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Cutting the grass

Evan Lorenz writes:

Combine a well-reputed CEO with a subpar business, and it's the business's reputation that remains intact, the Oracle of Omaha warns. But what happens when an unexceptional manager takes the reins of an excellent business? In preview, *Grant's* is bearish on Scotts Miracle-Gro Co. (SMG), and we reevaluate our stance on pick-not-to-click Innovative Industrial Properties, Inc. (IIPR; both on the New York Stock Exchange).

The Scotts Co. was born in 1868 when a Civil War veteran named Orlando McLean Scott began selling premium seeds (no weeds) out of his hardware store in Marysville, Ohio. Eight decades later, former advertising exec Horace Hagedorn and nurseryman Otto Stern developed Miracle-Gro, a liquid fertilizer to which they affixed the slogan, "You don't have to be an expert to create a beautiful garden." In 1995, the merger of seeds and fertilizer formed Scotts Miracle-Gro.

Today the united business commands nearly 50% of the American market for lawn and garden products. Scotts, Turf Builder, EZ Seed, Miracle-Gro, Organic Choice and Bug B-Gon are among the ubiquitous brands. Scotts Miracle-Gro is the exclusive American marketer and distributor of Bayer A.G.'s consumer Roundup products, the popular/infamous (depending on your legal positioning) herbicides brand.

The SMG share price would be higher if corporate aspirations had stopped there. However, in 2011, Jim Hagedorn, the son of Horace, Miracle-Gro co-founder—and current chairman and CEO of Scotts Miracle-Gro—had a bright idea: The company would pivot to marijuana. "I want to target the pot market," young Hagedorn told *The Wall Street Journal*. "There's no good reason we haven't."

Between 2015 and 2022, Scotts spent $1.6 billion on acquiring companies having to do with the product variously known as Mary Jane, Aunt Jane, Aunt Mary, rainy-day woman, green goddess, pakalolo, doobie, puff, herb, ganja, alfalfa, asparagus, broccoli, cabbage, devil's lettuce, Maui wowie, Astro turf, boof, blunt, gangster, sticky icky, bag of bones, Houdini, skunk, wooz and—according to the federal Drug Enforcement Agency—smoochy woochy poochy.

Scotts similarly invested in cannabis capital equipment such as hydroponic systems, indoor grow lights and a smoochy-woochy-poochy-related investment business. Hawthorne, the Scotts business unit that houses these forays, logged revenue of $1.4 billion in fiscal year 2021 (ending September), up from $48 million in 2015.

And that was the high. Over the past three years, the spot price of weed has collapsed to $1,031 per pound from over $1,600, according to Cannabis Benchmarks, as growers flooded the market. Unprofitable Curaleaf Holdings, Inc., the largest producer and distributor of pot by market capitalization, has suffered a collapse in market value to $3.3 billion from a peak of $12.3 billion in

Not for the bears

source: The Bloomberg

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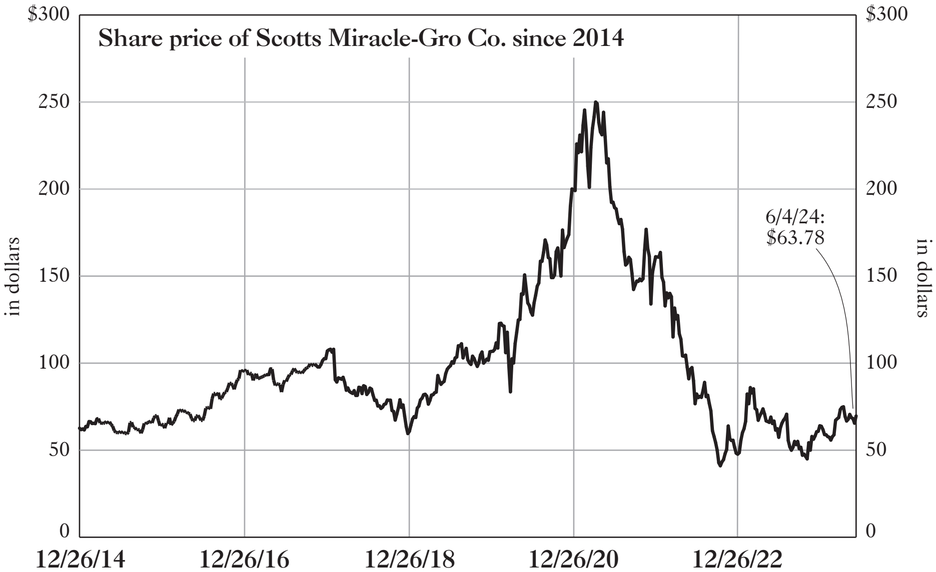
Not so miraculous



source: The Bloomberg

early 2021. From fiscal 2021 through the 12 months ended March 30, 2024, Scotts's Hawthorne sales have declined by an astounding 72.6%.

The peak and rapid fall caught Hagedorn unawares. At least, Luxx Lighting, Inc., the indoor grow-light company for which Scotts laid out $213.2 million on Dec. 30, 2021, became a dead loss within nine months of its acquisition.

Last week, RIV Capital, Inc., a pot dispensary, announced that it would merge with Cansortium, Inc. in an all-share transaction. As part of the deal, Scotts agreed to write-off $175 million in debt owed by RIV. On Monday—annoyingly—Scotts's share sank 7.7%. Why the news couldn't wait until we published is a mystery.

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The hangover following the wake-and-bake has led Mr. Market also to reappraise Innovative Industrial Properties (*Grant's*, Nov. 26, 2021). As it is, the U.S. government classifies marijuana as a Schedule I controlled substance, i.e., a drug with no accepted medical use, alongside heroin and LSD. In consequence, no American bank may lend to a dope merchant. Larger, more profitable skunk growers can issue stock or bonds, but smaller businesses are reduced to such costly financing workarounds as sale-leaseback transactions with Innovative Industrial.

However, the legal framework is changing. Last month, President Joe Biden announced that marijuana will be reclassified as a Schedule III substance, i.e., on par with anabolic steroids. If Congress passes the Secure and Fair Enforcement Regulation Banking Act, growers will have access to bank credit, crimping Innovative's profits. Judging from the questions lobbed during the REIT's May 9 earnings call, analysts are well-aware of this concern. It did not boost confidence in Innovative's business model when management discussed converting a company-owned vacant property in San Bernardino, Calif., on which zoning laws happen to prohibit the cultivation of doobie, into a self-storage business.

Since we had our say, Innovative has generated a 51.8% total loss versus a 19.8% gain in the S&P 500 (both figures include reinvested dividends). Post-collapse, the shares change hands at 13.3 times trailing funds from operations to yield 6.8%, compared with 44.9 times trailing FFO and a yield of 2.3% three Novembers ago. Valuation alone would counsel a change in analytical stance. Now combine valuation, including that fetching dividend yield, with one of the least-leveraged balance sheets in the REIT world (debt sums to just 11% of gross assets), and Innovative no longer ticks the bearish boxes.

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On top of the capital wasted on dope endeavors, the Scotts management also misplayed the Covid-era boom and bust in home and gardening sales. Sales of ordinary lawn- and garden-care products in the United States surged by 40% between fiscal years 2019 and 2021. However, as lockdowns ended in 2022, consumers decamped from their homes and Scotts's American sales fell by 8.4%. Hagedorn predicted a rebound the following year, but sales shrank by an additional 2.9% in 2023.

The acquisition binge plus a bulging inventory position has left Scotts highly leveraged. As of March 30, the balance sheet showed a net debt position of $2.8 billion, or 6.95 times trailing adjusted Ebitda. The lawncare giant is rated B1/single-B-plus, or middling junk, by Moody's Investors Service and S&P Global Ratings.

Scotts Miracle-Gro Co. at a glance

all figures in $ mns except per share data

	TTM*	FY2023**	FY2022	FY2021	FY2020
sales	$3,429.0	$3,551.3	$3,924.1	$4,925.0	$4,131.6
operating income	-114.0	-174.4	-434.0	723.0	585.2
net income	-347.8	-380.1	-437.5	512.5	387.4
earnings per share	-6.25	-6.79	-7.88	8.96	6.81
shares outstanding	57.4	56.0	55.5	57.2	56.9
cash	65.1	31.9	86.8	244.1	16.6
debt	2,818.3	2,609.7	2,970.5	2,294.5	1,521.5
total assets	3,924.2	3,413.7	4,296.8	4,800.0	3,380.5

* 12 months ended March 31, 2024.

** Fiscal year ends September 2024.

source: company reports

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Hagedorn is a controversial figure beyond his operational track record. A former F-16 fighter pilot, he talks like a sailor. In 2013, three directors resigned, not over a "disagreement relating to the Company's operations," as the filing with the Securities and Exchange Commission put it, but in reaction to the "use of inappropriate language." Four-letter words still pepper the company's earnings calls.

However, minority investors don't have much say about the tone at the top. Through a family partnership, Hagedorn controls 25.8% of shares outstanding. His sister, Katherine Hagedorn Littlefield, is a director, and his son, Chris Hagedorn, leads the dope division.

"I'm not a fan of the guy," says a friend of this publication who is long the stock but chary of the CEO. "But I am a fan of the business. I think historically it has been a good business. Their brands are strong. It makes money. They had two things happen at the same time, which was the misguided M&A and then this Covid boom-bust."

Today, Scotts Miracle-Gro is once again centered on its lawn-and-garden segment. In the 12 months ended March 30, the U.S. consumer division generated $2.8 billion in sales, Hawthorne $389.7 million and other (mostly lawn and garden sales in Canada) $235.4 million. As the only business unit in the black over the past year, U.S. operations account for more than 100% of trailing operating profits.

In late 2022, the company unfurled Project Springboard, a cost-cutting initiative with a focus on reducing headcount, working capital and distribution centers. It delivered $15 million in savings in fiscal 2023 and is expected to generate $65 million in extra profit this year and $20 million more in fiscal 2025.

While the doobie division operated in the red in the three months ended March, "I've challenged the team to achieve a $10 million profit run rate," Hagedorn said on the May 1 earnings call. "In the past two years, Hawthorne has gone from 15 distribution centers to two and has cut over 1,000 jobs, operating today with less than 300 people." On the call, Hagedorn said he is looking into "strategic options" for Hawthorne, meaning a potential sale or divestiture.

Home Depot, Inc. and Lowe's Cos., Inc., which together account for 47% of Scotts sales, were also hit by the Covid-whipsaw effect. And while each reported negative same-store sales over the past six quarters, they both circled the lawn-and-garden aisle as a bright spot in an otherwise languid first quarter.

"What we're seeing is that, within remodeling, there's a broader trend toward smaller, less costly projects," Matthew Saunders, senior vice president of building-products research at John Burns Research & Consulting, tells me. "When we look at landscaping, that tends to have a large weighting in smaller, discretionary projects than the overall remodeling market."

For fiscal 2024, Scotts targets additional debt paydowns of $350 million and adjusted Ebitda of $575 million compared with $447 million in Ebitda last year. To realize its ambition to reduce net leverage to around 4.5 times Ebitda by Sept. 30, management is cutting prices to win retailers' shelf space and collaborating with Martha Stewart on a new ad campaign.

Forecasting has not been the executive suite's top excellence—predictions last year of a sales rebound and of a decline in the ratio of net debt to less than five times Ebitda both fell short. Even so, investors continue to give Scotts the benefit of the doubt. The stock is priced at 23.8 times estimated fiscal 2024 earnings, 11.7 times estimated 2024 Ebitda and offers a 4.1% dividend yield.

Not one of the 10 analysts who follow SMG says sell, and 5 do say buy. However, short interest as a percentage of equity float has crept up to 10.2% from 8.2% at the start of the year, and insiders have sold 496,712 shares over the past 12 months for proceeds of $29.8 million. Some sales crossed the tape at prices as low as $49.64 per share, or 22% below the current price.

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In the long term, Scotts targets growth of 3% in its U.S. consumer division. It's a rate that almost matches the 3.3% annual growth that the business unit produced between 2016 and 2023, but that is 2.2 percentage points below the growth in nominal GDP and 2.7 percentage points slower than the growth that Home Depot and Lowe's reported in their lawn-and-garden aisles over the same period. In short, Scotts is losing market share.

Raised-bed soil, a cross between garden soil and potting mix, helps to illustrate the competitive pressures on Scotts. Kellogg Garden Organics's all-natural, raised-bed soil at Home Depot was persistently priced 25% below the Miracle-Gro equivalent. In response, Scotts recently marked its price down by 20%, closing the price gap to Kellogg to 6.5%. Such concessions may limit Scotts's ability to hit its margin targets.

Store brands, too, threaten plump margins. "We are pleased to be gaining traction with our own Sta-Green private brand as customers have responded to the quality and the value offered in these lawn-care products," William Boltz, Lowe's executive vice president of marketing, said on the May 21 earnings call. "And Sta-Green helps provide the consumer with a beautiful lawn that they can be proud of at a price that won't break the bank." Sta-Green's vegetable and flower garden soil, for example, costs 43% less than the Miracle-Gro comp.

"What we're hearing is that private label is growing in home and garden," Chris Beard, vice president of building products at John Burns, tells me. "Certainly there are companies that do invest a lot of marketing resources in promoting their brands, but what we're hearing from the retail landscape, not just home centers, is a preference for private label."

Nor does it help that the Scotts portfolio is more heavily weighted toward outdoor products than the indoor kind. At Home Depot, at least, indoor is the larger category (in 2023, $14.7 billion versus $10.3 billion for outdoor) and growing faster than annual growth (between 2016 and 2023, 7% versus 6.1%).

Indoors or out, this selling season is shaping up no better than the disappointing two that preceded it. Danny Summers, managing director of The Garden Center Group, in Acworth, Ga., tracks weekly sales of 125 centers across the country. "We were down 9.5% for week 21, that is May 20 to May 26," Summers tells me. "Overall, for the year we are down 5.5%."

As to debt reduction, there is less of it in the past 12 months than may meet the eye. Net indebtedness is in fact lower, by $795 million to $2.8 billion, but that has less to do with dollars than with accounting. To meet its working-capital needs, management factors its accounts receivable. Prior to Oct. 27, 2023, the front office treated factoring as a kind of debt (an "assignment

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of accounts receivable"); thereafter, it counted it as a sale, as the accounting rules permit. (Under the prior arrangement, Scotts agreed to repurchase receivables at the lenders' discretion on a weekly basis; under the new one, sales are non-recourse, thus allowing their derecognition on the balance sheet.) The impact is material, as Scotts sold $582.8 million in receivables as of March 30 with no reported increase in associated borrowings; on April 1, 2023, factoring showed up as a $380 million increase in short-term debt.

Indeed, the company seems to be pulling all the stops it can to boost cash flows from operations. Despite poor operational performance and skimpy shareholder returns, executive pay in stock, a non-cash expense, rose to $68.9 million in fiscal 2023, from $34.3 million in fiscal 2022; in the first six months of fiscal 2024, share-based comp came to $44.6 million.

Remunerating employees in stock is commonplace, but it's an atypical way to compensate vendors. Yet near the end of fiscal 2023, Scotts issued $20 million's worth of stock to pay for advertising expenses that it expects to incur in this fiscal year. If the finance suite seems open to trying new things, breakneck rates of turnover may explain why. Since 2021, three chief financial officers and one interim CFO have taken their turn at the helm of the Scotts accounts.

When the stock traded at an average of 20.3 times earnings, between 2015 and 2019, the fancy multiple seemed justified because marijuana sales were lit up. The multiple today—23.8 times fiscal 2024 earnings, Monday's share-price plunge notwithstanding—is even fancier, though management is targeting long-term growth of 3% as it loses share in its core U.S. consumer franchise. The failed skunk business leaves the balance sheet encumbered and highlights the risks presented by a CEO with a controlling ownership stake and a poor record of capital allocation. Certainly, Scotts deserves to trade at a discount.

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