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The Grass is Greener

Scotts Miracle-Gro is a high-quality business that for multiple reasons after the pandemic hit also became a hot stock. As investor enthusiasm has cooled, Jonathan Boyar explains why the company's shares today deserve a closer look.

The stars aligned for Scotts Miracle-Gro as the pandemic raged through the U.S. in 2020 and into this year. It is the dominant player in the U.S. market for lawn and garden products – brands including Scotts, Miracle-Gro and Ortho have more than 50% market share – and sales took off as those increasingly at home spent more time and money on their lawns and gardens. On top of that, its Hawthorne division is the top seller of indoor gardening, hydroponic and lighting equipment serving cannabis growers, another market that experienced a pandemic jolt to sales and from the ongoing relaxation of state laws against pot and related products. At $105 at the beginning of 2020, Scotts' shares hit nearly $255 in April of this year.

The high didn't last. The company earlier this year announced new capital-spending plans and took down margin expectations due to higher operating costs and a larger percentage of revenues coming from lower-margin Hawthorne. Comps against strong 2020 numbers disappointed as potential customers left their houses more frequently as the pandemic (intermittently) eased. Management talked up the potential for mergers and acquisitions. All that caused investor enthusiasm to wane and the stock ground down over the latter half of this year to a recent price of around $159.

Boyar Asset Management's Jonathan Boyar argues that the investor concern around Scotts has been overdone. He considers its U.S. consumer business a uniquely strong franchise, which will continue to thrive beyond any short-term negative comparisons as millennials increasingly move into homes and continue to show a greater propensity to spend on lawn and garden products than their parents. The company estimates that 20 million people have bought Scotts' products for the first time since the pandemic started. After a modest reset this year, Boyar expects high-margin revenue growth in the consumer business to resume.

INVESTMENT SNAPSHOT

Scotts Miracle-Gro
(NYSE: SMG)

Business: Develops, manufactures and distributes consumer lawn and garden products as well as a variety of products and equipment for commercial cannabis growers.

Share Information (@12/30/21):

Price	**158.99**
52-Week Range	133.36 – 254.34
Dividend Yield	1.7%
Market Cap	$8.68 billion

Financials (TTM):

Revenue	$4.93 billion
Operating Profit Margin	15.2%
Net Profit Margin	10.4%

Valuation Metrics
(@12/30/21):

	SMG	S&P 500
P/E (TTM)	17.8	28.8
Forward P/E (Est.)	16.7	22.7

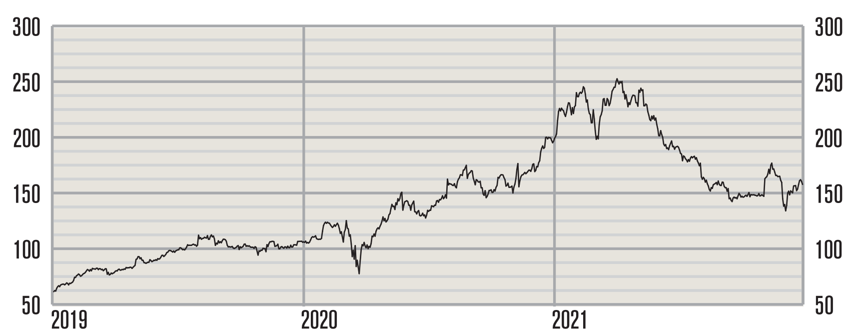
Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Kayne Anderson Rudnick	8.6%
Vanguard Group	7.4%
BlackRock	5.8%
Earnest Partners	2.5%
State Street	2.0%

Short Interest (as of 12/15/21):

Shares Short/Float	3.4%

SMG PRICE HISTORY



THE BOTTOM LINE
Given that both of its businesses have strong positions in attractive underlying markets – consumer lawn and garden and cannabis – Jonathan Boyar considers the market surprisingly indifferent about the company's stock. Valuing each business separately based on his 2024 EBITDA estimates, he pegs the shares' fair value at just under $245.

Sources: Company reports, other publicly available information

While there is regulatory risk around cannabis – it is still illegal under U.S. federal law – he believes the cat is essentially out of the bag as more states continue to legalize both medicinal and recreational use. Widespread legalization would significantly increase the number of cultivators and drive development of ancillary products, all of which would incrementally benefit Hawthorne. It has established a first-mover advantage in the developing industry and has 40-50% market shares, depending on the product line.

Cannabis is profitable for Scotts, generating low-teens operating margins, but Boyar expects margins to improve as Hawthorne scales and its contribution to the company's overall revenue increases beyond today's 30% level. Management has proven adept at product innovation, marketing and brand building on the consumer side, and he expects that expertise to further translate into enhanced market positions and profitability for Hawthorne as well.

The risk of misguided capital allocation is low, he says. Chairman and CEO Jim Hagedorn, a former F-16 fighter pilot, has run the company since 2001, taking over for his father, who founded the original Miracle-Gro in 1951. Jim's son Chris is the President of the Hawthorne division, and the family still owns more than 25% of the outstanding shares. Says Boyar: "When the stock was at around $250, they talked about special dividends. With the stock selling off dramatically they are discussing buybacks. They've been good acquirers over the years. They treat the money like it's their own – in a good way – because a lot of it is."

ON CAPITAL ALLOCATION:

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One potential negative is the company's line of Roundup-branded lawn and garden products in the U.S. It licenses the brand from Germany's Bayer, which has been fighting numerous legal battles over the safety of commercial Roundup products containing glyphosate. Over the summer Bayer said it would remove the additive from all Roundup versions – including the consumer ones sold by Scotts – by 2023. While Bayer indemnifies Scotts against any legal liability related to Roundup, there is some risk that the reformulated, glyphosate-free products won't sell as well. That could hurt – Boyar estimates the brand accounts for 10-15% of Scotts' overall profitability today – but he expects the impact, if any, to be well mitigated by Scotts having already developed a replacement product under its Ortho brand that could offset any falloff in Roundup sales.

In valuing Scotts' shares, Boyar assumes over the next three years that revenues increase 2% annually in the consumer business and 12% per year for Hawthorne. In that same period he expects EBITDA margins to increase modestly on the consumer side to around 24.5%, and to increase for Hawthorne from 13.5% to 19%. On the resulting 2024 EBITDA estimates he applies what he considers a reasonable 14x EV/EBITDA multiple for the consumer business and 15x for Hawthorne, which after adjusting for corporate expenses and net debt brings his estimate of fair value to just under $244 per share, a more than 50% premium to today's price.

If the market is slow to recognize that value, he expects the company to pursue a partial spinoff of Hawthorne, both to provide it with an independent currency to make acquisitions and to highlight its unique value. CEO Hagedorn has said Hawthorne is the most valuable pot-related franchise in the U.S. – publicly floating at least some of its shares would provide a solid test of that assertion. VII

Important Disclaimers