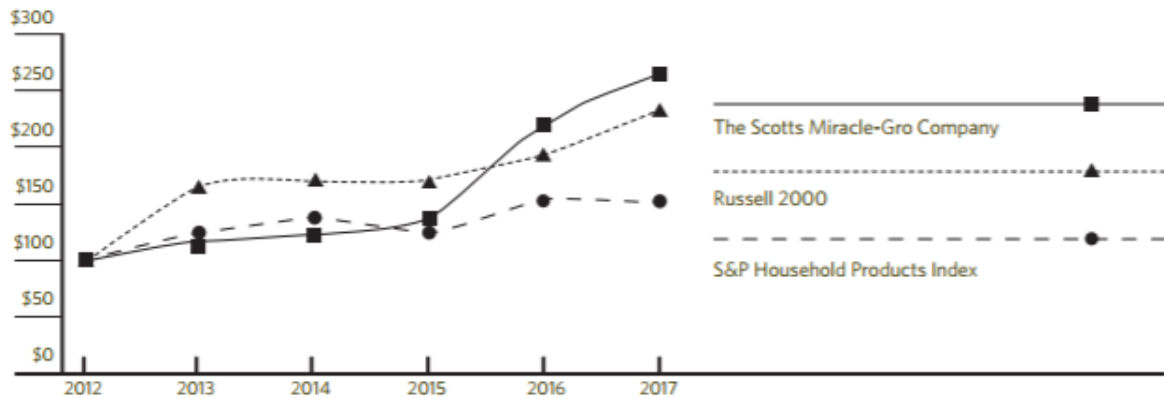
With President Trump's relaxed stance on all types of regulation, we can expect to see this business take off in the coming 2-3 years. The industry has foreseeable value, and SMG is the perfect way to gain exposure, and hedge against regulatory risk.

Growth Catalysts

- Medical/Recreational Marijuana Industry play with minimized risk
- Innovative technologies
- Hydroponic gardens
- Intellectual Property Rights
- RSI < 30 (22)

Comparison of 5-Year Cumulative Total Return*

Among The Scotts Miracle-Gro Company, The Russell 2000 Index and The S&P Household Products Index



*\$100 invested on 9/30/12 in stock or index, including reinvestment of dividends. Fiscal year ending September 30.

Innovative technologies

One step that Scotts Miracle-Gro is taking to be more conscious of their effect on the environment is shifting to the use of organic and natural products. In the next five years, SMG plans to take the majority of its products greener. By doing so, the company is going to fight for a more sustainable business model that will ultimately benefit the shareholders.

Hydroponic gardens are a unique space, one that SMG has significant market share. Hydroponic gardens are those without soil- which sounds like a far out concept but is the most popular way to bring gardening indoors. It makes city gardening, gardening without a lawn, and gardening in unfavorable climates possible.

Financial Analysis

Strong Balance Sheet

SMG remained fairly flat in asset growth, but they were able to retire roughly \$42 million of short term debt from FY2016, and total current liabilities are down approximately \$162 million. Long term borrowing is was up approximately \$227 million during the same period. The company is highly leveraged, with an average debt/equity ratio of 3.6 through the last 7 quarters.

SMG is down nearly 20% over the last two days, but I think there are still gains to realize. Although revenue has been nearly flat over the last 3 years, if we look at the CAGR of their operating income, it has increased by just over 10% annually. By effectively cutting costs, SMG will be able to capitalize on a growing horticulture industry, driven primary by medical marijuana growth. One of the biggest points of emphasis from CFO was increasing the company's free cash flow, and it is clear the steps they are taking are working. It is now a matter of cutting general and administrative costs, which will lead to more money for the company.

| | | | |
|-------------|-------------------------|------------------------|---------------|
| Year | Operating Income | Ending Value | 476.90 |
| 2015 | 352.10 | Beginning Value | 352.10 |
| 2016 | 413.80 | # of years | 3 |
| 2017 | 476.90 | CAGR | 10.64% |

SMG can be approached as both a consumer and healthcare play. The products offered by SMG best model after a consumer/home care company, however, SMG also offers exposure to the healthcare industry through its horticulture products. According to Forbes, by 2020, medical marijuana sales are projected to grow from their 2016 sales of \$4.7 billion up to \$13.3 billion. Canada plans full legalization by mid-2018 (will touch on Fafard and Brothers Ltd. Below). SMG offers exposure to the medical marijuana market, however, is a conservative play, as regulatory hits would not affect the company.

With Canada expecting full legalization by mid-2018, exposure into the Canadian market would provide a sizeable advantage over other players in the industry. In 2014, SMG subsidiary Scotts Canada Ltd. Acquired Quebec based Fafard and Brothers Ltd., a premier soil company in the region. Through the acquisition, SMG gains customer exposure in the budding cannabis market in Canada.

Over the last 5 years, total assets have grown by 7.24% annually. Inventories have grown by over 4.5%, and long-term assets have grown by just over 14% annually. Total debt since 2016 has fallen by over \$300 million, due to capital restructuring in 2017.

Competitors

Finding realistic competitors for SMG is tough because of the uniqueness of their business. Closest competitors would include Monsanto (however vastly different because of Monsanto's work with GMOS), along with a few other smaller companies listed below. I felt it was most applicable to narrow the comparable down to those within the Fertilizers and Agricultural Chemicals sub industry.

Holdings

Institutions hold roughly 71% of outstanding shares of SMG, while insiders hold the remaining 29%. Only four institutional investors hold more than 5% of the shares, and all are under 10%.

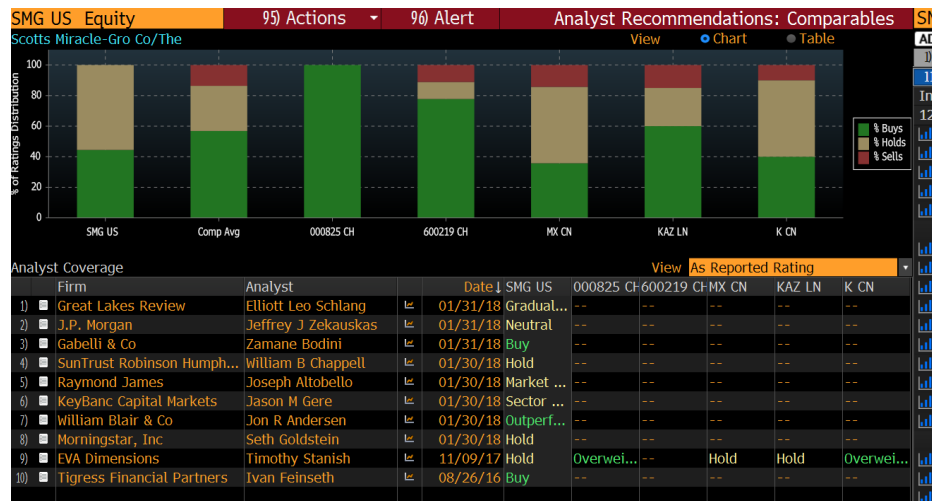
Comparable Analysis

| Classification | Type | Metric | SMG | Low | Comp Range | High |
|---|----------------|-------------|-------|--------|------------|--------|
| 1) Materials | Sector | P/E | 25.69 | 3.14 | | 56.48 |
| 2) Materials | Industry Group | EPS 1 Yr Gr | 5.82 | -78.92 | | 1.18k |
| 3) Chemicals | Industry | Rev 1 Yr Gr | 5.42 | -27.06 | | 16.20 |
| 4) Fertilizers & Agricultural Chemicals | Sub Industry | ROE | 37.26 | -3.43 | | 262.73 |
| | | Chg Pct 1M | 0.88 | -0.64 | | 33.92 |

Showing Closest 15 Comps by Mkt Cap

| Overview | Comp Sheets | Markets | EPS Preview | Ownership | Credit | Custom | ⚙ | | |
|-------------------------------|---------------|---------|-------------|------------|-----------------|-----------------|-------|---------|-------------|
| Name | Mkt Cap (USD) | Last Px | Chg Pct 1D | Chg Pct 1M | Rev - 1 Yr Gr:Y | EPS - 1 Yr Gr:Y | P/E | ROE | Dvd 12M Yld |
| Median | 5.64B | 15.39 | -0.21% | 4.77% | -3.13% | -5.99% | 28.97 | 13.87% | 1.61% |
| 100) SCOTTS MIRACLE-GRO CO | 6.20B | 107.93 | -0.09% | 0.88% | 5.42% | 5.82% | 25.69 | 37.26% | 1.91% |
| 101) UPL LTD | 6.29B | 12.38 | 2.54% | 3.38% | 16.20% | 78.04% | 23.15 | 26.75% | 0.89% |
| 102) HUBEI SANONDA CO LTD-B | 6.19B | 1.13 | -1.89% | 3.76% | -14.59% | -- | 29.15 | 3.60% | -- |
| 103) ISRAEL CHEMICALS LTD | 5.58B | 4.37 | -3.00% | 5.39% | -0.78% | -58.91% | 22.05 | 9.17% | 3.31% |
| 104) PHOSAGRO PJSC | 5.70B | 44.05 | -0.32% | -0.64% | -1.05% | 62.41% | 9.91 | 37.18% | 4.59% |
| 105) URALKALI PJSC | 6.42B | 2.19 | -3.67% | 4.94% | -27.06% | 1.18k% | 3.14 | 262.73% | -- |
| 106) QINGHAI SALT LAKE IND... | 6.40B | 2.30 | -5.03% | 4.60% | -2.82% | -63.20% | -- | -3.43% | 0.09% |
| 107) OCI NV | 5.57B | 26.47 | 0.52% | 1.85% | -12.79% | -56.39% | -- | -1.59% | -- |
| 108) K+S AG-REG | 5.44B | 28.44 | -0.60% | 10.91% | -17.22% | -78.92% | 28.95 | 2.40% | 1.30% |
| 109) SHANDONG HUALU HENG... | 4.83B | 2.98 | -3.23% | 18.72% | -11.40% | -3.56% | 29.55 | 12.85% | 0.41% |
| 110) SAUDI ARABIAN FERTILL... | 7.67B | 18.41 | 2.12% | 7.14% | -3.38% | -16.77% | 32.72 | 16.60% | 2.53% |

Analyst Recommendations



My price estimate for 2018 is towards the higher end of analyst recommendations, but I believe that the company has a lot of room to grow in 2018, and even further down the road as the marijuana industry comes to light. The fact that the price dropped 15% after earnings call indicates that the reaction from investors was overdone, especially so after the CEO said the company was slashing their revenue estimates for 2018. However, this dip presents an opportunity to get into the stock at a fair price, and take advantage of the growth of the industry in years to come.