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The Scotts Miracle-Gro Company (SMG)
Earnings Quality Update- 12/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of SMG at 4- (Acceptable).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

SMG reported a non-GAAP loss per share of $0.88 in the 12/31 quarter, falling 15 cps short of consensus. Revenue fell by 24% in a seasonally small quarter due to difficult comparisons. US Consumer sales fell by 16% which was better than management was expecting. Sales growth guidance for this segment for the year was upped to +2% to -2% from its previous 0% to -4% range. However, Hawthorn revenue declined by 38% as the oversold conditions in the cannabis market remained difficult and management does not expect a recovery before late summer. These two changes offset leaving sales guidance for the full year unchanged.

Gross margin declined by 570 bps on lower leverage and higher than expected costs. We continue to view the company's overall earnings quality as acceptable and believe the biggest risk is the company's ability to push through its planned prices increases without stunting volume growth.

- Inventory DSI jumped to 345 in the 12/12 quarter from 180 a year ago. Keep in mind that last year, the company was struggling to keep adequate inventory on hand amid abnormally strong demand. Of the approximate $600 million increase in inventory, management attributed about one-third to rebuilding stocks to an adequate level and one-fourth to higher prices. SMG uses FIFO inventory accounting so older inventories are expensed first. We continue to see good conditions for margins in the 3/22 quarter as the August and January price increases should match well against older, lower-cost inventories.

- SMG announced an unprecedented third price increase to take effect in April. This may help to offset costs as the company works its way into the higher cost inventory levels in the 6/21 quarter. However, prices will be higher by "in the teens" compared to last year and it remains to be seen how elastic the demand will prove to be.

- While raw materials costs were higher than the company was expecting, management also mentioned that it is seeing signs that prices for key inputs like urea are topping which could help on the cost front in the June quarter.

- The inventory reserve continued to fall from its unusually high level set in the 9/20 quarter. The reserve percentage has now fallen to its pre-pandemic level as a percentage of inventories. Still, it stands out that a 47% sequential increase in inventory was met with a 13% decline in the reserve. If the reserve percentage had remained constant with the 9/21 quarter, it would have taken about 20 cps off earnings growth in the period. This benefit appears to have run its course.

Inventory Jumped Again in the Quarter

SMG's trend of rising inventory continued into the 12/21 quarter as seen in the following table:

	1/1/2022	9/30/2021	7/03/2021	4/03/2021
Total Inventory	$1,657.2	$1,126.6	$962.8	$1,019.2
Cost of Sales	$447.3	$611.6	$1,115.1	$1,171.3
DSI	344.6	163.9	78.6	79.2

	1/02/2021	9/30/2020	6/27/2020	3/28/2020
Total Inventory	$1,068.3	$621.9	$493.1	$743.3
Cost of Sales	$557.8	$674.3	$966.0	$832.6
DSI	180.0	87.6	46.5	81.2

	12/28/2019	9/30/2019	6/29/2019	3/30/2019
Total Inventory	$866.1	$540.3	$533.7	$675.3
Cost of Sales	$311.6	$408.2	$746.9	$717.8
DSI	247.4	123.1	65.0	85.6

Note that the DSI calculation is made especially volatile in the fourth quarter given the low seasonal sales. Nevertheless, the huge sequential increase in the inventory balance is noteworthy. Management stated the following regarding the inventory build in the conference call:

> *"First, recall that inventory levels were lower than we had wanted a year ago as we were shipping product nearly as fast as we could build it in both major segments. Second, recall that we consciously built an inventory cushion last year to ensure we are able to keep our retailers at the appropriate levels throughout the season. And finally, about 25% of this increase is due to the higher input costs we've been experiencing over the past year. We remain comfortable with inventory at this level and continue to see it as a competitive advantage. We expect to see some competitors continue to struggle to meet demand this year, which we believe will work to our advantage."*

We are not especially concerned that the company has overbuilt and management strongly indicated on the call that inventory levels at its retail customers are about the same as a year ago. However, SMG accounts for its inventory under the FIFO method, meaning it expenses older inventories that were acquired at lower costs. As management noted, about 25% of the increase in inventory balances YOY is due to higher costs that have been stored in inventory and will be making their way to the income statement over the next couple of quarters. SMG has been increasing prices over the last year to help offset these higher costs.

- After the 3/21 quarter, the company announced "high single-digit price increases" in its US Consumer business which took effect in the 9/21 quarter.

- After the 9/21 quarter, SMG announced another price increase to take effect in January of 2022 which it described as “more targeted” ranging from “mid-single to low double-digits depending on the product line.”

- In the conference call for the 12/21 quarter, management announced an unprecedented third price increase for the year which will take effect in April.

Management indicated on the call that adding all the price increases together will result in prices this spring and summer being up “in the teens” from last year. Management continues to be optimistic that it will be able to pass along the higher prices. Based on sequential volume trends, the company believes it will be able to maintain many of the new gardeners it picked up with the pandemic. However, given the rising cost of other items such as food and gasoline, we could see some new gardeners being reluctant to spend as much as before at substantially higher prices.

After the 9/21 quarter, we thought the company could have a decent 3/22 quarter as sales benefitted from the August and January price increases while it expensed the older, lower-cost inventories. However, we were worried that margins in the 6/22 quarter might be pressured as newer, higher-cost inventories hit the income statement. The newly announced price increases for April help reduce that concern, as does management stating that it is beginning to see prices come under control for certain key items. On the call, management discussed its position in locking in contract prices for the year and recent trends it is seeing in raw materials prices:

> *“In total, we are 70% locked on commodities for the year, which is slightly behind normal. We would normally have all of our costs locked right now on pallets, but we're only at 30% because vendors are not currently entering into long-term contracts due to the volatility of lumber prices. On everything else, we're actually in good shape, including urea, where we're nearly 80% locked for the year.* ***The better news is that we're starting to see some relief. Resin has been retreating for a couple of months now. Urea has begun to do the same.*** *No one has been accurately predicting input costs for the last year, so I want to be cautious. Still, I'm increasingly optimistic that the pricing moves we've taken should offset these commodity headwinds on a full year basis.”*

As we see it, margins in the 6/22 quarter will come down to how the April price increases stick with consumers and how much of the company’s new pandemic gardeners stay with the hobby.

Inventory Reserves Fell Again

We highlighted in the 9/21 quarter that growth benefitted from the inventory reserve declining from an unusually high level in the year-ago quarter. This trend continued into the 12/21 quarter as shown in the below table:

	1/1/2022	9/30/2021	7/03/2021	4/03/2021
Total Inventory	$1,657.2	$1,126.6	$962.8	$1,019.2
Adjustments to reflect inventories at net realizable value	$19.4	$22.5	$21.3	$21.4
% of Net Inventory	1.2%	2.0%	2.2%	2.1%

	1/02/2021	9/30/2020	6/27/2020	3/28/2020
Total Inventory	$1,068.3	$621.9	$493.1	$743.3
Adjustments to reflect inventories at net realizable value	$23.9	$31.3	$13.9	$12.5
% of Net Inventory	2.2%	5.0%	2.8%	1.7%

	12/28/2019	9/30/2019	6/29/2019	3/30/2019
Total Inventory	$866.1	$540.3	$533.7	$675.3
Adjustments to reflect inventories at net realizable value	$11.4	$8.8	$9.4	$8.1
% of Net Inventory	1.3%	1.6%	1.8%	1.2%

We see that the reserve as a percentage of net inventory declined to 1.2% in the most recent quarter from 2.2% a year ago. This is more in line with pre-pandemic levels. Still, it stands out that a 47% sequential increase in inventory was met with a 13% decline in the reserve. If the reserve percentage had remained constant with the 9/21 quarter, it would have taken about 20 cps off earnings growth in the period. This benefit appears to have run its course.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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